Gammon & Grange, P.C. November 2001

Nonprofit *Alert*®

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

Inside This Issue:

Plus...

NPA Highlight of the Month:

Local Tax Authorities Eye Nonprofits for Revenue

— page 3 —

Gift Fund Loses Legal Battle; Appeal Likely

Donor advised funds offer significant opportunities for nonprofits, but they can also create significant pitfalls, as the Fund for Anonymous Gifts realized recently when a federal court ruled the Fund did not qualify as a public charity.

The U.S. District Court for D.C. ruled the Fund did not meet the public support test and, therefore, is a private foundation—not a public charity.

Public Support Test

Primarily, the court was concerned with the Fund's strategy for attracting donors. The court said the Fund was "not organized in such a manner to attract the 'broadly based support' necessary to qualify as a publicly-supported charity."

The Fund said it would not employ a professional fundraiser nor budget any money for fundraising. It had no written documents explaining how funds would be solicited from the general public. The court noted that the Fund "planned to rely on donors who had personal connections to the Trustee."

"This plan for attracting new donors, in addition to the lack of any plan to solicit the general public for support... indicates the IRS was correct in its determination," the court concluded. *Fund for Anon.Gifts v. IRS*, No. 95-1629(RCL) (D.D.C. 9/25/01).

Long Running Legal Battle

This ruling comes after more than five years of legal wrangling that began when the IRS revoked the Fund's exemption, claiming that much of the fund's activities did not further its exempt purpose.

The IRS determined that the Fund's arrangement with donors merely circumvented restrictions on charitable deductions and

The IRS argued the Fund's changes didn't go far enough and insisted that it could not meet the public support test.

(continued on page 4)

New Withholding Rule Applies to Foundations Making Int'l Grants

Late last year, the IRS released final regs governing the withholding rules for private foundations that make grants to international entities. Foundations have only recently begun to realize the full impact of those regs, however.

The new regs require U.S. foundations to withhold taxes from grant payments that they make to foreign individuals or organizations if those entities perform all or part of their missions in the U.S.

Certain exemptions apply if the foreign entity would qualify for a tax exemption in the U.S. or if it's covered by a tax treaty. If the entity uses the grant solely to conduct an activity *outside* the U.S., then no withholding is required.

Foundations that fail to properly withhold are subject to tax penalties.

➢**This is an issue of concern for both grantors and grantees. Legal counsel should be consulted regarding the array of "expenditure responsibility" requirements that may apply and to help avoid undue taxable expenditures.**

➔➔➔ ***E-Legal or Ill-Legal: Website Issues You Should Know*** ←←←

Come tour a web sight fraught with legal land mines. Your tour guides: Gammon & Grange's Rick Campanelli and Scott Ward, who help nonprofits manage legal compliance issues on their web sites...and elsewhere. The tag team presents this popular seminar at the upcoming CMA 2002 conference in February. Contact Gammon & Grange for information, or register at www.cmaonline.org.

Liability & Risk Management

Lender's Knowledge Voids Claim for Pastor's Debts

A California church is not liable for loan notes its pastor signed when the lender knew that the loan money was being used improperly and not for the benefit of the church, a state appellate court has ruled. The case involved a series of transactions, instigated by the lender offering loans to the church for the purchase of real estate. That property was then to be sold to a private group, of which the lender was a member. The church was never to hold any actual interest in the property. When the deal soured, the lender sought recovery of his $800,000 in loans to the church. The court refused, however, saying that the lender's knowledge precluded any recovery. *Saks v. Charity Mission Bapt. Church*, No. B082512 (CA Ct.ofApp., 2nd App.Dist. 2001).

Ordinarily, the chief executive, such as a pastor, is deemed to have full legal authority to bind the organization, and such transactions will be enforced. But the unsavory tactics of the lender in this case saved the church from certain liability. Of course, if a manager acts without actual authority, he or she may end up personally responsible for a deal gone bad. To understand how certain leaders may legally obligate your organization, read Nonprofit Alert

What's In a Name? Just Ask These Two Nonprofits

Who has rights to a trademarked name depends on where you want to use it, says the Eight Circuit Court of Appeals in response to a dispute between two health care organizations. Both claimed rights to the name "CareLink." The National Association for Health Care Communications (Healthcom) first used the name nationally and filed for a federal trademark. However, the Central Arkansas Area Agency on Aging (the Agency) previously registered the name under the Arkansas trademark statute and used the name in a six-county area of the state. The Agency discovered Healthcom's use of "CareLink" when a local hospital offered its services. The Agency then formally demanded that Healthcom stop using the name "CareLink," but Healthcom refused and filed suit seeking an injunction against the Agency. A trial court sided with the Agency, but on appeal, the Eighth Circuit revised the ruling to prevent Healthcom from using the "CareLink" name only in the six-county area of Arkansas where the Agency operated. Even though Healthcom had federal trademark protection, the doctrine still permitted the Agency to use the "CareLink" name in its six-county area because the Agency was the prior user and had penetrated that market before Healthcom gained federal protection, the court concluded. *N'al Assoc. for Health Care Communications v. Central Ark. Area Agency on Aging*, No. 00-1964 (8th Cir., 2001).

The bottom line: early federal trademark registration is always preferable and may be critical to your "brand" identity. Understand the basics with Nonprofit Alert® Memo, *Trademark Law for Nonprofits.* See back page to order.

Fraudulent Solicitors May Face Longer Jail Time

Sen. Mitch McConnell (R-KY) has introduced legislation to increase penalties for scam artists who fraudulently solicit in the name of charity. Minimum jail time for those convicted of such crimes would increase from one year to five years. The legislation also strengthens enforcement authority of the Federal Trade Commission and other agencies in curbing charity abuses. Currently, federal law addresses fraudulent solicitations only as they relate to sales of products or services, but McConnell's proposal makes fraudulent charitable solicitation a federal crime.

Consumer inquiries about questionable charity practices rose by 40% following the September 11 terrorist attacks, according to reports from The Better Business Bureau. If you suspect a charity scam, contact the FTC at 1-877-FTC-HELP or report the offender to your state charity officials listed at www.nasconet.org.

Employees & Volunteers

Missing Evidence Suggests Bad Intent, Court Says

It is a well-worn maxim that employee discipline should be fairly administered and carefully documented. Now the Second Circuit Court of Appeals adds this twist: failure to produce adequate documentation can imply bad conduct. The case grew out of a sex discrimination lawsuit filed by a female assistant vice president after she was fired by her supervisor because she "didn't have a good relationship" with another manager. But the other manager testified that he had not spoken with the firing supervisor. Further, the supervisor told her the termination "had nothing to do with her performance," yet her last paycheck listed "inferior performance" as the reason for termination. At trial, the supervisor testified he actually fired her for inferior performance, but claimed he could not produce any evidence documenting his actions because he had thrown away her personnel files after she was terminated. He was also unable to produce evidence of any other women working at her level in the company, claiming those files had also been purged. The woman produced copies of her work records, showing bonus statements, performance evaluations, and regular reports. Nothing indicated inferior performance. The Second Circuit ruled the company's complete lack of evidence disputing the woman's claims, along with the substantial evidence pointing to her outstanding

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*
Nonprofit *Alert* is published monthly by the law firm of Gammon & Grange, P.C., which represents nonprofits nationwide. References in **Nonprofit *Alert*** in no way constitute an endorsement by **Nonprofit *Alert*** or by Gammon & Grange, P.C. **Nonprofit *Alert*** is distributed with the understanding that no legal, accounting or other professional services are rendered, and no attorney/client relationship is established. If legal advice or other expert assistance is required, the services of a professional should be obtained.

performance, led to the conclusion of discriminatory intent. *Zimmer-man v. Assoc. First Capital Corp.*, 251 F.3d 376 (2nd Cir. 2001).

Whether the employer's sloppy records handling or intentional destruction of records accounted for the lack of evidence here, the lesson is clear: consistently document and keep records on file until all statutes of limitations have passed! Learn more with Nonprofit *Alert*® Memo, *Records Retention Policy*.

Tax-Exempt Issues

Business League, Charity Get IRS Okay on PAC

A business league, affiliated with a public charity, won't jeopardize its exempt status by forming a political action committee (PAC), the IRS has ruled. The business league is a §501(c)(6) organization, but it is controlled by the charity (a §501(c)(3)). The purpose of the PAC will be to further the business league's exempt purposes by supporting political candidates whose views are favorable to the industry represented by the business league. The PAC intends to solicit money from members of the business league and the charity. The business league also plans to permit the PAC to use its mailing list, although any solicitations, etc. mailed to the names on that list will be entirely funded by the PAC. The charity will not contribute any benefits to the PAC. Under these circumstances, the IRS said formation of the PAC would not endanger the exempt status of the business league or the charity. IRS LTR 200103084.

Although the IRS approved this PAC without any adverse consequences to the charities, 501(c)(3)'s must take extreme care to avoid any actual or implied support of a PAC. Such support is strictly prohibited. The key in this case was that the 501(c)(3) was entirely segregated from the PAC. standards under which ministers are eligible for housing allowances, check Nonprofit Alert® Memo, *Ministerial Housing Allowances*. Contact Gammon & Grange, (703) 761-5000 to order. Learn what you can and can't do with Nonprofit Alert® Memo, *Nonprofit Lobbying and Political Activity—Know Your Limits.*

Nonprofit Mailers Slapped With USPS Subpoenas

The Fourth Circuit has upheld the enforcement of subpoenas against three commercial vendors in Virginia that specialize in nonprofit bulk mailings. The vendors were suspected of engaging in improper cooperative mailing agreements with nonprofit organizations in order to use the less expensive bulk mail rate afforded to nonprofits. USPS guidelines permit a nonprofit to engage the services of commercial mailing vendors like those in this case, but the arrangement must be a "legitimate principal-agent relationship,"

NPA Highlight of the Month

Local Regulators Want "Voluntary" Payments From Charities

Investors aren't the only ones losing money these days. Many local and state governments have seen their operating budgets dwindle from falling tax revenues in hard economic times. To counter that problem, some tax authorities have come up with an idea to levy taxes on nonprofits, a group they say has escaped a tax burden for too long.

The mayor of Montpelier, VT, for instance, recently sent a letter to all the charities in his city, politely requesting them to voluntarily pay $1.39 per every $100 worth of tax-exempt property they own. The reason, he says, is to help offset the city's increasing demand for infrastructure and government services like police and fire protection. According to the mayor's office, Montpelier sports an unusually high percentage of tax-exempt properties within its city limits, making revenues disproportionately low from property taxes that fund city services. The solution: ask charities to chip in at the same rate commercial businesses are taxed. The mayor points out that he did not request the additional $1.88 per $100 of property that all other property owners pay to support city schools.

A similar effort in Baltimore, MD to collect an "energy tax" from nonprofits met with resistance earlier this year, but was finally resolved when a charity coalition negotiated voluntary payments instead of the imposed tax. Several years ago, the District of Columbia Tax Revision Commission recommended a broad-based gross receipts tax on revenues of tax-exempt organizations, including educational institutions and trade associations. (*NPA*, June '98).

Some of these initiatives may arise from well-publicized nonprofit forays into profit-making activities. For example, a recent *Chronicle of Philanthropy* study revealed that over 75% of the nation's largest charities reported income from unrelated business dealings in 1998. That number is expected to be even higher for current tax years.

Voluntary taxation of charities is not a new concept, but it's been out of vogue in recent years due in large part to the relative prosperity that most municipalities enjoyed during the booming economy. Now, with the economy sliding into recession, local tax regulators are targeting nonprofits. If your organization is asked to contribute "voluntary" taxes, your board should think long and hard about the implications. If the taxes are truly "voluntary," nothing legally compels your organization to contribute. But the poor publicity that could erupt from a charity's decision *not* to support its local government may outweigh any savings in the long run. Many local assessors are also taking the approach of narrowing statutory exemptions by taxing properties not actually "under charitable use." In either case, charities should obtain sound advice to distinguish legal requirements from political or prudent business judgments, then determine how best to proceed. Contact the attorneys at Gammon & Grange for advice.

meaning the nonprofit must control the mailing, pay all its costs and shoulder all its risks. The USPS sought subpoenas of the three vendors to determine the level of their involvement in the mailings. The vendors argued that the USPS guidelines were not clear regarding involvement. As long as the nonprofit's name appeared in the letterhead, the vendors argued, then the nonprofit was responsible for the mailing and, therefore, eligible for the nonprofit bulk rate. Maybe so, said the Fourth Circuit, but the USPS should at least be allowed the subpoenas to determine that for themselves. The vendors' "trouble and expense of compliance" was "trumped by the overriding public interest in ensuring the expeditious investigation of possible unlawful activity," the court decided. *U.S. v. American Target Advertising*, No. 00-1384 (4th Cir. 2001).

➥ **Litigation in this area occurs for good reason: nonprofit bulk rates are about 43% less expensive than regular mail rates. The USPS gets especially suspicious when nonprofits partner mailings with other groups because the nonprofit rate is available only if *all* cooperating organizations are eligible to use the nonprofit rate. The stakes are high; consult legal counsel if you're concerned about "mixed mailings." Respond carefully to any USPS challenge. For nonprofit mailings handled by commercial vendors, the nonprofit must remain in control.**

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.

State Rules & Regs

State Won't Appeal "Pervasively Sectarian" Standard

The State of Maryland has decided not to appeal a ruling by the Fourth Circuit that effectively opens a state funding program to religious colleges and universities, so long as the institutions use the aid exclusively for secular—not sectarian—purposes. In the August issue, *Nonprofit Alert*® reported that the Fourth Circuit said government does not violate the Establishment Clause if it makes aid available for a secular purpose to a broad range of groups without reference to their religion, and if the government prohibits that aid from being used for religious purposes. State authorities reportedly considered appealing that decision, but the statute of limitations for an appeal passed last month without any further action, meaning the ruling will stand. *Columbia Union College v. Oliver*, No. 96-1831-MJG (4th Cir. 2001).

➥ **The Fourth Circuit said the "pervasively sectarian" test was obsolete, but the Supreme Court has not been altogether clear in its guidance. Read more in Nonprofit Alert® Memo, *Religious Colleges' Participation in Tax-Exempt Financing Programs.***

Fund for Anonymous Gifts . . . **(continued from p. 1)**

The Court of Appeals ruled the Fund's changes were sufficient for exempt purposes, but remanded to determine whether it could meet the public support test. That led to the recent district court ruling. Fund attorneys say they will likely appeal.

➢ **If the ruling stands, the Fund will face additional regulations applicable to private foundations. More significantly, it must also comply with lower caps on the deductibility of contributions, which could make the Fund a less attractive donation vehicle. Whatever the outcome, it is clear the IRS is concerned about such funds appropriately limiting donor involvement and attracting sufficiently diverse donor support so the public support test will be met.**

Nonprofit Alert®

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

November 2001

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