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Nonprofit *Alert*®

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

Inside This Issue:

How Much is Too Much? Supreme Court Weighs State Telemarketing Regulations

Can a state prosecute a professional solicitor for fraud if the solicitor fails to tell donors what percentage of contributions go to the solicitor and not the charity? That's the question the Supreme Court is considering this term as it reviews the case of *Ryan v. Telemarketing Associates.*

The outcome of the case could change the way telemarketing regulations are interpreted and enforced at the state and local levels. It could also produce new liabilities and limitations for charities and the professional fundraisers they hire.

A Fraction to Charity

The case involves a telemarketing company in Illinois that raised funds for VietNow, a nonprofit veterans group. VietNow contracted with the telemarketer to receive 15% of the funds raised. The remaining 85% went to the telemarketer to cover solicitation expenses (which included publication of a newsletter for VietNow) and payment for services rendered.

Solicitation was conducted legally via telephone, but donors were not told how much of their contributions would actually go to VietNow.

The telemarketing company also compiled a list of repeat donors and raised significant amounts from those calls, but continued to charge the charity the same overhead expenses even though the repeat calls reduced the telemarketer's administrative costs.

Charges of Fraud

The Illinois Attorney General brought fraud charges against the telemarketer, but the state's supreme court dismissed the case. Illinois appealed, and 18 other states have joined with the Illinois Attorney General in asking the U.S. Supreme Court to review the case. A decision is likely sometime next spring.

Much of what constitutes charitable solicitation also involves education and communication about a charity's mission. For that reason, a series of Supreme Court rulings in the 1980's set First Amendment Free Speech protections for charitable solicitation. But the Court's willingness to hear this case could mean it is considering tightening those provisions.

IRS Handbook Offers Insight on Nonprofit Issues

A new version of IRS's venerable "technical instruction" handbook hit newsstands last month with updates to sections on charitable trusts, partnerships, and executive compensation. The handbook is intended to assist IRS agents, but charity officials often refer to it for clues about how the IRS interprets tax laws. The IRS also released a revised version of Form 1023, Application for Exempt Status. The form's instructions were updated to explain responsibilities and requirements of public charities and state solicitation laws. The IRS expects to finalize the revisions by next spring.

The revised Form 1023 and handbook, *Exempt Organizations CPE Technical Instruction Program 2003,* are available online at www.irs.gov.eo.

Mileage Rates Change for 2003

The charitable mileage rate will remain unchanged at 14 cents per mile in 2003, but the business mileage rate will decrease to 36 cents per mile (down from 36.5 cents), the IRS announced. Nonprofits often use these rates to reimburse employee travel, which helps reduce detailed expense documentation. Find tips about how to use these rates in Nonprofit Alert® Memo, *Expense Reimbursement for Volunteers and Employees.* To order, see back page.

Liability & Risk Management

IRS Nails Nonprofit Exec, a.k.a. Car Salesman; Exec & Charity Face Serious Penalties

The IRS has levied fines and penalties against the founder of a nonprofit charity for multiple offenses, including excess benefit transactions. The founder, who previously worked as a used car salesman, established the nonprofit to accept automobile donations on behalf of various charities. Donors could designate charities for which their automobiles would be earmarked and receive a tax deduction. If donors didn't specify a charity, the autos were sold at auction and the proceeds distributed to various charities after expenses were paid. The trouble with this arrangement was that the founder headquartered the nonprofit at his son's used car lot, where automobiles were sold commercially. Donated vehicles were sold alongside used autos being sold for profit. The nonprofit provided donors with receipts that detailed only the retail Kelley Blue Book value for the autos, not the actual fair market value, trade-in value, or loan value. Some of the cars were actually sold for scrap; others were not in operating condition. An IRS investigation uncovered dubious receipts for those vehicles, plus other financial irregularities including expenses charged to the nonprofit for maintenance of the founder's family automobiles and unsubstantiated payments to a towing company owned by the founder's son. Also troubling was the nonprofit's "board," which was composed entirely of the founder, his wife, his father-in-law, and a CPA. The founder acted as president and executive director. The IRS concluded that the founder was a disqualified person subject to penalties for excess benefits that he incurred from the nonprofit. Because of his position, the IRS also ruled he exercised substantial influence over the affairs of the organization, which made him liable for the organization manager tax. Finally, the IRS assessed penalties against the nonprofit for its role in providing misleading information to donors, which led to their erroneous claims of inflated charitable deductions. IRS TAM 200243057.

Questionable practices in car donation program led to excess benefits.

Although the IRS has recently targeted car donation programs, the issues here are much larger, involving conflicts of interest and intermediate sanctions. If your nonprofit doesn't yet have a formal conflicts of interest policy, seriously consider adopting one. For a sample policy and guidance on implementation, see Nonprofit Alert® Memo, *Conflicts of Interest Policy*.

Bad Throw Makes Good Case for Assuming Risk

Athletes assume certain risks when they participate in sporting events, the New Hampshire Supreme Court reminded sports enthusiasts last month in a decision that relieved an amateur softball league of liability for injuries a player received during a game. The player in attempting to beat out a ground ball to shortstop was beaned by a wild throw, knocked unconscious, and suffered brain injuries. She later recovered and sued the softball league, claiming the league was liable for the shortstop's negligence. A trial court dismissed the action, and the New Hampshire Supreme Court upheld the dismissal because the injury was a "common risk inherent in and arising out of a softball game." The court said it was reasonable to expect that infielders would "commonly make errant throws" in a softball game and therefore, should not be held liable for an injury that stemmed just as much from the victim's willful participation in the softball game. *Allen v. Dover Co-Recreational Softball League,* No. 2001-457 (N.H. 9/30/02).

This ruling illustrates the legal doctrine known as "assumption of the risk." Although the doctrine doesn't apply equally in all states, the concept is one that courts often rely upon to assess blame, in circumstances where victims choose to participate in events with known risks, as was the case here. If your nonprofit sponsors sporting events, outings, or other activities that involve special risks, the use of written waivers and releases—though not always fully enforceable—help create an informed and effective assumption of such risks.

Employees & Volunteers

Employer Not Liable for Harassment by Clients

Employees can't sue their employers for sexual harassment caused by clients or customers, a California appeals court has ruled. The case involved a female employee of a transportation company who was sexually harassed and assaulted by one of her company's adult male clients. The company specialized in the transportation of developmentally disabled adults and children. The assailant was developmentally disabled and was being transported from his home to a care provider at the time of the attack. The employee sued the company for negligence, but a trial court rejected her claim. The appeals court agreed and found that state

Consider risks for harassment and other offenses by clients.

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law provided no cause of action against an employer in this particular scenario. The employer's liability did not extend to clients or customers over which the employer could not exercise control, the court ruled. Employer liability didn't extend beyond its premises or personnel, the court wrote. *Salazar v. Diversified Paratransit Inc.,* No. B142840 (CA Ct.App., 2nd, 10/02).

Note, this ruling might have been decided differently had the employee been harassed by a client on the business premises of the employer. As a general rule, employers should take every reasonable precaution to ensure workplace safety and freedom from harassment for all of employees, including protection against known or foreseeable risks posed by clients or customers who enter the work environment.

Tax-Exempt Issues

Trimming the Tree . . . and the Gift Annuity Rates

Nonprofits should lower the rates they pay on charitable gift annuities by at least a half point starting next month, recommends the American Council on Gift Annuities (ACGA). The reason? The drop in the stock market, coupled with continued low interest rates and a decline in the yield on Treasury notes, says the ACGA. That means nonprofits are probably not making as much on their annuity assets but are still paying out the same rates as they've paid for the past several years. The ACGA estimates charities now earn an average return of 6.25% on their annuity investments, compared to 6.75% just a year ago. The ACGA also says most charities will receive only half the value of a gift annuity, as compared with nearly 90% that many charities received in more prosperous years.

Now's the time for your organization to review its charitable gift annuity assets and bring payout rates in line with earnings. A full chart of the recommended rates is available at www.acga-web.org. See also Nonprofit Alert® Memo, *Guidelines for Charitable Gift Annuities.* To order, see page 4.

Property Development Won't Affect Charity Status

A charity owned and managed a substantial amount of property but wanted to completely overhaul the property and re-develop it into a facility that would include rental spaces, which the charity would lease. The re-development would require the demolition of all existing buildings on the charity's property, many of which were under-utilized because of poor design or deteriorated conditions. The charity proposed to contract with independent firms for the actual demolition and construction work. In the alternative, the charity proposed to enter ground leases with commercial firms that would conduct some or all of the construction work. In either case, charity officials would review and monitor all construction plans. Leases on the completed facility would then be negotiated on the basis of gross receipts or

NPA Highlight of the Month

Year End To-Do List: Records Retention Policy

A record retention policy lacks the glamour of executive compensation, the urgency of fundraising, or the energy of board governance, but if neglected, it can become a crippling Achilles heal to the unwary organization. Every charitable organization, just like every business, should develop and implement a records retention plan that harmonizes federal and state record-keeping requirements with the organization's charitable purposes and activities. Besides compliance with legal record-keeping rules, a records retention policy helps reduce an organization's liability risk by preserving potential evidence, while disposing unnecessary or redundant materials in a precise, predictable and coordinated manner.

The Sarbanes-Oxley Act, which Congress passed this summer, imposes additional records retention rules on public companies and their accounting/auditing teams. It does not specifically address nonprofit organizations, but its requirements are instructive for what may lie ahead in the nonprofit world. A key provision places criminal liability on individuals who knowingly destroy documents or materials relating to a federal agency or bankruptcy proceedings. "Documents or materials" will most likely be interpreted to include electronic data, such as emails and metadata, which have been the subject of much records retention issues in recent years. "Metadata" is the electronic identification of a message's sender, recipient, and date of transmission. Advanced retrieval tools can now identify additional information contained in a message's metadata, including subject matter. This means that electronic records may, in some situations, create greater liability than paper records because electronic records are expected to be more complete and accessible.

Nonprofits that don't already have a records retention plan in place should develop and adopt one. Those that do should review it with an eye toward electronic records. Keep a list of all hardware and software the organization uses, along with a calendar log of destroyed data. If served with notice of a lawsuit, or if you reasonably expect a lawsuit to be filed, then immediately put all document destruction procedures on hold and consult legal counsel to avoid charges of unlawful data destruction.

With year-end fast approaching, now is a good time to review your record retention policy and make updates to implement in the coming year. Find more tips on developing a viable policy, along with a comprehensive list of what to keep and what to trash, in Nonprofit Alert® Memo, *Records Retention Policy*, available from Gammon & Grange, P.C. See ordering instructions on the back page.

sales expected to be generated by the leased property. A parking lot would also be constructed, but the charity proposed to lease that operation to a third party. The IRS ruled that the charity's proposed renovation plan did not endanger its exempt status, regardless of whether the charity itself managed the effort or whether the charity contracted with an independent firm. IRS LTR 200241050.

It was further determined that revenue from each of the rental activities would qualify as "rents from real property" that are excluded from unrelated business income pursuant to IRC §512(b)(3). This ruling will interest exempt organizations holding investment rental property, as it indicates what types of services connected with property rental the organization may provide without violating the "rents from real property" passive income exception to UBI.

Figures Confirm 2001 Donations Slacked Way Off

Experts warned of the impending decline for months but new data compiled by the *Chronicle of Philanthropy* now confirms their expectations: charitable giving dropped off last year to a gain of only 5.15%, after adjusting for inflation. To put that number in perspective, consider that charitable giving had been growing at an average rate of 11.4% from 1997 through 2000. The stock market slump and the weak economy are blamed for the lackluster showing. Some experts think the numbers would've been considerably worse if contributions had not increased in response to the Sept. 11 attacks. Nevertheless, many charities that posted big post-Sept. 11 gains still reported an overall decline for the year. Among those was the Salvation Army, which posted a 3.4% decline. An unrelated survey conducted by the Barna Research Group also reveals that the percentage of donors has dropped to its lowest level since the 1960's. In the 12 months ending in July, 2002, roughly 69% of Americans donated money to charity, compared to 80% who gave during that same time period in 2001.

More on the *Chronicle* report is available at http://philanthropy.com. Copies of the Barna survey are available at www.epsilon.com.

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Enjoy a Blessed Holiday Season!
from the
Staff of the Nonprofit Alert®

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