Gammon & Grange, P.C. September 1999

# Nonprofit *Alert*®

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

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Plus...

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Boy Scouts & Public Accommodation

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***More Judicial Guidance***

## Joint Venture Deal Hinges on Control

It's all a matter of control, warns the Tax Court in a recent ruling that bolsters the IRS's position on joint ventures between tax-exempt organizations and for-profit entities. The ruling upheld the IRS's denial of exempt status to Redlands Surgical Services (RSS), a subsidiary of a tax-exempt, 501(c)(3) hospital.

RSS was a nonprofit subsidiary formed to succeed the hospital in a partnership arrangement that the hospital entered with a for-profit corporation. The original partnership purpose was to increase the hospital's outpatient surgery capacity by operating a new surgery center.

RSS first filed for exempt status in 1990. Six years later, the IRS issued a denial letter, determining that RSS benefited more than insubstantial private interests and served substantial non-exempt purposes. The IRS argued that the partnership was a successful profit-making business that had not provided any charity care.

More importantly, the IRS pointed to the partnership agreement which gave the for-profit corporation substantial control over the nonprofit surgery center. A related management contract that RSS entered after the partnership agreement was signed also gave additional control to the for-profit corporation for the first 15 years of the surgery center's operation. The contract was then renewable at the for-profit's sole discretion for two additional five-year periods.

The Tax Court agreed with the IRS, finding a number of reasons to deny exempt status to RSS: nothing obligated the for-profit partners to put charitable purposes ahead of profit-making;

RSS lacked voting control over the partnership and held insufficient control to guarantee achievement of charitable purposes; and

the management contract gave the for-profit control over daily operations and provided incentive to maximize income rather than serve charitable purposes. *Redlands Surgical Services, Inc. v. Commr.*, 113 T.C. No. 3 (7/19/99).

> **"It is no answer to say that none of petitioner's income from this activity was applied to private interests, for the activity is indivisible, and no discrete part . . . is severable from those activities that produce income to be applied to the other partners' profit."**
> *— Judge Michael B. Thornton, Redlands Surgical Services, Inc. v. Commr.*

**Investments by exempt organizations in for-profits generally don't create problems of this magnitude, but when an exempt organization participates in managing a limited partnership or similar entity, the IRS joint venture rules apply. Consult legal counsel before entering any organizational relationship with a for-profit.**

### >>>> Considering Trademarks? Act Before the Millennium <<<<

Gammon & Grange's trademark practice urges organizations considering trademark registrations or renewals to act before December 1, 1999, so the process won't be impacted by possible Y2K glitches. Although the Patent and Trademark Office has announced that it is Y2K ready, a pre-December filing should allow sufficient time for the PTO to complete its initial processing before any potential Y2K bugs strike. Read more in **Nonprofit *Alert*®** Memo 9301-2, *Trademark Law for Nonprofits* (see back page to order), or call Nancy LeSourd or Rebecca Zachritz at Gammon & Grange for help on trademark issues.

# Liability & Risk Management

## *Court Okays Voter Guides, But IRS Still Watching*

The Christian Coalition won a major victory last month when it convinced a federal judge that its widely-distributed voter guides did not violate federal election laws. The ruling came just weeks after the Coalition lost its bid for exempt status before the IRS. Although this ruling has no bearing on the Coalition's exempt status, it is an important development for tax-exempt organizations nationwide that face scrutiny from the Federal Election Commission (FEC) for engaging in political activity. Here, the FEC filed suit against the Coalition, alleging that its voter guides were partisan political publications that supported Republican candidates in the 1990, 1992, and 1994 elections. But the court ruled that the guides passed as advocacy expenditures under federal election laws because they did not expressly advocate the election or defeat of a particular candidate, with two exceptions. The court ruled that the Coalition crossed the line in 1994 when it expressly advocated the reelection of former House Speaker Newt Gingrich, then shared its mailing list with Oliver North's 1994 Senate campaign. For those two offenses, the court imposed civil penalties, but left the Coalition free to continue distribution of its non-partisan voter guides. *FEC v. Christian Coalition,* No. 96-1781 (JHG) (Dist. D.C. 8/2/99).

**This ruling helps define what types of political activity are permissible under federal election laws. Note it does not address what is permissible under federal tax laws, however. For further guidance on the bounds of permissible political activity, review Nonprofit *Alert*® Memo 9101-3, *Nonprofit Lobbying & Political Activity*. See back page for ordering instructions.**

## *Contract . . . What Contract? Church Asks Court*

Communications between a church finance committee and a contractor can lead to a valid and binding contract, a Minnesota court has ruled, particularly when the contractor relies on the statements and incurs losses as a result. The case began when a church member contacted a building contractor and requested proposals for painting the church. The contractor submitted proposals that the church finance committee reviewed and signed. The contractor assumed this meant the proposals were accepted, so he began to prepare for the work. However, he never received any advance payments as required under the contract. Several months later, he was told the church had decided against hiring him after all. The contractor then brought a breach of contract action against the church, claiming damages for the costs of labor, materials and lost profits. The court ruled that a valid contract existed because there was an offer and acceptance of the terms. The court also found that the advance payments were part of the payment terms, not a condition precedent to forming the contract. Therefore, the church was liable for the contractor's losses. *Conrad d/b/a/ Edgeworks v. Clark Memorial United Church of Christ,* No. C2-98-1394, (Minn. Ct.App. 1999).

**Organizations that rely on decisions by committees should formalize them with a vote by the board or an equivalent governing body before the organization becomes legally obligated. Without such finality, miscommunications like those that occurred here can ruin a good working relationship and lead to liabilities that otherwise would be avoidable.**

# Employees & Volunteers

## *Internal Complaint Triggers Retaliation Protection*

The First Circuit has ruled that an employee's internal complaint to management is enough to trigger the retaliation protection provisions of the Fair Labor Standards Act (FLSA). The case involved a receptionist who was told at the time of hiring that her position was "exempt" under the FLSA and, therefore, not entitled to overtime pay. She later requested a change in duties to include more research and administration, but when told no, she sent a letter to her supervisor insisting that she was owed overtime pay if she was to continue in the position of receptionist. Ultimately, she was fired from her position. She then sued for overtime pay, claiming she was fired in retaliation for asserting her rights under the FLSA. A district court granted summary judgment for the employer, but the First Circuit reversed, finding that the receptionist's letter to her supervisor qualified as a complaint or a proceeding related to the FLSA, which gave her retaliatory discharge protection. Since the employer had incorrectly classified her as an "exempt" employee, she was entitled to overtime pay for the period of her employment as a receptionist.

**The federal circuit courts are divided on this issue, with the Sixth, Eighth, Tenth and Eleventh Circuits holding the same as this First Circuit ruling. But the Second and Ninth Circuits have held that a formal complaint to a government agency or a court is required before FLSA protection applies. Proper worker classification is at the heart of a sound wage and hour policy. For further guidance order Nonprofit *Alert*® Memo 9208-1, *Nonprofit Employers & the Fair Labor Standards Act.* See ordering instructions on the back page.**

## *Who Says There's No Free Lunch? Just Ask IRS*

The IRS has announced it won't challenge a recent Ninth Circuit ruling that categorized certain employer-provided meals as deminimis

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tax-free fringe benefits to employees. (*NPA*, July '99). The announcement is good news for all employers, even nonprofits, that provide meals to employees under circumstances similar to those described in the ruling. The case involved a casino that required employees to stay on the premises at all times during work hours for security reasons. Because of that requirement, the casino provided meals to employees as tax-free fringe benefits. The court agreed with the casino that such meals were "for the convenience of the employer," and therefore were non-taxable de minimis fringe benefits. Since more than half the casino employees received the employer-provided meals, this made the value of *all* the meals excludable from employees' income. *Boyd Gaming Corp. v. Commr.*, 99-1 USTC, (9th Cir., 5/12/99). IRS Announce. 99-77.

**The Ninth Circuit decision overturned an earlier ruling by the Tax Court and settled a long-debated section of the tax code. The IRS's decision not to pursue the case further solidifies the ruling. Could this benefit your employees? Nonprofit *Alert*® Memo 9311-2, *Employee Benefits: A Summary for Nonprofit Employers* helps answer that question. See back page to order.**

### *Regs v. Law: FMLA Dominates, Regardless of Regs*

Where regulations set forth by the Department of Labor grant more leave than the law itself provides under the Family & Medical Leave Act (FMLA), the Eleventh Circuit says employers need only follow the law, not the more generous leave provisions of the regulations. The court made its ruling in a case that involved a female employee who took 13 weeks of employer-provided paid disability after childbirth. She then took an additional two weeks unpaid leave, arguing for the extra time because the employer never informed her that paid leave would run concurrently with the 12 weeks unpaid leave available under FMLA. The court found nothing in the law requiring employers to notify employees that FMLA leave runs concurrently. In fact, neither the language of the law nor its legislative history suggested that Congress intended anything longer than 12 weeks of leave; only the regulations included a passage requiring employers to inform employees. The court found that the regulations, therefore, added requirements and granted entitlements well beyond those allowed by the law. As a result, the court said that regulation was invalid and unenforceable. Because the employer granted paid leave longer than the minimum 12 weeks required under FMLA, the employer was not also required to grant the employee additional weeks of unpaid leave, the court said. *McGregor v. Autozone, Inc.*, No. CV-97-A-478-N (11th Cir., 7/14/99).

**Employers must carefully comply with these regulations; but where the regs depart from the statutes, the statute prevails. For further guidance, refer to Nonprofit *Alert*® Memo 9407-1, *All in the Family—Living With the Family & Medical Leave Act.* See back page for ordering instructions.**

## Tax-Exempt Issues

### *It's Back to School for Taxpayers Deducting Tuition*

### *NPA Highlight of the Month*

# Court Lectures Boy Scouts on Being Morally Straight

In a ruling replete with a stern lecture, the New Jersey Supreme Court last month interpreted the Boy Scout oath's commitment to be "morally straight" as fully compatible with homosexuality, and thus required the reinstatement of an avowed gay scout leader. The court leaped over the Boy Scout's 90 years of history as a private and voluntary organization and found that the organization was in fact a "place of public accommodation." A state law was amended in 1991 to include a prohibition against discrimination in public accommodations based on an individual's "affectional or sexual orientation." The court said that language effectively prohibited the Boy Scouts from refusing membership to homosexuals, despite the organization's argument that such a change in the Boy Scout's long-standing policy would thwart its charitable mission of teaching traditional values to young people. The court said the Boy Scout organization was "a place of public accommodation" based on several factors, including its broad-based membership solicitation and its historical partnerships with various public entities and public service organizations. The Boy Scouts also argued that the state law infringed its First Amendment rights of association, but the court concluded that granting homosexuals access to the accommodations afforded by scouting did not affect in any significant way the Boy Scout's ability to express its views and carry out its activities. *James Dale v. Boy Scouts of America, and Monmouth Council, Boy Scouts of America,* 1999 WL 565900 (8/4/99).

**This ruling continues a disturbing progeny of cases stemming from the Supreme Court's decision in *Bob Jones Univ. v. United States*, 461 U.S. 574 (1983), where public policy trumped not just traditional values, but Constitutional liberties. Most vulnerable to this erosion of fundamental freedoms are groups that have some type of public membership or constituency such as colleges and clubs, and those whose values are not well-defined. Groups concerned about the impact of these devolvements on their future mission should work with legal counsel to make sure their core values have been clearly articulated and, where appropriate, grounded in religious writings or other doctrinal foundations.**

Two recent tuition cases highlight the deductibility issues that arise anytime there's a hint of *quid pro quo*. In just-released field service memorandum, the IRS prohibited parents from claiming charitable deductions for tuition payments made to a Jewish school that their children attended. The parents claimed they and their children received only incidental benefits from the payments; the direct beneficiaries were all members of the Jewish faith, since the school preserved Judaism through careful adherence to its study. But the IRS rejected this rationale, reasoning that it would expand charitable deductions far beyond what Congress intended, since numerous forms of charitable "payments" could then be categorized as providing religious benefits. IRS FSA 1999-1070. In another tuition case, the Tax Court ruled that a taxpayer could take a charitable deduction for $400,000 in property that he donated to a local church, even though the church's pastor later waived tuition for the taxpayer's nieces and nephews at the church school. The court found that the tuition waiver was solely the pastor's idea and was not a condition to receiving the gift of property. The taxpayer had never even discussed the possibility of tuition waivers with the pastor or any church official prior to making the gift. *S. Robert Davis v. Commr.*, T.C. Memo. 1999-250 (7/29/99).

**Regardless of the doctrinal motivation or significance of a gift, the *quid pro quo* of tuition waivers automatically eliminates the charitable deduction except for any value of the gift in excess of the tuition's fair market value.**

### *Proposed Regs Cover Disclosure for Foundations*

The IRS has released proposed regulations governing new public disclosure requirements for private foundations. These regulations include the disclosure of tax-exempt applications and annual informational returns filed with the IRS (also known as Form 990). The requirements resulted from passage of the Tax and Trade Relief Act of 1998, which extended to private foundations the same public disclosure rules that public charities must follow. (*NPA*, May '99). The requirements are similar to those required of all tax-exempt organizations with one notable exception. Private foundations arerequired to release the names and addresses of their donors, whereas tax-exempt organizations may withhold this information. The proposed regs now undergo a period of public comment and will likely be finalized early next year. IRS Reg 121946-98. *Federal Register,* Vol. 64, No. 153, 8/9/99.

**Nonprofit *Alert*® Memo 9904-1, *Nonprofit Disclosure Rules*, covers the final rules applicable to public tax-exempt organizations. Is your organization complying? To order a copy, see instructions below.**

## State Rules & Regs

### *Pennsylvania Appeals Bible Tax to Supreme Court*

The state attorney general has filed an appeal with the U.S. Supreme Court asking it to overturn a state supreme court decision that prohibits a sales tax exemption on the sale of Bibles and other religious publications. Earlier this year, the state supreme court ruled the exemption was unconstitutional because it amounted to a governmental "preference for communication of religious messages" in violation of the Establishment Clause. (*NPA*, June '99).

### *New York Nonprofit Mail Order Sales Escape Taxes*

The state Department of Taxation and Finance has ruled that a nonprofit educational organization must collect sales taxes on books and other materials it sells at professional development seminars and programs held at various on-site locations throughout the state, but the organization is excused from collecting sales taxes on items it sells through a mail-order program. State sales taxes only apply to sales made in a "shop or store;" therefore, the department reasoned that the mail-order program was excluded, whereas the on-site locations qualified as "shops or stores." NY TSB-A-99 (19)S.

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