



Nonprofit Alert®

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

1. Nonprofit Overview

1.1 Landmark Case Preserves Pennsylvania Tax Exemption.

Washington and Jefferson College, a private four-year liberal arts college in western Pennsylvania, has retained its tax exempt status after the state supreme court ruled the college satisfied a five-prong test for public charities. The closely watched case endured numerous challenges and appeals since 1994 when the city tax assessor levied real estate taxes on 87 college properties, claiming the college did not qualify as an exempt organization. Coincidentally, the court's ruling was issued almost consecutively with a new state law that elaborates the five criteria for public charity status, which say an entity must:

- advance a charitable purpose (W&J's charitable purpose was the education of youth);
- donate a substantial portion of its services (W&J met this requirement by showing that at least half its educational services were provided free of charge, including tuition assistance and operating funds from an endowment);
- benefit a substantial and indefinite class of persons who are legitimate subjects of charity (approximately 82% of W&J's total aid to students was comprised of need-based grants);
- relieve some of a government burden (private colleges in Pennsylvania account for nearly 40% of the state's undergraduate enrollment; the court included W&J in this figure);
- operate free from private profit motive (W&J has operated as a nonprofit since its founding in the 18th century). *City of Washington v. Board of Assessment Appeals and Washington & Jefferson College*, 666 A.2d 352 (Pa. 1997).

★ **This case captured nationwide attention because Pennsylvania has been among the most aggressive states in trimming its tax exempt rolls. (See related quote at ¶7.1).**

1.2 *Inurement Governs Third Party "Insiders."* Prohibitions against private inurement may apply to any organization "insider," including third parties that a charitable organization hires to perform services for the organization, according to a long-awaited ruling by the Tax Court. The case involved the United Cancer Council (UCC), which lost its exempt status in 1990, retroactive to 1984 when it entered a contract with the professional fundraising firm of Watson and Hughey (which later changed its name to Direct Response Consulting Services). The IRS revoked UCC's exempt status because the

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contract gave the fundraiser substantial profit over a five-year period through multiple compensation channels. Insider status turns on the degree of control an individual exercises over an organization and not strictly a titular position, the court explained. Because the fundraiser had complete control over the organization's fundraising (including exclusive use of the organization's mailing list) and exhibited substantial control over UCC's finances, the court ruled the fundraiser was an insider subject to the private inurement prohibitions. *United Cancer Council v. Commissioner*, 109 T.C. No. 17.

★ **The court also determined that the fundraiser received excessive and unreasonable compensation because it earned \$8 million under the contract, while UCC received only about \$2 million of the funds raised.**

 **For help understanding the nuances of excessive compensation and the penalties for insiders, review NP9109-4, *The Essential Don'ts of Private Inurement*, and NP9608-1, *Avoiding the Snares of Intermediate Sanctions*. See back page to order.**

2. Liability & Risk Management

2.1 *Volunteer Looses Harassment Case Against Hospital.* A female student at Marymount College, a private New York college, cannot claim sexual harassment against the college or the hospital where she was assigned to a volunteer internship, the Second Circuit has ruled. The college arranged for the student to perform 200 hours of field work at the Rockland Psychiatric Center. For a period of five months, a hospital doctor subjected the student and other female employees to verbal sexual harassment. She complained to her hospital supervisor, but the harassment continued. Marymount eventually transferred her to another facility after

she complained to her instructor. It wasn't until the college brought the incident to the attention of hospital administrators that an investigation began, however. The student later sued the hospital for harassment under Title VII and Title IX, but the court said she was not an employee for purposes of Title VII, and the hospital was not an educational institution for purposes of Title IX; therefore, she could not bring a claim. *O'Connor v. Davis*, No. 728 (2nd Cir. 1997).

★ Although Title VII very loosely defines an employee as an "individual employed by an employer," the court said the term can only be applied to individuals who are "hired" and receive remuneration. The court also refused to impute the college's internship program to the hospital, which could have qualified the hospital as an educational institution subject to Title IX. Both these interpretations are important to organizations that rely on volunteers and/or personnel arrangements with other entities.

➡ Complex liability issues can arise whenever a nonprofit enters any kind of affiliation or collaboration arrangement with other entities. For a thoughtful discussion of the legal issues arising from such joint ventures, order *Beyond Collaboration*, free from the Center for Nonprofit Governance Boards, (202)452-6262.

2.2 Seven Arrested for Embezzlement at Goodwill Industries.

Police have arrested seven employees, all members of one family, on charges of embezzling hundreds of thousands of dollars from Goodwill Thrift Stores in Santa Clara County California. The employees reportedly took donated items and money from the Goodwill stores where they worked over a period of eight years. An investigation turned up more than \$400,000 in the possession of one of the accused, who admitted it was Goodwill funds, according to police. Another investigation found bank and investment accounts of nearly \$900,000 in the name of another accused. Goodwill claims the employees sold truckloads of donated goods from the back of one store and stole cash during busy periods at other stores.

➡ It's hard to screen out all bad apples, but internal controls can remove them from the barrel sooner. Implement the 39 steps of prudent internal controls explained in NP9106-2, *Accounting and Fiduciary Guidelines for Nonprofits*.

2.3 Legal Questions Prompt Request for Board Resignations.

The executive committee of the National Association for the Advancement of Colored People (NAACP) asked four of its

national board members to resign amid rising questions of legal trouble. One board member is under investigation for mishandling church funds at the religious nonprofit where he serves as president. Two others pled guilty to misdemeanor charges of grand larceny and embezzlement, while a fourth member was arrested for not paying child support.

★ The NAACP said it could not afford the damage to its reputation that would occur if the four remained on its board. The organization has also created a special panel to review its ethics code and recommend improvements. ➡ Rather than scramble for damage control after such embarrassing revelations, prevent their occurrence with resources like NP9107-1, *Responsible Governance by Nonprofit Board Members*, and NP9110-3, *Conflicts of Interest Policy and Resolution*.

3. Employees & Volunteers

3.1 Employee Drug Testing Must Be Without Pretext. An executive secretary, who was fired when she refused to take a drug test, has a legitimate claim against her employer for ordering a urine test on nothing more than testimony by two management employees, one of whom had a pretextual reason for ordering the test. The secretary submitted to pre-employment drug and alcohol testing at the time she was hired, but eight months later, she was ordered to test again. The company's employee handbook stated that employees could be tested whenever the employer "had cause to believe" they were under the influence of intoxicants. However, evidence suggested one of the managers who ordered the test did so out of spite for having been recently challenged by the secretary in a public meeting. *Kraslawsky v. Upper Deck Co.*, 65 Cal.Rptr. 2d 297 (Cal.App. 1997).

★ The court said the company's drug testing policy was constitutional as drafted in the employee handbook. The problem was in how the managers applied it in this case. Random drug or alcohol testing must be exactly that: random with no underlying suggestion of retaliation or punishment.

➡ For a summary of substance abuse issues facing nonprofits, including the components of a testing program, refer to NP9706-1, *Substance Abuse Prevention in the Nonprofit Workplace*. See back page to order.

3.2 Common Mistakes Hamper W-2's, Create Penalties. With W-2 Forms due next month, employers beware these common errors noted by the Social Security Administration:

- out-of-balance forms usually caused by using the wrong wage base or misplacing decimals;
- incorrect employee names and/or social security numbers, especially those that have changed due to marriage, divorce, etc.;
- incorrect or missing employer identification number (EIN);
- including titles or abbreviations, such as Dr., Mr., or Mrs.

★ Double-check these simple areas for potential mistakes. It could save your organization a bundle: penalties for incorrect or incomplete W-2's run as high as \$250,000.

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4. Tax-Exempt News & Issues

4.1 Writing on the Wall Generates UBIT. Advertisements for commercial products and services posted on a charity's office walls generate unrelated business income taxable to the charity, the IRS has ruled. The charity sought IRS approval for characterizing the income as rental proceeds from leases of ad space, which would not be taxable. But the IRS said the arrangement was like a taxable license instead of a lease because the commercial advertisers would not have "possession of the premises"; they would only have the charity's permission to use certain wall space. IRS LTR 9740032.

★ **In this clever characterization of income, the IRS once again defines the strict boundaries for UBIT. It is conceivable, however, that a good argument could be made for exempting certain ads that might contain information directly relevant to a charity's mission, but that argument was not raised here.**

 **If the idea of generating revenue from your blank walls is alluring, first consult NP9110-1, *A UBIT Primer for Nonprofits*, which shows how entrepreneurial activity may be safely conducted while avoiding UBIT. See back page to order.**

4.2 Tax Exempt Bonds More Popular as Finance Tool.

There's an emerging trend among 501(c)(3) organizations to use tax exempt bonds as financing tools for building or other capital projects, according to Kenneth Rogers of Standard & Poor's, who reports hundreds of organizations are currently engaged in some form of exempt bond arrangement. He notes

however, that cultural organizations make up the largest percentage of 501(c)(3)'s using this tool.

★ **Organizations considering bond offerings take note: the IRS launched hundreds of examinations into tax exempt bond offerings in recent years, according to Gerald Sack, branch chief of the IRS Exempt Organizations Division. Last year, the IRS even issued eight Technical Advice Memoranda on the subject.**

 **Although bonds may be an attractive revenue source, especially for capital projects, bond offerings are complex and should only be pursued with competent counsel. Review NP9109-2, *Avoiding Pitfalls When Nonprofits Issue Bonds & Other Securities*.**

5. State Rules & Regulations

5.1 California Shuts Down "Living Trust Mill." A lawyer who allegedly ran a "living trust mill" by using sales agents to sell estate planning services has been sued by the California Attorney General for aiding and abetting the unlawful practice of law. The lawyer provided materials for the agents, including a paralegal certificate, his bar association membership card, and his business license and resume. The Attorney General alleges that the lawyer's representatives did not know if the information they provided about living trusts was accurate or appropriate to individual circumstances.

★ **This case may clarify the boundary lines between the legitimate sphere of financial services and the**

NPA Highlight of the Month

Fumigating the Year 2000 Bug: What Works for Nonprofits

Most nonprofit leaders have at least heard about the "millennium bug" plaguing computer systems that can't recognize the year 2000 date. Some organizations are eradicating the bug by purchasing expensive new information systems. For those who merely want to "fumigate," many computer consultants are touting their wares. But for organizations that can't afford either solution, alternative measures must be considered. Purdue University has developed a model that many organizations—commercial and nonprofit alike—are exploring. The solution preserves all existing data, and it runs on the university's present system. A mass of computer codes had to be scanned and updated for the solution to work at Purdue, but university officials say they have spent about \$450,000 (mostly on salaries of employees who handled scanning), in lieu of millions of dollars to update or replace the university's entire system. The solution involves changing computers to read a "sliding century," which begins 74 years before the current year and ends 25 years later. This was less expensive, officials said, than adding new date fields to all their programs. Purdue sold distribution rights to Venture 2000, Inc., a Jacksonville, Fla. company, which now sells the solution commercially.

★ **Experts predict U.S. corporations and the government will spend around \$600 billion to upgrade or replace existing systems with year-2000 fixes. The problem arose because old systems were designed to save valuable memory space by dropping the first two digits of a year. When the year 2000 arrives, those systems will read it as "00," triggering a plethora of problems from late notices to data deletions. The most serious problems are predicted in large database programs, such as administrative and accounting systems. Most recent models of personal computers are not affected, although older software may develop glitches.**

 **Does your organization have a plan yet for fumigating the millennium bug? Experts advise organizations against making new system purchases before adequately addressing a plan for the year 2000 problem. And by all means, don't plan on devising a fix to the year 2000 problem while at the same time trying to install new software programs and train employees. Plan ahead and avoid headaches—only 730 days left!**

unauthorized practice of law. Charities and their donors should be careful not to rely on financial planners for legal advice or document preparation in the course of estate planning.

5.2 Florida Favors Phone Freebies for Philanthropies. The Florida legislature recently passed a tax exemption for telephone services to religious institutions. Under the new law, no city, county, or municipal taxes will apply to telephone services for any church or religious institution that is already exempt from Florida sales taxes. FL Code §166.231(5).

6. Gifts & Fund Raising

6.1 Charitable Remainder Trusts Get Timing Reprieve. The IRS has revised its earlier plan to change the timing of annuity or unitrust payouts due to noncharitable beneficiaries of charitable remainder trusts (CRTs). Originally, IRS regulations permitted those payouts to be made "within a reasonable period" after the close of the tax year. But some practitioners abused the rule by using it to delay first year payments until after the first tax year closed, then characterize them as nontaxable distributions on which no tax was owed. This essentially allowed one year's worth of tax free payments to noncharitable beneficiaries. In proposed rules, issued earlier this year, the IRS planned to require payouts by the end of the tax years in which the payments were due. However, the IRS said it received numerous complaints regarding the undue burden this change would place on non-abusing CRTs. The Taxpayer Relief Act also made the timing changes unnecessary. IRS Notice 97-68.

★ For these reasons, the IRS is allowing CRTs created before January 1, 1998 to make their payouts for the 1997 tax year within a reasonable period of time after the close of the tax year if they meet certain additional requirements. However, the IRS continues its consideration of the timing amendments for future tax years, starting with 1998.

6.2 Catalog of Charities Showcases Little-Known

Groups. A group of grantmakers and philanthropists in Massachusetts is

trying a novel approach to public relations: an 80-page catalog highlighting the state's community foundations and small charities that otherwise couldn't afford the luxury of such marketing on their own. Each charity receives a brief description, plus a summary of their specific needs. A toll-free telephone number and an enclosed form are provided with the catalog so readers can respond directly. The catalog grew out of a project by the Boston Foundation to encourage charitable giving among Massachusetts residents, who are among the wealthiest in the nation but rank near the bottom in giving, according to IRS data.



The catalogue is available from the Ellis L. Phillips Foundation, 29 Commonwealth Ave., Boston, MA 02116, or at: www.agmconnect.org/catalog1.

7. Executive Items of Interest

7.1 Quote of the Month. "COLLEGES AND UNIVERSITIES CAN LEARN FROM OUR EXPERIENCE ... AND ACT TO COMBAT THE PERSISTENT DANGER OF CHALLENGES TO THEIR TAX EXEMPTIONS. MOST IMPORTANT, THEY MUST PAY MORE ATTENTION TO BUILDING GOOD COMMUNITY RELATIONS." — Brian C. Mitchell, President of the Association of Independent Colleges and Universities of Pennsylvania, commenting about the three-year legal battle Washington & Jefferson College waged against local tax authorities to secure its exempt status. (See related story, ¶1.1, above).

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