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Nonprofit *Alert*®

Alerting nonprofit leaders to key legal developments and responsive risk management steps.

Inside This Issue:

After Nine-Year Battle With IRS,

Charity Settles Inurement Charges

United Cancer Council (UCC), an Indianapolis charity, has finally settled its long-running dispute with the IRS, an attorney for the charity announced last month.

The settlement requires the charity to pay an undisclosed sum to the IRS, then donate its remaining assets to other charitable health organizations. However, those other organizations must not have any relationship with the for-profit company formerly known as the Watson and Hughey Company (WH).

WH conducted fundraising activities for UCC from 1984 to 1989. The IRS claimed UCC's fundraising contract gave WH excessive control over UCC's finances and management, making WH an insider of UCC and resulting in private inurement of UCC's earnings to WH.

Consequently, the IRS revoked UCC's tax exemption in 1990. UCC challenged the revocation in the Seventh Circuit Court of Appeals last year and won a ruling that said the arrangement did not generate private inurement because WH was not an actual insider of UCC. The Seventh Circuit remanded the case to the tax court to determine whether UCC's directors operated the charity for the prohibited private benefit of WH. (*NPA*, Mar.'99).

But UCC settled its case with the IRS before the tax court could decide the private benefit issue. The settlement recognizes UCC's exempt status UCC's exempt status retroactive to January 1, 1990, but does not restore it from 1986 to 1989. This dispute captured nationwide attention because it marked the IRS's first attempt to classify a professional fundraiser as an "insider," subject to the private inurement and private benefit prohibitions.

Minister's Social Security Update

The March issue of **Nonprofit *Alert*®** reported that for a limited time only, ministers are now able to opt back into the Social Security system under the Ticket_to_Work Act, enacted in late 1999. The story generated several inquiries from readers asking for details about exactly how to do this.

The IRS has now made available Form 2031, which ministers should use to revoke their exemptions. The form requires the minister's name, address, and social security number; the date of ordination or licensure; the ordaining or licensing body; and the ordaining body's employer identification number.

The law provides a two_year open season for ministers who wish to revoke their prior Social Security opt_out exemption. The deadline to opt back in is the due date of a minister's income tax return for the second tax year after 1999 (i.e. April 15, 2002 for most ministers). The minister may elect for the revocation to become effective either the first or second tax year after 1999 (i.e. 2001 or 2002). The minister will then be liable for paying self_employment tax for the effective year of revocation. Once the minister has revoked a prior opt-out exemption, however, the revocation is irrevocable under current laws.

➤ **Form 2031 is available on the IRS web site at http://ftp.fedworld.gov/pub/irs_pdf/f2031.pdf, or you may request it from the IRS at 1_800_TAX-FORMS.**

>!>!> Happy to Be Spam Free <!<!<

Junk email, or spam, as it's more commonly called, slows worker productivity and ties up electronic traffic, plus it's *really* annoying. Want to stop it? The Direct Marketing Association (DMA) offers a free service called e-MPS (short for "e-Mail Preference Service") that allows you to take your name and your employees off the spam lists of over 4,500 DMA member organizations. Enter the email address(es) you want removed, and DMA members are obligated to delete them from their spam lists. To access, go to http://www.e-mps.org.

Liability & Risk Management

Get Out of the Club: Exec's Fraud Binds Bank

Fleet Bank cannot foreclose on a loan it made to a war veterans' club because the president of the club, who signed the loan documents, did not have borrowing authority. The president initially took a commercial loan of $35,000 from the bank on behalf of the club. He had authority from the club for this first loan, as evidenced by a letter on club stationary signed by the club treasurer. That loan was secured by club property. Two years later, the president took out another loan for $55,000, followed by a third loan of $9,000. For these transactions, he only submitted undated and unsigned resolutions, purportedly passed by the club's board of directors authorizing the loans. He used these funds to pay off the club's first loan, but applied the remainder of the funds to his personal use. Later, the club defaulted on payments, and the bank moved to foreclose. The club claimed it had not authorized the second and third loans. The bank argued the president had *apparent* authority, based on the actual authority he possessed when he took the original loan on the club's behalf. The court sided with the club, finding that apparent authority requires "words or conduct of the principal [i.e, the club] communicated to the third party [i.e. the bank]." The president's authority to enter the first loan agreement "would not automatically invest [him] with unlimited apparent authority to bind [the club] in the future." Because the bank didn't make any effort to determine the president's actual authority, the court refused to allow the bank's foreclosure on the loan. *Fleet Bank v. Consola, et. al,* No. 84467 (NY Sup.Ct.App.Div, 3rd Dept.,1/6/00).

This is a prime example of the abuse that can result when an organization lacks—or its directors and officers overlook— proper checks and balances.

Now An Employee—Now He's Not, for Liability

A nonprofit athletic league is not liable for the negligence of one of its employees because the employee was not on duty for the league at the time of the negligence. The employee worked full-time during the day for the league as its basketball coordinator. At night, he worked part-time in the same facility for a county recreation program. A basketball player was injured during a night game when he hit his head against an iron bar. The player brought a negligence action against the county recreation program *and* the athletic league, claiming the coordinator should have known about and prevented the danger because of his duties for both organizations. However, the court dismissed the portion of the lawsuit against the athletic league because it ruled that the coordinator was acting exclusively for the county at the time of injury. The court noted that although he may have been more familiar with the facility because of his daytime work with the athletic league, his actions were not supervised or controlled by the athletic league at night when the accident occurred. The league was, therefore, not liable for his negligence. *LaFate v. New Castle County*, No. 97C-11-112, (DE C.A. New Castle Co., 10/22/99).

Know exactly for whom your organization is liable and how to manage the potential liability. Get all the details with Nonprofit *Alert*® Memo 9402-1, *Minimizing Liability Through Responsible Hiring & Supervision.* See back page to order. Consider additional copies for all your managers with hiring or supervisory authority.

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Employees & Volunteers

Does Harassment Investigation Hurt the Accused?

The answer is a resounding "no," according to the Second Circuit, which recently reviewed a case brought by an accused sexual harasser, who claimed the investigation his employer conducted caused him to suffer emotional distress. The case began when sexual harassment complaints were lodged against a trainee at the Carrier Corporation. The executive in charge of the training program made note of the complaints but did not immediately launch an investigation. Months later, the same trainee was the subject of another sexual harassment complaint in a different office. The supervisor in that office settled the issue to the satisfaction of all involved, but when the training program executive heard of the incident, she began a new investigation. This investigation eventually resulted in a letter of reprimand placed in the trainee's personnel file. When the trainee completed the training program, he was not offered a permanent position at the company. He then sued for intentional infliction of emotional distress, claiming the corporation was negligent in conducting the harassment investigation against him because the matter had already been settled by his immediate supervisor. A jury agreed and awarded him $400,000 in damages. On appeal, however, the Second Circuit said the executive in charge of the training program did everything that a reasonable employer should do when handling allegations of sexual harassment. An employer's liability for sexual harassment isn't necessarily relieved merely because a supervisor "settles" a complaint, especially if the employer has knowledge of other questionable incidents and fails to act. The Second Circuit overturned the verdict in favor of the company. *Malik v. Carrier Corp.,* 202 F.3d 97 (2nd Cir., 2000).

Generally, an employer's best course to avoid liability for sexual harassment is to investigate sexual harassment complaints immediately and thoroughly. For more guidance, read Nonprofit *Alert*® Memo 9201-2, *Your Sexual Harassment Policy: Implement & Educate.*

Outsourcing Doesn't Relieve Discrimination Liability

A federal court has ruled that employers may be liable for hostile work environment discrimination that occurs on their premises against any of their independent contractors. In this case, Wal-Mart hired Danco, Inc., whose owners were both Mexican-Americans, to maintain its parking lots. Both owners were subjected to repeated acts of discrimination, including racial slurs and physical assaults. When they complained to their Wal-mart manager, he told them he couldn't take any action because he had no proof of the discrimination. On one occasion, the words "white supremacy" were spray painted across the Danco owners' parking spot. The manager promised to remove the spray paint, but failed to do so for over a month. Shortly thereafter, Wal-mart replaced the manager but also terminated Danco's contract, citing poor performance. Danco and its owners sued for discrimination on a hostile work environment theory. A lower court found in their favor and awarded damages of $300,000. Wal-mart appealed, arguing that Danco couldn't file a hostile work environment claim because federal law does not provide such a remedy to independent contractors, but the First Circuit disagreed. It held that the law's protection against hostile work environment discrimination may extend to independent contractors, particularly to those who work on an employer's premises. *Danco, Inc. v. Wal-Mart Stores, Inc.*, 178 F.3d 8 (1st Cir., 1999).

This case could have far-reaching implications as outsourcing grows in popularity among organizations looking for a way to reduce costs. This case demonstrates, however, that reducing costs does not necessarily reduce liabilities. Nonprofit *Alert*® Memo 9312-1, *Avoiding Employment Discrimination*, can help assess your organization's potential liabilities from employment and independent contractor relationships.

Tax-Exempt Issues

Scholarships to Schools Must Play By the Rules

A charity's scholarship program complies with tax law because it awards grants only for higher education on an objective and nondiscriminatory basis, the IRS has ruled. The charity only considers scholarship applicants who possess certain grade point averages and who are active in the charity's areas of interest. Recipients are required to submit annual program and financial reports. Scholarship money is paid directly to the recipients' colleges or universities, and the charity takes various steps to insure that the recipients use the money exclusively for education costs. All these conditions bring the scholarship program within the requirements of §4945(g)(1) of the tax code, making the scholarship awards non-taxable expenditures of the charity. IRS LTR 200009053.

Heavy Weights: Charity Program Muscles Out UBI

An exempt educational and scientific organization may operate a weight management program, train health care professionals, and provide public education on medical issues without incurring any unrelated business income (UBI) tax, but sales at the organization's book and convenience stores will create taxable UBI, the IRS has concluded. The organization maintained a medical facility where it conducted weight management classes and various training

NPA Highlight of the Month

Housing Bill Offers Charitable Choice

The U.S. House of Representatives passed a bill last month that could produce significant benefits for religious and charitable organizations that provide housing for low-income, elderly, or disabled citizens. The Home Ownership and Economic Development Act of 2000 includes a generous provision that enhances the relationship between government and religious institutions that provide low cost housing. However, opponents have criticized the measure on the grounds that it unconstitutionally violates the separation of church and state. The measure's author, Rep. Mark Souder (R-IN), counters that the bill merely codifies the Department of Housing and Urban Development's (HUD) current practice of nondiscrimination against religious organizations that receive HUD funding to operate low-income housing programs. This practice is consistent with the "Charitable Choice" measure included in the Welfare Reform Act of 1996, which prohibits state and local governments from discriminating against religious organizations when contracting with private entities to provide social services using federal welfare funds. Some charities have encountered difficulties in obtaining or maintaining federal funding under Charitable Choice, but others report success. Many charities are still unaware of such funding opportunities, according to a study conducted last year. At that time, only about three percent of the nation's religious social service providers had taken advantage of Charitable Choice funds.

The Charitable Choice concept continues to spark debate among government officials and charities. For an informative summary of this innovative concept, refer to Nonprofit *Alert*® Memo 9702-1, *Charitable Choice: Government Funding to Religious Social Service Providers*. For a free copy of last year's study, *Religious Congregations and Welfare Reform: Who Will Take Advantage of Charitable Choice?*, call the Aspen Institute's Nonprofit Sector Research Fund at (202) 736-5838.

programs for medical professionals and the general public. The IRS found that those activities were all educational in nature and, as such, did not generate UBI. The organization contended that its retail store sales were also exempt from UBI because the stores were operated mainly for the convenience of the organization's employees. The IRS disagreed, ruling that all sales at the retail stores were subject to UBI because the sales were made primarily to the public and did not meet the convenience exception. IRS FSA 200012051.

Should your organization be paying UBI taxes on its sales revenues? Find out by reading Nonprofit *Alert*® Memo 9110-1, *UBIT Primer for Nonprofits*.

Party On ...But Don't Expect Deduction, Court Says

Funds that parents contributed to a school, earmarked to finance their daughter's high school graduation party, are not deductible as charitable contributions, the Tax Court has ruled, because the party was not a charitable event. Parents and neighbors organized the party as an alternative celebration for seniors to prevent "partying and drinking" after graduation. The court said their purpose was "commendable," but that alone "did not elevate the cost of the party to a charitable deduction." The court viewed the contribution as payment of the daughter's admission to the party, which is simply not deductible under any charitable theory. *Coffman v. Commissioner,* T.C. Memo 2000-7.

Had the parents merely contributed to the school without earmarking the funds, then their contribution likely would have been fully deductible. The lesson here: be careful how your organization receives donor-designated funds. Make it clear that the charity has the final say in how the funds are used, even if they're earmarked. Then, the funds likely will be deductible. For more information, read Nonprofit *Alert*® Memorandum 9302-1, *Avoiding the Pitfalls of Donor-Designated Gifts*.

State Rules & Regs

Bill Requires Sufficient Link to Tax Internet Sales

A landmark 1992 Supreme Court case, *Quill v. North Dakota*, has formed the basis for legislation recently introduced in Congress that would bar states from forcing businesses to collect sales taxes when they lack a "nexus" or "physical presence" in the state. With the advent of e-commerce, states have loosely interpreted that earlier ruling, creating confusion over the taxability of Internet sales. The proposed legislation creates "safe harbors" for Internet commerce and defines a federal standard for interpreting "nexus," applicable to both charitable and commercial Internet transactions. (S. 2401).

Improving the Odds for Charitable Gambling

Lawmakers in Minnesota and Oklahoma are considering various bills that would amend their charitable gaming statutes. In Minnesota, two bills have been introduced that would reduce the taxes on gross receipts from charitable gambling, after prizes, from 9% to 7.5%. This reduction would apply to receipts from charitable raffles, bingo, and paddle wheels. In Oklahoma, the state tax commission has announced a proposal to amend its charitable gaming laws to simplify record keeping and reporting duties, and to allow electronic reporting.

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