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Nonprofit *Alert*®

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

Inside This Issue:

Corporate Sponsorships Face Tax Trouble Under Proposed IRS Regulations

The IRS has issued proposed regulations that could raise tax liabilities for charities that have exclusive sponsorship agree-ments with corporations if those agreements produce "substantial benefits" for the corporate sponsors.

The proposed regs do not alter existing tax laws, but they define guidelines that the IRS will follow to enforce the Taxpayer Relief Act of 1997.

Under the present tax code, income from corporate sponsorship agreements is taxable to a charity if it is unrelated to the charity's primary mission, or if the corporate sponsor receives a "substantial benefit," defined as any benefit other than: (1) use of the sponsor's name or logo, or (2) goods or services that have an insubstantial value, as determined by a formula in the tax code.

With this new proposal, the IRS tightens the definition of "substantial benefit" to mean any amount above fair market value paid by an exclusive product or service sponsor. For instance, a nonprofit that signs a contract with a soft drink company, making that company the exclusive provider of its product at the nonprofit's events, would likely be taxed on the portion of the company's payment, which exceeds the fair market value of the service it is providing to the nonprofit.

The full impact of these proposed regs isn't clear at present, but with the possibility of their eventual adoption in clear view, charities would be wise to revisit existing sponsorship agreements now.All the benefits a corporate sponsor will receive under such agreements should be specified so that any presumption of "substantial benefits" is negated.

➤ **The proposed regs are at http://www.wais.access.gpo.gov. The IRS is accepting comments on the proposal until May 30.**

House Expedites Zoning Disputes

A bill (H.R. 2372) approved by the House of Representatives last month would give property owners, including churches and other nonprofits, easier and quicker access to the federal court system to resolve property and zoning disputes. The bill would allow property owners to file claims directly in federal court once they've gone through at least one appeal with local authorities, rather than spending years dragging through various appeals in the state court system. Supporters of the bill say it's necessary to guarantee property owners their constitu-tional rights, but opponents argue it will diminish the authority of local officials, which will ultimately harm neighborhoods.

➤ **If passed, this bill could be a boon for nonprofits nationwide that have fought many local zoning battles involving everything from homeless shelters to church expansion to wildlife preserves. Although a similar piece of legislation passed the House in 1997, the future of this bill is uncertain. The President has indicated he intends to veto the bill if it passes in its current form because it compromises the rights of local communities.**

➤➤➤It's GRRRREAT: Kellogg's Reports on Philanthropy ➤➤➤

A recent report by the W.K. Kellogg Foundation examines how the Internet works as a charitable tool. The report describes over 140 web sites devoted to philanthropy, volunteerism, and social change. Both com-mercial and nonprofit sites are included in the listing. The report also contains a summary of ideas about how the Internet can be used to spread philanthropic values. The full report is available free from the foundation's web site at http://www.wkkf.org/Publications/e-phil.pdf.

Liability & Risk Management

Board Compensation: Must Make It Reasonable

A private foundation may pay annual compensation to its board members without running afoul of the self-dealing rules, the IRS says. The board members include several children and grandchildren of the foundation's originator, all of whom were responsible for evaluating and appraising grant applications. Compensation to the board members was meant to cover their travel expenses and other costs associated with attending board meetings. The IRS found the amount proposed was reasonable, based on the board member's responsibilities, and it was comparable to amounts paid by similar organizations. IRS LTR 20007039.

For additional guidance in evaluating payments to your organization's executives, review Nonprofit *Alert*® Memo 9102-7, *Establishing Reasonable Compensation for Nonprofit Leaders.* See back page to order.

Nonprofit Fundraising Isn't Simple Child's Play

A New Jersey nonprofit, which relied on children to sell candy in door-to-door fundraising programs, must revise its solicitation tactics. A lawsuit filed by the Illinois Attorney General alleges the organization, d.b.a. Successful Teens, violated charitable trust and child labor laws by using children under age 16 to sell candy and conduct solicitations. The lawsuit also claimed the organization's executives filed incomplete financial reports and misrepresented to the public the purpose of the candy sales. Representatives of the organization reportedly picked up kids from a central location, then transported them into unfamiliar neighborhoods where they conducted solicitations for which they were paid nominal amounts, based on the amount of candy they each sold. The Attorney General reported that the organization's executive director was also a defendant in a 1992 case against an organization called Youth in Action, which ultimately went out of business after being charged with similar offenses involving illegal employment of children.

Profitable Perks Portend Personal Penalties

Pennsylvania's Attorney General has filed a federal lawsuit against three officials and five board members of the now bankrupt Allegheny Health, Education and Research Foundation (AHERF), for allegedly misusing foundation funds. According to published reports, the suit claims the officials misdirected about $78.5 million from "restricted endowments" at the foundation and used it to pay salaries, operating expenses, and employee perks, including golf club memberships and tickets to sporting events. The foundation later declared bankruptcy. The foundation operated eight hospitals in Philadelphia and Pittsburgh, which have all now been sold.

This case x-rays the fault lines in an organization's management firewall. Thus, the personal assets of the negligent board and officers become potential casualties. State officials say they chose this route because it gives them a better chance of recovery since creditors were already "lining up" against the bankrupt foundation. To remind your board and officers of their responsibilities, order Nonprofit *Alert*® Memos 9209-1, *Legal Duties of Nonprofit Directors*, and 9107-1, *Responsible Governance by Nonprofit Board Members*. See back page to order both memos.

Nonprofit's Spending Spree Buys Fed Attention

Federal auditors are investigating over $300,000 in questionable expenditures at the National Asian Pacific Center on Aging. The Seattle-based organization operates a nationwide job placement service for older Asian-American workers. Most of its funding comes from federal grants and contracts. Last year, Department of Labor investigators launched an audit after receiving complaints about the organization. The auditors found a significant abuse of taxpayer dollars, capped by a $1.8 million embezzlement scheme. The organization's bookkeeper pled guilty to the embezzlement earlier this year, but investigators continued to turn up evidence of other mismanagement, including some $35,000 in inappropriate travel, credit card charges, and miscellaneous expenses charged primarily by the organization's director but billed to federal grants. The organization also reportedly spent large sums on prohibited lobbying and political activities.

Are appropriate checks and balances in place at your organization to prevent financial abuses like these? Review your internal accounting controls by implementing the suggestions in Nonprofit *Alert*® Memo 9106-2, *Accounting and Fiduciary Guidelines for Nonprofits*. See back page to order.

Employees & Volunteers

Government Funds Do Not Negate FLSA Exemption

To prove a claim under the Fair Labor Standards Act (FLSA), employees have the burden of showing that their nonprofit employer is covered by the law—something that proved hard to do in this case. An employee of the nonprofit Chesapeake Volunteers in Youth Services, Inc., sued the organization for 1,000 hours of overtime pay. The employee argued that because the organization received funding from the county court system and the city, it was actually a public agency or political subdivision of the local government, subject to the FLSA. The court disagreed, finding that the organization's source of funding had nothing to do with its FLSA status. The court observed that the organization was not

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controlled by any government entity, maintained its own independent board, and was managed by individuals who were not responsible to any public official or the general electorate. The organization was exempt from the FLSA, the court ruled, and the employee's claims failed. *Briggs v. Chesapeake Volunteers in Youth Serv., Inc.*, 1999 WL 961739 (ED VA 1999).

While nonprofit organizations are generally exempt from the FLSA, two limitations must be kept in mind: nonprofit's aren't exempt if (1) they engage in ordinary commercial activities in competition with other commercial entities, or (2) if their employees engage in interstate commerce. Learn more with Nonprofit *Alert*® Memo 9208-1, *Nonprofit Employers & the Fair Labor Standards Act.* See back page to order.

Over and Over: Repetitive Motion Injuries Must Stop

If OSHA has its way, employers will have to improve working conditions for employees subject to repetitive motion injuries. Proposed OSHA rules would require employers to upgrade working conditions after at least one work-related injury. As an example, OSHA says an employer might have to adjust workstations if one employee suffers carpal-tunnel syndrome. OSHA estimates the average cost of such an adjustment would be $150 per workstation, but could cost employers a total of $4.2 billion annually. Still, that's less than half the cost of lost labor and worker's comp that employers now pay annually for workplace injuries, OSHA claims.

Because most administrative offices at nonprofit organizations are labor-intensive, these new rules could foreshadow costly changes. Assess your potential risks with Nonprofit Alert® Memo 9305-1, *OSHA Requirements for Nonprofit Employers*.

Tax-Exempt Issues

Receipt Deadline Passes for Calendar Deduction

The IRS has denied a charitable deduction to a company that contributed bulk quantities of calendars and books to a nonprofit organization for distribution to the needy because the charity failed to provide the company with appropriate documentation within the time limits specified in the tax code to qualify for the charitable deduction. There was also little evidence that the items were ever distributed to those in need or used for their intended charitable purposes. The charity did, however, provide a letter acknowledging the donation, but it was not received until after the company had filed its tax return, which failed to meet the "contemporaneous written acknowledgment" requirement of the tax code. The IRS also said the company overstated its deduction, since most of the calendars were already two to three months old at the time of the donation. Based on a fair market analysis, the IRS questioned whether old calendars had any value at all. IRS TAM 200003005.

Although it's a donor's responsibility to obtain proper documentation to justify a claimed deduction, it is the charity that must provide the "contemporaneous written acknowledgment" for the donor. Review your

NPA Highlight of the Month

Employer Liable for Supervisor's Retaliatory Harassment

An adverse employment action made in retaliation for an employee's opposition to discrimination is clearly prohibited under federal laws. But when retaliation takes the form of personal harassment and there is no adverse employment action, the results aren't so straightforward. The Sixth Circuit recently adopted a new approach to this difficult situation and became the first federal circuit court to extend what is commonly called the *Farragher* sexual harassment analysis to nonsexual harassment as well. The case involved a female clerk who suffered verbal harassment from her male supervisor. The clerk complained about the harassment, and the supervisor was promptly transferred with strict instructions to stay away from the clerk and not to talk to her. However, the supervisor continued to contact the clerk by phone. He also allegedly visited her office on at least 15 separate occasions, stalked her in the parking lot, followed her home, and vandalized her driveway several times. The clerk took medical leave because the harassment caused her to suffer anxiety attacks. She then sued her employer for sexual harassment and retaliation, but a lower court dismissed the case because she had suffered no tangible employment action. The lower court also refused to classify the supervisor's behavior as "sexual in nature" and therefore would not consider it "sexual harassment." The Sixth Circuit reversed, saying that an employer is vicariously liable for retaliatory harassment by a supervisor even if the harassment doesn't result in a tangible employment action like demotion or dismissal. The court noted, however, that if an employer has an effective anti-harassment procedure in place, there may be a legitimate defense if the employer can show that the employee simply failed to use the existing procedure to handle his or her claims. *Morris v. Oldham County Fiscal Court*, 2000 WL 38449 (6th Cir, 2000).

Sexual harassment laws have undergone many changes in recent years, following a number of high profile court cases like *Farragher*. For an overview of current laws, read recently updated Nonprofit *Alert*® Memo 9201-2, *Sexual Harassment Policy for Nonprofit Employers*. See back page to order copies and consider training all your managers and supervisors about the changes in the laws, particularly now that courts are more willing to hold employers vicariously liable for the acts of their employees.

organization's receipting practices with the guidelines and the sample acknowledgments in Nonprofit *Alert*® Memo 9505-1, *Demystifying the Receipting of Charitable Gifts*. To order, see box below.

Christian Coalition Battles IRS Over Exemption

Following a major legal victory over the Federal Election Commission last fall, the Christian Coalition is now pursuing another battle—this time against the IRS. The organization has filed a federal lawsuit, claiming the IRS discriminates against conservative groups. The IRS issued a ruling last year that found some of the Coalition's activities, such as the distribution of voter guides at churches, to be politically partisan in nature. The IRS then denied exempt status to the Coalition. At the same time, the Coalition was fighting FEC charges over its voter guides, but a federal judge eventually dismissed most of those charges, ruling that the guides qualified as advocacy expenditures under federal election laws. (*NPA*, Sept.'99).

State Rules & Regs

Mississippi Rejects Release, Holds Instructor Liable

A Mississippi Supreme Court ruling makes it more difficult for organizations in the state to limit their liability through the use of common release forms. The case involved a student who took scuba diving lessons from a yacht club. Before beginning class, he signed a release that absolved the instructor and club from all liability for any injuries he might suffer. Later, the student suffered decompression illness when he underwent a dive that was too long. Experts testified the instructor was negligent in planning the dive and in failing to make safety stops, which led to the student's illness. A lower court dismissed the case because the student signed a release, but the state supreme court reversed and ruled in the student's favor, saying the law does not look favorably on contracts that exculpate parties from liability for their own negligence. The court found the instructor negligent and noted that the release form had not been properly explained or negotiated by the parties. Its terms were not specific; therefore, the court construed them against the instructor. *Turnbough v. Ladner*, 1999.MSS.0042968 (12/9/99).

Virginia Enacts Collection of Internet Laws

As the home state for AOL, UUNET, and Network Solutions, Virginia has taken the lead in enacting a host of Internet laws that cover everything from spam (H.B. 1714) to consumer privacy (H.B. 2152). A controversial measure also passed into law recently, making Virginia the first state to enact the Uniform Computer Information Transaction Act and creating a legal framework for e-commerce transactions. An additional bill (H.B. 1491) is pending, which would recognize web sites as personal property and establish new protections for web site owners. Potentially, any web site owner anywhere in the world could register his/her web site in Virginia and invoke the state's protections if the bill becomes law.

More information about Virginia's regulatory approach to emerging technology and the legal implications it presents is available online at http://www.state.va.us.

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