



Nonprofit *Alert*®

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

Nonprofit Overview

Guidance Available At Last,

IRS Releases Regs on Intermediate Sanctions

After a two-year delay, the IRS has published much-anticipated guidance on intermediate sanctions, clarifying how 501(c)(3) and 501(c)(4) organizations will be penalized if they engage in excess benefit transactions with a disqualified person (i.e. an organization "insider"). Although intermediate sanctions most often arise with regard to executive pay or benefits, their scope is much broader, applying to *anyone* in an organization who exercises substantial influence, regardless of whether they hold an executive title or position. Marcus Owens, director of the IRS Exempt Organizations Division, said the regs don't create "a new class of bad acts. [They're] simply intended to give the [IRS] the tools to correct excessive compensation." The regs offer examples of "bad" compensation transactions such as:

- revenue sharing deals that tie an individual's compensation to a percentage of the organization's profits, especially if that individual controls the activity producing the profits;
- board-approved compensation packages that aren't properly supported with comparative data on compensation for like positions in like organizations under like circumstances; and
- salary or benefits packages offered to family members of disqualified persons without proper board approval, justification, and documentation. IRS Proposed Reg-246256-96.

★ **Intermediate sanctions, found in §4958 of the tax code, generally apply only to 501(c)(3) organizations after they receive exempt status. But as written, the IRS may also apply §4958 to organizations that aren't required to file for exempt status, like churches and groups with less than \$5,000 in annual gross receipts, according to Treasury officials.**



To comment on the regulations, contact the IRS before Nov. 2 at CC:DOM:CORP:R (Reg-246256-96), Rm. 5226, POB 7604, Ben Franklin Station, Washington, DC 20044, or visit the IRS Web site at <http://www.irs.gov>.



To understand more about the proposed regulations, order Memo 9608-1, *Avoiding the Snares of Intermediate Sanctions*. See back page to order.

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"Historic Wealth Transfer": \$1 Trillion to Charities.

Three years ago a Cornell University study calculated \$10.4 trillion in an unprecedented flood of wealth that baby boomers are ready to pass on over the next decades. Now economist Russ Prince, conducting a study for the Prudential Investments Advisory Group and the Highland Capital Holding Corporation, estimates that just over \$1 trillion could go to charities. He says about one-third of the wealthy households surveyed indicated they've already made planned gifts to charity through will bequests, charitable trusts, or some other testamentary device. However, that leaves two-thirds of such households yet to engage in planned giving.

★ **Interestingly, the study reports a vast majority of those who have already made planned gifts to charity did so because their financial planners "sold" them on the idea as a financial product rather than a charitable donation. The study looked at more than 500 households with net worths of at least \$1 million. (See also "Quote of the Month," p. 4).**

Liability & Risk Management

Children's Charity Banned From Fundraising. The United Children's Fund of Knoxville, is paying \$15,000 and observing a two-year ban on fundraising in Minnesota to settle a 1996 lawsuit brought by the state's Attorney General. The charity's professional fund raiser, Direct Response Consulting Services in McLean, Va., also agreed to pay \$110,000 for allegedly sending deceptive and misleading appeals on behalf of the charity. The Attorney General said the charity collected over \$2.5 million nationally for local children's cancer drives, but all the money went for fundraising costs instead of cancer programs. The charity also allegedly filed false and misleading financial reports that overstated the educational component of its efforts.

★ A unique feature of the settlement requires Direct Response to insure that all its current and future clients, who conduct solicitations in Minnesota, have independent and functioning boards and that they approve each solicitation.

➔ The Attorney General's approach seems to be one of improving organizational integrity by holding board members more accountable for fundraising activities. Audit your board by ordering Memo 9107-1, *Responsible Governance by Nonprofit Board Members* can help. See back page to order.

Art Museum Drops Lawsuit Against Donor. The Museum of Contemporary Art in Chicago has withdrawn its lawsuit against a donor who didn't follow through on a \$5 million pledge. The settlement calls for the museum to receive two paintings for its contemporary collection, in exchange for dropping its lawsuit against Paul Oliver-Hoffmann, a real-estate developer who previously served as chairman of the museum's board. Oliver-Hoffmann gave a written pledge in 1990, promising to give the museum funds for a new annex. He later clashed with board members over how the money was to be used. Last December, the museum sued, but Oliver-Hoffmann died in April with the lawsuit pending. His widow claims the pledge was merely a "letter of intent," not a legally binding document.

➔ The lines between pledges and letters of intent are often blurred—especially in the minds of donors. Eliminate the ambiguity in your solicitations and receipts by reviewing the tips in Memo 9505-1, *Demystifying the Receipting of Charitable Gifts*.

Nonprofit Alert®

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Change of Heart Costs Association \$9.9 Million. The nonprofit American Medical Association has agreed to pay almost \$10 million to the Sunbeam Corporation in settlement for renegeing on an endorsement deal that would've had the AMA giving its stamp of approval to the company's blood pressure monitors, humidifiers and other home health products. AMA's endorsement deal, cut last year, unleashed a flood of controversy when critics learned the AMA didn't actually plan to test the products itself. The deal would have meant millions in royalties for AMA. Now, AMA collects nothing, but pays \$7.9 million in damages, plus \$2 million in legal fees to Sunbeam—about half of the \$20 million in damages Sunbeam claimed.

★ Even where the legal risks are small, nonprofits intent on reaping the benefits of endorsement deals must seriously assess the potential for negative media coverage if they lend their names to products or services not worthy of their implied endorsements.

➔ To position your organization for optimum media coverage in all situations, review Memo 9210-1, *Developing a Media Policy*. See back page to order.

Employees & Volunteers

Boy Scouts May Be Liable for Negligent Retention.

A Virginia court has allowed an Eagle Scout's claims of negligent retention to proceed against the Boy Scouts of America (BSA) for allegedly placing an individual with previous molestation charges in the position of scoutmaster. The Eagle Scout claims to have been molested by the scoutmaster more than 13 times while participating in Scouting activities during 1995 and 1996. The scoutmaster was allegedly indicted in 1986 on another molestation charge, but was acquitted in court. The Eagle Scout charged the BSA knew or should have known of the prior charges but performed "no independent investigation" and retained the scoutmaster for another ten years. The BSA conceded negligent hiring, but contested the negligent retention, citing several federal cases that do not recognize the tort. However, the Virginia court relied on two state circuit opinions as precedent for recognizing the claim and allowing it to go forward. *Tremel v. Reid*, VLW 098-8-258.

★ Negligent retention is a relatively new tort, not recognized in every state. It goes one step beyond the more common tort of negligent hiring by holding employers liable for keeping known offenders on the job.

➔ To help avoid these charges, review your background and reference checking procedures with Memo 9402-1, *Minimizing Liability in the Employment Process*. See back page to order.

Insider Transactions: Slow Down, Curve Ahead!

Board members of the nonprofit Anclote Psychiatric Center formed a for-profit hospital for the sole purpose of purchasing all the nonprofit's assets. The board members were also stockholders of the new for-profit hospital. Upon investigation, the IRS determined the sale price was below fair market value,

which resulted in prohibited private inurement to the board members. The IRS revoked the psychiatric center's nonprofit status and assessed tax deficiencies. The center challenged the IRS, and a seven-year legal battle ensued. The Tax Court finally upheld the IRS's revocation and assessment, finding that the board members personally profited from the sale. The court determined that the board members bought the nonprofit's assets at a significant discount (approximately \$1.2 million less than the fair market value of \$7.8 million), which fell outside any reasonable range of fair market values."

Anclote Psychiatric Ctr. Inc. v. Commissioner, T.C. Memo 1998-273.

Although this occurred before passage of intermediate sanctions (see p. 1), this transaction would now be governed by these new rules. Whenever transactions involve one or more insiders, STOP and make sure your organization's conflicts of interest policies are faithfully followed and the intermediate sanctions criteria for fair market value are demonstrably in place. For further guidance, order Memo 9109-4, *The Essential Don'ts of Private Inurement*. See back page to order.

Tax-Exempt Issues

CGA Case Finally Ends After Long Legal Battle. The four year-old antitrust class action suit against the American

Council on Gift Annuities and hundreds of charities nationwide finally ended this summer when the 5th Circuit ruled that charities may legally work together in setting payout rates on the gift annuities they offer. The lawsuit, brought by the beneficiaries of a Texas donor, accused the Council of conspiring with charities to set rates artificially low. After numerous rounds of litigation and the passage of two federal laws intended to circumvent the lawsuit (*NPA*, Aug. '97), the plaintiff finally exhausted all legal arguments.

★ **Charitable gift annuities allow donors to purchase a lifetime annuity and claim a tax deduction at the same time. At death, the funds revert to charity. Charities are not required to use the Council's rates, but they are widely accepted because they help maintain the charitable nature of these annuities so they don't compete with commercial investment products.**



Your organization can take several steps to prevent private inurement, as detailed in NP9109-4, *Essential Don'ts of Private Inurement*, which includes new updates on intermediate sanctions.

To Count or Not To Count Earmarked Gifts? Since 1993, practitioners have complained about a complicated accounting rule that prohibits charities from counting gifts earmarked for other groups as part of the proceeds generated by their own fundraising programs. Promulgated by the Financial Accounting Standards Board (FASB), the rule was intended to standardize the way charities report receipts on their financial statements, but many have resisted implementing the rule because it could significantly increase their reported overhead

NPA Highlight of the Month

From Camp Vacations to Resident Living, Special Housing Arrangements Prompt Tax Liabilities

Two recent cases push employer-provided benefits into the spotlight, with authorities handing down narrow rulings on what constitutes employee compensation. The first case centered on a summer camp owned by the Salvation Army. The Town of Standish, Maine levied property taxes on the camp after it learned that the Salvation Army permitted its officers and their families to vacation there during the off-season. This use wasn't exclusively for a charitable mission, the town asserted, which disqualified the camp for a property tax exemption. But the state supreme court rejected that argument and left the exemption intact. The court noted, however, that such private use *would* constitute taxable compensation to the officers for the vacation services. *Salvation Army v. Town of Standish*, No. Cum-97-525.

In the second case, the issue was whether resident interns received taxable compensation whenever they accepted housing provided by their hospital employer. The hospital argued it was necessary for the residents to live nearby as a condition of their employment. But the IRS dismissed that rationale because the residents did not perform a significant portion of their duties in such housing, nor did the hospital conduct a significant portion of its business there. The IRS also noted the hospital routinely granted housing waivers for interns to live elsewhere, and those residents performed the same duties as others. The IRS said the results might have been different if the hospital had shown that residents living in the hospital-provided housing assumed added responsibilities that made it necessary for them to live there. IRS LTR 9824001.

★ **The IRS imposes a 3-part test on employer-provided housing to determine if it qualifies as non-taxable compensation to employees: 1) Is the housing provided for the employer's convenience? 2) Is it a condition of employment? and 3) Is it furnished on the employer's premises?**



To understand more about how this housing test and other "fringe" benefits apply to employees in your organization, order recently-updated Memo 9311-2, *Employee Benefits: A Summary for Nonprofit Employers*. See back page to order.

costs. Now, FASB has proposed that organizations with “an ongoing economic interest in the net assets” of the intended earmarked beneficiary can count such designated gifts in their fundraising revenues. That would allow groups with separate fundraising arms, such as university and hospital foundations, to count such gifts. But organizations, like United Way, that raise money for other charities would not be permitted to treat such fiduciary funds as their revenues.

★ **FASB is accepting public comments on the proposal until Sept. 15. Final recommendations take effect June 15, 1999.**



For a free brochure explaining the rule, contact FASB at (800) 748-0659 or <http://www.rutgers.edu/accounting/raw/fasb/draft/draftpg.html>.

State Rules & Regs

Maryland Laws Favor Nonprofits. The General Assembly recently enacted two laws that benefit nonprofits. H.B. 1155 allows 501(c)(3)'s to apply for certain tax credits if they hire former welfare recipients or disabled individuals. H.B. 461 permits charities that buy property worth \$300,000 or less to obtain property tax refunds at the time of settlement, rather than waiting until the end of the year, as required under previous laws.

Oregon Harpoons Aquarium Exemption.

The state tax court says Oregon Coast Aquarium's contract with a commercial vendor disqualifies the food service area from property tax exemptions. Under state law, an organization that leases property from a nonprofit must qualify for its own exemption. *Oregon Coast Aquarium v. Dept. of Revenue*, No. 4113 (1998).

Pennsylvania Exempts Park; Admission Fees Okay.

A long-running property tax dispute over DuPont's Longwood Gardens, located outside Philadelphia, ended this summer with the state supreme court ruling the park qualified as a charity

exempt from property taxes. The school district challenged the exemption because the park charged admission, but the court said it still applied since the fees didn't cover all the park's expenses.

Quote of the Month ...

“FINANCIAL PROFESSIONALS ARE REALLY DRIVING THE CREATION OF PLANNED GIFTS, WHICH MEANS THEY MAY BE PROMOTING PARTICULAR PRODUCTS, WHETHER OR NOT THEY'RE APPROPRIATE.”—Researcher Russ Prince, on findings from his study about the transfer of wealth. See related story on p.).

Online Freebie Makes Managing Easier. The Management Assistance Program offers free online training for nonprofit executives. Carter McNamara, the program's designer, says managers need *practical* not theoretical training. “One manager put it to me bluntly: ‘Teach me about managing, then you can tell me about chaos theory!’.” Access the program at http://www.mapnp.org/library/mgmt/mba_prog.htm.

And Finally ...

Goodwill Hunting: Big Gift From Clueless Donor.

The Center for Steinbeck Studies in San Jose recently accepted a gift of a \$40,000 leather-bound, typed manuscript of John Steinbeck's *The Moon Is Down*, complete with handwritten notes believed to be made by the author. The source of the gift: Goodwill Industries in Bakersfield, Cal., where an employee found the item in a bag of books!

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