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Nonprofit Alert®

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

Inside This Issue of NPA

Music to Donors' Ears: Contribution for Composer Qualifies as Tax Deduction

Charities often encounter difficulties with well-meaning donors who want to benefit specific individuals with earmarked contributions. The issue arises more frequently in charities that authorize deputized fundraising or raise support for missionaries, students, or relief workers.

Donors cannot claim these contributions as charitable tax deductions because the charity merely acts as a conduit for the donation passing to an individual. To be deductible, a donor's contribution must benefit a charitable organization, not an individual . The charity must have full control and discretion over the contribution, unfettered by any commitment.

The donors' expressed interest made the donation look suspicious...

Favorite Composer

One couple seeking to support their favorite composer, almost stopped the music with their contribution. They first approached a nonprofit music consortium and proposed a contribution to commission a work by their favorite composer. The consortium hosted composer events, funded recordings, and commissioned musical works for performance. Prudently, consortium officials told the donors that the institution couldn't receive earmarked funds. Six months later, the donors made the contribution anyway without the earmarking and claimed the tax deduction.

Earmarked Donation?

After accepting the donation, the charity entered a commissioning agreement later that year with the same composer who the donors favored. The composer was paid a fee, plus expenses, for his work. The charity used the donors' contribution to cover the composer's fee and part of his expenses. This made the donors' contribution *appear* as if it had been impermissibly earmarked for the donor's private purposes, prompting questions about whether it was tax deductible for the donors. The IRS ruled that the contribution was deductible because the charity had correctly declined to receive earmarked funds, and recognized no obligation to honor the donor's interest in supporting the works of the their favorite composer.

The donors' expressed interest perhaps made the donation look suspicious, but at the time of the actual contribution, the donors had been clearly informed that the charity determined disbursements, without regard to the donors' interests. "[T]he common understanding was that the contribution would become part of the general funds...and would be distributed in the manner chosen by [the charity's] officers," the IRS concluded. IRS LTR 200250029.

The Moral of the Story

Two factors influencing the IRS's findings here were: 1) the charity sent a detailed thank you letter to the donors, disclaiming any assurances that the funds would be used for a particular composer; and 2) the charity selected composers only through a well-established selection process. Earmarked contributions may be received for projects or expenses already pre-budgeted by a charity, or for unbudgeted projects that the charity subsequently selects by following objective criteria and staying within the charity's exempt purposes.

For additional guidance refer to Nonprofit Alert® Memo, Donor Designated Gifts: Pitfalls & Provisos. See back page to order.

Liability & Risk Management

Nonprofits Ordered to Dissolve After Profiting Executive and Abandoning Charitable Purpose

Two Tennessee nonprofits have been ordered to dissolve because of multiple personal benefits collected by the founder, her family and friends. The Cherokee Children and Family Services organization, along with the Cherokee Children Nutrition program were ordered into court receivership to collect their assets for distribution to other charities. An investigation by the state attorney general revealed that the organizations' founder, WillieAnn Madison, engaged in frequent financial mismanagement, including use of charity credit cards for personal purchases, interest-free loans to family members, and lucrative contracts with commercial entities owned or managed by family members.

The "business judgment rule" applies only where boards make informed decisions in good faith.

On one occasion, the charities needed more space, so Madison personally purchased property and rented it to the charities, pocketing more than $500,000 in rental income. This was in addition to her $125,000 annual salary, plus $50,000 bonuses, and the annual $72,000 that the charities paid to her husband's accounting firm for bookkeeping. The court wrote that the facts of the case demonstrated "a consistent disregard of the fundamental nature of a nonprofit public benefit corporation." In defense, the charities argued that the "business judgment rule" prevented dissolution because the charities' boards made decisions that were reasonable under the circumstances. That rule applies where boards make informed decisions in good faith, the court wrote. "The rule does not apply when the director or officer has an interest in the decision, did not actually make a decision, or made an uninformed decision," the court concluded. *Summers v. Cherokee Children & Family Services*, No. 2001-00880-COA-CV (9/26/02).

The first line of protection against such abuses should be a thoughtful and well monitored conflicts of interest policy. See Nonprofit Alert® Memo, *Conflicts of Interest* for a sample policy and implementing board resolution. Ordering information appears on the back page.

"Do-Not-Call" Means One and All; Limited Exception Only for Charities

New telemarketing rules proposed last month by the Federal Trade Commission (FTC) impose significant limitations and penalties on professional telemarketing and fundraising firms, including those working on behalf of charities. The proposed rules would require those firms to maintain "do-not-call" lists of donors or other contacts who specifically request not to be called. Calling listed numbers will trigger fines up to $11,000 per call. Charities that conduct their own telemarketing with in-house personnel would be exempt from both the list maintenance requirements and the penalties, however. At least 27 states already maintain their own "do-not-call" lists, which would become part of the FTC's proposed national list.

These new rules have been prompted by the rapid spread of computer dialing, leading to an estimated 100 million telemarketing calls *per day*. More details are available on the FTC's web site at www.ftc.gov/bcp/conline/edcams/donotcall.

Volunteers Sue Foundation for Contract Breach

A group of volunteers in Washington state have filed a lawsuit against the Northwest Area Foundation, alleging breach of contract for failing to complete an anti-poverty program that the foundation initiated in the Yakima Valley region of the state. More than 300 volunteers signed onto the lawsuit, claiming $1.25 million in direct damages (i.e. the amount that the foundation allegedly promised as part of the anti-poverty initiative), plus triple damages for unfair and deceptive practices. The foundation supports a $150 million program aimed at fighting poverty in sixteen western communities. Last fall, the foundation cancelled its plans to move forward with the program in Yakima Valley, citing disagreements among various groups there. Foundation officials say they spent more than $750,000 in Yakima Valley during two years of a planning process that failed to yield measurable progress. The two sides will now resolve their differences in court.

At what point does exploration of potential projects create contractual liabilities for a charity?

This case raises several important legal issues: 1) what standing do volunteers have in these situations, and 2) at what point does a charity's exploration of potential projects become contractually binding.

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Tax-Exempt Issues

Camp Caretaker's Rent Doesn't Destroy Exemption

Services received in lieu of rental payments from a caretaker who lives on the property don't ruin a charitable organization's property tax exemption, says a Connecticut court. The ruling arose from a case involving a beachfront camp, owned by a local Girl Scout Council in East Haven, Conn. The camp included a beach cottage where the property manager lived. Although the camp operated only seasonally, the manager's duties were full-time, year-round. He was also available 24-hours a day for emergencies. The camp initially received a property tax exemption because it met the charitable exception, but the tax assessor later declared taxes retroactive to 1997, arguing that the Scouts were receiving rental income from the property manager in the form of his services rendered. Under a local statute (which is similar to many other state and local laws around the nation), property does not qualify for the charitable exemption if it generates rent. The assessor also asserted that the property manager's year-round services didn't further the charitable purposes of the Scouts since the camp operated for only a portion of the year. The court disagreed, finding instead that the camp required a full-time caretaker for security, maintenance, and other purposes—all of which furthered the Scout's charitable purposes, regardless of whether the camp was in session.

Although this case sets direct precedent only in Connecticut, many states apply some form of unrelated business income test to limit or deny property tax exemptions. This ruling buttresses the importance of residential managers or on-site caretakers who manage charitable properties, as essential players in helping accomplish an organization's charitable purpose.

NPA Highlight of the Month

Employee Internet Use: Improving Productivity or Increasing Liabilities?

Few workplaces function in this day and age without Internet access. The relative ease of using the Internet improves efficiency and productivity in everything from communication to research. But because it's so convenient, many employees also use the Internet to conduct personal affairs at work, which conversely *hampers* workplace efficiency and productivity. This activity may also expose an employer to liability, depending on the sort of Internet activity the employee conducts. Downloading pornography, for instance, could result in discrimination or harassment lawsuits; downloading music, movies, or other protected material could violate copyright laws. And of course, there's always the risk of downloading viruses or worms that could infect the employer's network.

The best protection against these electronic problems is to adopt and enforce a computer use policy. Commercially-available monitoring software can then be used to ensure compliance with the policy, or employers can simply rely on spot checks or internal reviews to ensure compliance. Whatever the approach, the policy should be clear with specific points that address:

- what items are considered property of the employer, such as office computers, laptops, and lists of email addresses; such property is provided strictly for business purposes of the employer;
- what material is off limits for downloading on work computers (i.e. material that's copyrighted, pornographic, harassing, non-work related, etc.);
- prohibitions against posting, sending, or receiving potentially offensive material to anyone inside or outside the organization;
- what degree (if any) of personal use employees are permitted on workplace computers during business hours;
- how workplace computer use will be monitored and/or penalized for violations (i.e. all email, bookmarks, Internet sites visited, etc. are subject to access by supervisors).

Think this all sounds too much like "Big Brother" for your organization? Consider the case of the employee who successfully sued for emotional distress after a co-worker downloaded pictures of a naked woman who's face resembled the employee. The co-worker showed others in the office, including several supervisors and managerial staff. No one stopped the circulation or reprimanded the action. An Ohio court said the incident didn't constitute harassment, but the company's actions were "deplorable" enough to merit the employee's emotional distress claim. *Hale v. Dayton*, No. 18800 (OH Ct.App. 2002).

Liability issues aside, a computer use policy is justifiable for productivity reasons alone. One recent survey found an overwhelming majority of Internet users prefer shopping online at work rather than home. For employers who think their employees only shop online during lunch hours, the same survey found that the peak of Internet shopping occurs from 10 a.m. - noon, and 3 - 5 p.m. in the afternoon. Surprisingly, the survey recorded a lull in shopping activity during the noon - 1 p.m. lunch hour!

Foundations Score Favorable IRS Rulings on Training Seminars and Classroom Construction

Two recent IRS rulings demonstrate the IRS's flexibility in evaluating taxable activities of private foundations. In the first ruling, the IRS approved a foundation's construction of classrooms and gymnasium for lease to a church. The foundation already maintained a lease agreement with the church on an additional tract of land and buildings, where the church conducted religious activities. The same lease terms would apply to the new classrooms and gym, prohibiting use of the facilities for anything other than exclusive religious purposes. Because rent would be set at no cost or a nominal amount, thereby producing no significant income for the foundation, the IRS said it furthered the foundation's exempt purposes of supporting arts, religion, health, and education nonprofits. The IRS also said the facilities could be excluded from the foundation's minimum investment return calculations since they were assets used to carry out the foundation's exempt purposes. In the second ruling, the IRS permitted a foundation to spend funds on the production of audio tapes, training materials and seminars for prison chaplains. The foundation's purpose was to support worldwide missionary work. Since the tapes and training were all used to advance religious purposes, the IRS said the expenditures were qualifying distributions, not taxable to the foundation. IRS LTRS 200246036 & 200251019.

Private foundations can be liable for tax penalties if they invest or spend assets in jeopardizing investments. "Program-related investments," such as those in the two cases above, are treated as exempt because they primarily accomplish one or more charitable purposes and do not produce significant income or appreciate the value of property.

President's Order Directs Federal Aid to Churches and Faith-Based Charities

Following the Senate's failure to pass faith-based initiatives during the last legislative term, President Bush has now signed an executive order directing the federal government to include religious groups among those considered for federal social service grants. The order says religious groups should be considered equally with other groups, meaning they can't be turned down for federal funds merely because of their religious nature or because they consider religion in their hiring practices. Those issues had been major sticking points in the faith-based legislation that failed to win Senate approval last term. Opponents claimed the proposal violated the constitutional separation of church and state. But advocates argued it created a "level playing field" for all nonprofit groups.

A summary of the executive order is available on the White House web site at http://www.whitehouse.gov/news/releases/2002/12/20021212-3.html.

Ordering Information: Memos referenced in the ***Nonprofit Alert*** can be purchased for $20 each ($10 for 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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