



Nonprofit *Alert*®

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

August 2002

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Court Approves Hospital's For-Profit Venture

A nonprofit hospital's joint venture with a for-profit health care company does not interfere with the nonprofit's exclusive charitable operations, a federal court in Texas has ruled.

This decision clarifies the boundaries for nonprofits/for-profit relationships and gives greater flexibility to nonprofits engaged in commercial joint ventures.

Joint Venture

The case pitted St. David's Health Care System against the IRS in a dispute over the hospital's exempt status. Since 1925, St. David's had been a 501(c)(3). But in 1996, the hospital partnered with the for-profit Columbia/HCA Healthcare, Inc. in a deal that required St. David's to contribute all its assets in exchange for a 45.9 percent interest in the partnership.

Two years later, the IRS audited the hospital and revoked its exempt status, ruling that the partnership did not permit St. David's to operate exclusively for charitable purposes and improperly allowed HCA to privately benefit.

Community Board

The IRS argued that St. David's was not controlled by a community board and, therefore, lacked one of the requirements for tax exemption. But the court said "no

one factor is an absolute requirement for exemption." A "community board" is based on who has overall control, rather than who has majority control, the court said.

St. David's satisfied the community board requirement, the court said, because "exceptional protections" established under the partnership agreement guarded its charitable operations. For instance, St. David's could select the manager, unilaterally dissolve the partnership, and remove the CEO.

Private Benefit

Relying on the 1999 landmark *Redlands* case, the court said the standard for determining private benefit depends on who controls the organization. In this case, the court said the rights that St. David's retained made it "difficult to imagine a corporate structure more protective of an organization's charitable purpose."

St. David's Health Care System v. U.S., No. A-01-CA-046 JN (U.S. West. Dist TX, 6/7/02).

Enron Fallout Brings Disclosure Implications for Nonprofits

One of the corporate reform bills now making its way through Congress could impose additional disclosure on nonprofit boards. The Corporate & Auditing Accountability, Responsibility and Transparency Act (H.R. 3763 & S. 2673) would require corporations and executive officers to file SEC reports, detailing their relationships with nonprofits.

If executives, directors, or their immediate family members sit on a nonprofit board, then the relationship must be disclosed. If a corporation or an executive contributes more than \$10,000 or provides "material benefit" (including lobbying) to a nonprofit, then that activity must also be disclosed.

Supporters of the measure say it'll keep corporate boards independent, but others claim it places an onerous burden on corporations that will likely result in fewer corporate charitable contributions and activities.

New IRS Guidance for Churches & Religious Organizations

The IRS has just released an updated version of Publication 1828, *Tax Guide for Churches and Religious Organizations*, available at www.irs.gov under the "Charities & Nonprofits" link. The guide covers everything from UBIT to disclosure rules and replaces an earlier version, last published in 1994.

Liability & Risk Management

Who's Reading What? Board Minutes Sent to Mayor Become Public Records, Open to Inspection

An Ohio appeals court has ruled that the private board minutes of a nonprofit hospital became "public records" when they were sent to the mayor's office for review. Two residents filed suit, requesting the mayor release copies of board minutes that referenced condemnation proceedings for property on which a new hospital was planned.

Carefully screen and redact all documents before sending to public officials.

The mayor refused, saying the official records were kept by the hospital. Later, on deposition, the mayor admitted she'd received the minutes at her office, but that she always took them home and shredded them. The court ruled, however, that the minutes became public records when she received them at the mayor's office. As such, the mayor was legally obligated to make them available for public inspection upon request. The court stopped short of ordering her to produce the records because she'd already admitted they didn't exist. Instead, the court remanded the case to determine how many documents were lost and to levy a fine for destruction of those documents. *State of Ohio v. City of Alliance*, No. 2001CA00101 (OH Ct. App., 5th Dist., 3/11/02).

If a public official sits on your board or participates in the governance of your organization, don't send board minutes or other sensitive documents to his/her office unless confidential material is redacted. Otherwise, they could become "public records" open to inspection by anyone, including the media.

Shelter Exec Pleads Guilty to Embezzling \$1 Million

The co-founder and former president of Hale House, a Harlem shelter for children of drug-addicted mothers, pled guilty last month to felony charges of embezzling more than \$1 million from the nonprofit. The state attorney general indicted Dr. Lorraine Hale, age 75, and her husband, Jesse

Charismatic executives may pose risk to an organization if proper checks & balances aren't in place.

DeVore, age 70, for numerous financial offenses, including forging checks and diverting donations into personal accounts. The couple also allegedly created phony board members that they used to funnel money from the shelter for their personal use. The

indictment alleged that the couple used the money to pay for improvements on their home, buy artwork, pay for the college tuition of their nephew, and support a theatrical production company that Mr. DeVore directed. The charges carried sentences of 5 to 15 years, but because of the couple's advanced age and failing health, prosecutors accepted their guilty pleas rather than seek prison terms. A civil suit, seeking restitution of the embezzled funds, is also pending. Dr. Hale resigned her position with the charity in May 2001 when media reports questioned her financial practices.



Good executives welcome, accountability, both at the operational and board levels. Proper checks and balances should be in place for all executives. Nonprofit Alert Memo, *Governing Responsibly by Nonprofit Board Members*, shows you how. See back page for ordering information. It may also be time for an outside legal audit of your organization. Call (703) 761-5000 or e-mail npa@gandglaw.com for a free nonprofit legal audit package.

Copyright Office Cuts "Webcasting" Rates

The U.S. Copyright Office has announced plans to reduce the proposed rates that Internet broadcasters must pay for "webcasting" radio-style music programs over the Internet. An arbitration panel had previously set the rate at 14 cents per listener per song, but broadcasters strongly opposed that decision, arguing it was too high.

The Copyright Office has now cut the rate to 7 cents per listener per song, which is comparable to what commercial stations pay to re-broadcast radio shows online. Internet broadcasters must pay the rate when they broadcast material copyrighted to musicians and recording companies.



For nonprofit organizations that provide webstreaming, the final rate determination means it's now time to evaluate your webcasting activities and determine whether reliance on a statutory copyright license is still valid or whether separate rate negotiations with the Recording Industry Association of America would be advisable. Contact the IP attorneys at Gammon & Grange for more help.

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Employees & Volunteers

Hear No Evil: Intercepting Employee Personal Calls

An employer may intercept but not monitor his employees' personal phone calls in the ordinary course of business under the "business-extension" exemption to federal wiretapping laws, a federal court in Alabama has ruled. The case involved an insurance agency that routinely monitored employee calls as they marketed insurance products by phone. One employee, who was undergoing a messy divorce, alleged that the agency recorded her personal calls. The court decided that the business-extension exception did not extend to taping personal calls. "A personal call can be intercepted to determine its nature but never its contents," the court wrote. Because the agency recorded every conversation on certain phone lines and preserved those recordings for later review, the court said the agency went well beyond the exemption. An employee handbook that notified employees about telephone monitoring was not sufficient to prove the employee's implied consent because the agency could not establish whether the employee ever received the handbook. *Smith v. Devers*, No. Civ.A. 01-T-551-N (M.D. AL, 2002).

Disabled Volunteers Offer Significant Service

A new report illustrates the benefits of volunteer programs that accommodate disabled individuals. The report offers practical "lessons learned" on how to create effective programs that engage disabled volunteers and identifies planning tips for addressing the challenges that such volunteers may face. Among those challenges: the perception that disabled volunteers can't contribute to an organization or that such individuals aren't interested in volunteering. The report was funded through a grant by the Corporation for National and Community Service and produced by the Points of Light Foundation. More than 2,900 disabled volunteers were involved in the study, which focused on a 60-day service period at 20 different Volunteer Centers around the country.



A steady pool of volunteers is essential to the success of most organizations. This report provides a blueprint for developing a process to include disabled volunteers in your organization. It is available at www.pointsoflight.org/involved/involved.html. Gammon & Grange also offers a helpful resource, *Nonprofit Alert® Memo, Managing Volunteers: Risks & Rewards*. See back page to order copies for all your managers and volunteer coordinators.

NPA Highlight of the Month

Widely Used Passenger Van Poses High Risk

A report issued last year by the National Highway Traffic Safety Administration (NHTSA) warned against the rollover risks of 15-passenger vans, many of which are still in operation, especially at nonprofit organizations like churches and schools. A number of these vans have been involved in widely-publicized single vehicle crashes resulting in fatalities, so the importance of addressing this safety issue takes on added immediacy for nonprofits.

According to the NHTSA, 15-passenger vans are more likely to roll over when fully loaded with occupants than when lightly loaded due to changes in the center of gravity. Vans loaded with ten or more occupants had three times the rollover ratio than those with fewer than ten occupants. Vans loaded with 15 occupants had six times greater risk than when the vans carried only five occupants. Sudden vehicle maneuvers could also increase the propensity for rollover accidents. Nonprofits and other entities that rely on untrained volunteer drivers who normally drive smaller vehicles and are not familiar with the 15-passenger van's limitations and responsiveness, may be placing their passengers and their organizations at greater risks.

If your organization operates a 15-passenger van, immediately prioritize plans to replace the van with a safer vehicle. If requirements are such that the van must continue in operation, then implement the following practices recommended by Guideone, a risk management firm specializing in protection for churches and religious organizations:

- carefully screen/train all drivers; inform drivers about the NHTSA findings and the risks inherent with 15-passenger vans;
- establish procedures to limit the number of occupants who will be transported and fill the front seats first;
- require all occupants to wear seat belts at all times;
- maintain high-quality, low-mileage tires on the vans at all times;
- never load items on the roof or pull a trailer with a 15-passenger van.



The NHTSA report is available at www.nhtsa.dot.gov/people/ncsa/pdf/15vanRollNote.pdf, or copies may be requested by phone at (202) 366-4198. For helpful and free information from Guideone about the safety measures recommended for 15-passenger vans, visit www.guideonecenter.com/Church/Articles.

Tax-Exempt Issues

Sold to the Highest Bidder: Tax Tips for Auctions

With the charity auction season fast approaching as organizations gear up for fall fundraisers, a few tax tips may be helpful—both for the benefit of your donors and for your organization. If you expect donors to make charitable contributions as part of their auction bidding, then the charity should estimate the fair market value of auction items in order for donors to claim a tax deduction. Donors may then claim deductions for the amount that their winning bid exceeds an item's fair market value. Sounds simple enough . . . until the charity has to estimate the value of a "priceless" item, like dinner at the CEO's house or artwork created by children. In those cases, a fair market value estimate may be based on the value of similar merchandise or services. Dinner at the CEO's house, for instance, would be valued at the actual cost of the food, wine and other incidentals (like party favors), plus the cost of preparing and serving a similar meal in a restaurant. The charity should publically disclose the value of the item during the auction so that donors may adjust their bids accordingly and include whatever charitable contribution they intend above the actual value of the item.

 **Charities should also be prepared to provide proper receipts showing the fair market value of the item and the donor's winning bid, so no question remains about the amount of a donor's charitable contribution. Read more in Nonprofit Alert Memo, *Charitable Gifts: Receiving & Receipting*.**

Work Activity Center Furthers Charity's Purpose

A 501(c)(3) that trains and educates the developmentally disabled will not incur unrelated business income tax (UBIT) on profits it collects from a manufacturing activity program it conducts, the IRS has ruled. The organization had sponsored the training

program for more than 20 years, teaching developmentally and physically disabled children and adults how to assemble component parts for local industry contractors. When one of the largest contractors closed its regional distribution center, the charity was forced to expand its operations by purchasing and storing the manufacturing components needed to continue its programs. To do so, the organization purchased land, built a warehouse and added additional programs to teach its clientele about warehousing products. All the funds generated by these programs were used for the organization's exempt purpose. The organization also generated funds through traditional fundraising and tuition from its clientele. Finding all this additional work "reasonably necessary," the IRS ruled that the expansion of services and the new work activities did not produce UBIT because they contributed importantly to the organization's charitable and educational purposes. IRS LTR 200225044.

 **Keys to avoiding UBIT: (1) Clear and primary relationship between the questioned activity and the organization's exempt purpose; (2) Minimal competition with similar for-profit businesses; (3) Profit motive minimal or absent; (4) Profits used to grow the exempt entity rather than the business-like activity.**

Ordering Information: Memos referenced in the *Nonprofit Alert* can be purchased for \$20 each (\$10 for firm clients) from Gammon & Grange, P.C. Five or more copies of the same memo are bulk priced at \$5 each. Call, write, or email us at the address below.

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