Gammon & Grange, P.C. May 2001

Nonprofit *Alert*®

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

Ninth Circuit on Joint Ventures: If Nonprofit Yields Control, Exemption Is Lost

The IRS picked up a surprise victory recently when the Ninth Circuit upheld an important Tax Court ruling on nonprofit/for-profit joint ventures.

The case, *Redlands Surgical Services v. Commissioner*, drew national attention when the IRS refused to grant exempt status for a nonprofit subsidiary of a California hospital corporation.

Issues of Control

The IRS successfully argued that a charity may enter joint ventures with for-profits only if the charity retains control over the income and assets necessary to carry out its charitable functions. If the arrangement is not so structured, then impermissible private inurement may arise, leading to a loss or denial of tax exemption.

The court agreed that Redlands effectively gave up control over most of its operations, leaving its for-profit partner in charge. This conferred a private benefit on the for-profit partner, the court said, which prevented Redlands from operating with an exclusive charitable purpose.

Case History

Redlands originally challenged the IRS's denial of its exempt status and filed extensive administrative documents with the Tax Court, but that court sided with the IRS in a 1999 ruling.

The case was appealed to the Ninth Circuit where oral arguments were heard on March 15, 2001. The court then issued its *per curiam* opinion only ten days later.

The speed with which that decision was rendered surprised most practitioners and suggested the court was solidly behind the IRS's arguments. Although the case involved a whole hospital joint venture, the issue of control is applicable to any any nonprofit entering a joint venture with a for-profit entity. Redlands plans to petition the Ninth Circuit for a rehearing.

➤ **If your nonprofit is considering a joint venture arrangement with a for-profit partner, find key guidance in Nonprofit *Alert*® Memo, *Subsidiaries & Nonprofit Affiliates*, available from Gammon & Grange, P.C. See back page to order.**

Supreme Court OK's Mandatory Employer Arbitration Contracts

In a decision hailed by many nonprofit employers, the Supreme Court ruled last month to uphold mandatory arbitration agreements in most employment contracts.

A provision in the Federal Arbitration Act exempts only employment contracts of transportation workers, the Court ruled.

The case involved an employee of a California Circuit City store who sued for harassment under a state law. He had previously signed an employment contract when he began work with the company, agreeing to arbitrate "any and all...claims, disputes or controversies" related to his employment. Circuit City argued that this required the employee to submit his claims to arbitration rather than litigate through a state court.

The ruling settles a question that several Circuit Courts of Appeals had already addressed, with the Supreme Court adopting the prevailing view among those lower courts. *Circuit City Stores, Inc. v. Adams*, No. 99-1379 (3/21/01).

➤ **The decision should encourage the use of arbitration agreements as standard provisions in employment contracts. To learn how alternative dispute provisions might work for your organization, read Nonprofit Alert® Memo, *ADR: Arbitrate, Don't Litigate!***

Liability & Risk Management

Library Not at Fault for Child's Use of Internet Porn

A nonprofit library cannot be sued for allowing a child to use its computers to access sexually explicit materials on the Internet, an appeals court in San Francisco has ruled. The mother of a 12-year old boy brought suit against the library, alleging it maintained a public nuisance by allowing her son to use library computers to download sexually explicit material ten different times. Before the incident occurred, the library board had adopted an "open Internet" policy, which allowed free and equal access to any Internet resources, regardless of content or user age. The policy stated that the library disclaimed any responsibility for the content of any Internet resources reached through the use of its computers. The court dismissed the lawsuit, finding that the mother's claims were preempted by a federal law that protects providers of interactive computer services from liability for information furnished by another content provider. This federal immunity covered the library, the court ruled. *Kathleen R. v. City of Livermore,* 87 Cal.App. 4th 684 (2001).

If your organization offers Internet access to the public through any medium, federal protections for Internet service providers is only one component of a comprehensive risk management plan. For more information, call Rick Campanelli or Scott Ward at Gammon & Grange, P.C., (703) 761-5000.

Charity Officers Pay Hefty Fine for False Reports

The former president and vice president of the Multiple Sclerosis Association, based in Cherry Hill, N.J., have agreed to pay $225,000 in settlement of charges brought against them and the organization by the attorney general of New Jersey. The state claimed the officers mislead donors, filed false financial reports, and diverted organizational funds to pay personal expenses. Under the settlement, the charity also agreed to institute tighter internal controls over its fundraising activities and provide potential donors with accurate information. The settlement prevents both officers from ever working with any other charity in the state.

This case highlights the need for strict financial controls and internal reviews. Your annual financial audit is not a fraud audit. To get more mileage from your annual audit and to evaluate your current internal controls, read Nonprofit Alert® Memo, *Annual Audits: Vital Risk Management*.

CEO Personally Liable for Overtime Oversight

Following an investigation by the Department of Labor, the CEO of a nonprofit nursing home in Puerto Rico has been found personally liable for violating the Fair Labor Standards Act (FLSA) by not paying minimum wages or overtime compensation to her employees. DoL brought suit against the nursing home and the CEO, claiming employees were not paid overtime for the extra shift hours they worked or for half of their lunch hours when employees were sent back to work. A federal district court found both the nursing home and CEO liable, deeming the CEO at fault because she had "general supervisory control" over all hiring/firing, work schedules, and wages, including the authority for setting all wages. The court fined her five years of back pay, plus liquidated damages. *Herman v. Hogar Praderas de Amor,* Civ. No. 98-1342 (D.PR., 1/25/01).

Although the FLSA applies to "any person acting directly or indirectly in the interest of an employer," it's not often that a court will extend personal liability under this statute to a CEO. The court did so in this case because it found the CEO personally committed the misdeeds that ultimately led to FLSA violations. To avoid these penalties, make sure your human resource director reads *FLSA: What It Means for Nonprofit Employers.* See back page to order.

Employees & Volunteers

Supreme Court Will Decide Repetitive Motion Cases

The Supreme Court has agreed to consider arguments in two cases this fall that could determine whether repetitive-stress injuries will be covered under the Americans With Disabilities Act (ADA). One of the cases addresses carpal tunnel syndrome, a repetitive stress injury that causes pain in the hands and wrists. The other case addresses the ADA's reasonable accommodation provision and whether it requires an employer to reassign an employee with a repetitive stress injury even if reassignment would circumvent the employer's seniority system.

Because Congress recently repealed OSHA standards covering ergonomics and repetitive-stress injuries (*NPA*, Apr.'01), these cases could produce an alternate means of protection for the estimated 1.2 million workers affected by such injuries.

Opera Discord Strikes Sour Note for Radio Manager

The station manager at a nonprofit radio station operated by a Virginia university has sued for $2 million in damages following his termination after 24 years of service. The dispute arose from the manager's decision to drop Saturday broadcasts of the Metropolitan Opera due to a lack of listener support. The decision angered opera lovers, who persuaded the university to overrule the manager's decision and reinstate the programs. The

Nonprofit *Alert*®
8280 Greensboro Drive, 7th Floor, McLean, VA 22102-3807
(703) 761-5000 Facsimile: (703) 761-5023
E-mail: npa@gandglaw.com
Editor-in-Chief . . . . *George R. Grange, II*
Editor . . . . *Sarah J. Schmidt*

manager then criticized university officials publicly for exerting control and violating the station's "independence." Three months later, the university dismissed the station manager, but offered him a temporary job at the station. The manager appealed through the university's grievance process but lost. To settle the dispute, the university then offered to re-hire the manager for six months, which would have permitted him to achieve 25 years of service and qualify for retirement, but the manager rejected the offer and filed suit for breach of contract and defamation.

Much of the difficulty in this case could likely have been avoided through a more prudent approach to discipline and termination. Avoid these errors in your organization with the helpful tips in Nonprofit Alert® Memo, *Terminations: Wisely Managing Troublesome Employees.* See back page to order.

ADA Coverage for Temps and Contingents Explained

Contingent or assigned workers (i.e. those hired through temporary staffing agencies or contract firms) have virtually the same protections under the Americans With Disabilities Act (ADA) as other workers, according to new enforcement rules released by the EEOC. Generally, contingent workers classify as employees of both the staffing agency and the organization that hires them through the agency. The catch lies in determining which employer is liable at what point in time. For instance, the rules say that a staffing agency is responsible for providing reasonable accommodations for a disabled contingent worker during the application process, but once the worker proceeds to the hiring process, then both the agency and the hiring organization are liable. Both are liable for the costs of reasonable accommodations. Either entity may be liable if it fails to take corrective action when it knows the other entity is discriminating against disabled contingent workers.

These are important points to remember for nonprofits that rely on temporary or seasonal workers. ADA requirements are not usually delegable. Nonprofit Alert® Memo, *ADA: Basic Requirements for Nonprofits*, spells out the details.

Tax-Exempt Issues

Membership Reward Skirts Self-Dealing Prohibition

A private foundation made an unrestricted grant to a 501(c)(3) public charity based on the recommendation of a substantial contributor to the foundation. The contributor didn't hold an office nor exercise any authority in the foundation, but because he was one of the foundation's major contributors, he was considered a disqualified person. After the public charity received the foundation's grant, it paid off a debt to another entity. As a result of the debt fulfillment, that entity gave the foundation contributor a charter membership to thank him for the role he played in securing the grant, which eventually led to the debt payment. Following an examination of the foundation's tax return, the IRS sought to tax both the foundation and the charity for self-dealing and to revoke the foundation's exempt status, but the three year statute of limitations ran out before the IRS took action. The IRS then attempted to extend the limitations period, but the charity filed for a ruling by the IRS National Office to end the matter. In technical advice, the National Office determined that the benefits the contributor received were only tenuous

NPA Highlight of the Month

After Many Changes, Gift Fund Achieves Exemption

Although donor advised funds (DAFs) have been around for many years, they really hit the IRS radar with intensity during the last decade as large financial firms like Fidelity rocketed to dominance with nonprofit DAFs marketed to their investors. In 1999, the Tompkins Community Charitable Gift Fund, Inc. took one of the IRS's early regulatory hits.

The fund applied for exempt status but was rejected because the IRS alleged it lacked the proper control over contributions to its proposed DAF. The fund was to be operated by the Tompkins Community Trust Company, a state-chartered bank. The IRS did not approve of the bank's control over the charitable fund and questioned whether the fund had a true exempt purpose.

Three years and many changes later, the Tompkins Fund has now secured exempt status from the IRS. It's charitable purposes include "receiving, holding, investing, and distributing charitable contributions received from donors." The bank still owns the fund, but amended bylaws and a conflict of interest policy mitigate the earlier control problems. Contributions to the DAF are now expressly unconditional and irrevocable. A pooled income fund that was originally proposed has been abandoned because the IRS said it only aided non-charitable beneficiaries, which prevented it from operating with an exclusive charitable purpose.

This case is instructive because it sheds some much needed light on the key issues the IRS considers when reviewing DAFs. Although the Department of Treasury proposed legislation last year that would create more specific legal standards for such funds, DAFs are currently governed only by non-specific tax regulations (*NPA*, Sept. '00). For more guidance in establishing this increasingly popular planned giving tool, order Nonprofit *Alert*® Memo, *Donor Designated Gifts: Pitfalls & Provisos.* Ordering instructions appear on the next page.

because the charter membership conferred no rights or privileges of any economic value. That alone did not result in an act of self-dealing, the office ruled. Furthermore, the IRS could not extend the limitations period because the foundation had properly disclosed the grant-making transaction. It had no obligation to disclose the fact that its contributor recommended the grant. IRS TAM 2001-14035.

If, however, the foundation had purposely withheld information, then the tax code permits a six-year limitations period rather than the three-year period that applied in this case.

Niece's Access to Collection Is Private Benefit

What's good for the goose is good for the gander, the IRS seemed to say with a recent ruling that prohibited private access to a collection of documents owned by a trust. The trustees initially passed a resolution prohibiting all public access to the collection until a conservation project could be completed that would preserve many of the fragile pieces in the collection. Then, the great niece of the trust's founder decided she needed access to the collection for research on a book she was writing. The book was intended for purely commercial purposes and was not requested or authorized by the trust. The IRS ruled that the trust could not grant access to the great niece without violating the rules against impermissible private benefit. Because the trustees had denied access to the general public, the IRS said the great niece's exclusive access would only serve her private interests "by allowing her to profit commercially" and enhance her book with material that was otherwise off limits to the public. IRS LTR 2001-14040.

An unusual set of facts makes this case a classic example of private benefit. Learn more with Nonprofit Alert® Memo, *Private Inurement: Essential Do's & Don'ts.* Ordering info appears in box at right.

IRS Enforcement Against Nonprofits Slows Down

IRS data provided to *The Chronicle of Philanthropy* shows that enforcement efforts against tax exempt organizations has fallen sharply during the last decade. In 1990, for example, 3.3% of tax-exempt returns were audited. That number had diminished to 1.3% in 1998. Speaking last month to the Senate Finance Committee, IRS Commissioner Charles O. Rossotti attributed the decline to a lack of manpower. He said the IRS workforce fell by 17% between 1992-2000, but the number of returns filed by tax exempt organizations increased by 13% during that same period.

These IRS statistics and others are compiled in the *1999 Internal Revenue Service Data Book*, scheduled for release later this year.

State Rules & Regs

Wisconsin Court Compensates Drunk Employee

The Wisconsin Supreme Court upheld a decision last month by the state Industry Review Commission, allowing a man to collect workers' compensation for injuries he received after getting drunk on a business trip. The Commission granted workers' comp because it ruled the man was a "traveling employee" when the injury occurred, but it reduced the compensation by 15% because he was intoxicated. While on a business trip, the man stopped at a local tavern and consumed several drinks. He then attempted to enter a mobile home by breaking a window in the door, but passed out. When he awoke, he was lying inside the home, but the door was open. His hands were frostbitten so badly that all fingers and thumbs had to be amputated. *Heritage Mutual Insurance Company et.al. v. William Larsen*, Case No. 98_3577 (WI Sup. Ct., 4/4/01).

Although intoxication does not defeat a worker's compensation claim in Wisconsin, don't count on every state being so lenient. Even the Wisconsin court admitted "the wisdom of a policy which permits drunken employees to recover even a diminished compensation ...[is] arguable."

Ordering Information: Memos referenced in the ***Nonprofit Alert*** are $20 per memo *prepaid* ($10 for firm clients). Five or more copies of the same memo are bulk priced at $5 each.
Subscription Information: Subscriptions to the ***Nonprofit Alert*** are $75/year, $130/two years. Additional subscriptions to the same organization are $25 each/year. Subscriptions for 100 or more may qualify for additional bulk discounts. Send inquiries to: Editor, ***Nonprofit Alert***, 8280 Greensboro Dr., 7th Floor, McLean, VA 22102-3807; (703) 761-5000; npa@gandglaw.com.

Richard M. Campanelli
Stephen M. Clarke
A. Wray Fitch III
Thaddeus Furlong
James A. Gammon*
George R. Grange II
Stephen S. Kao
Stephen H. King
Nancy Oliver LeSourd
Kenneth E. Lui
Timothy R. Obitts
Sarah J. Schmidt
H. Robert Showers
Scott J. Ward
Michael J. Woodruff
Rebecca D. Zachritz
* of Counsel

GAMMON & GRANGE, P.C.
7th Floor, 8280 Greensboro Drive, McLean, VA 22102-3807

May 2001

**First Class
U.S. Postage
PAID
Laurel, MD
Permit #1290**