

# Nonprofit Alert®

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

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## New Legal Trend Continues;

### Court Upholds County Fundraising Law

A federal district judge in Florida has upheld a county law that requires charities and professional fund raisers to register before conducting solicitations in the county. Florida already imposes state solicitation registrations on charities, but this law, passed by a *county* government, imposes additional requirements on charities that operate or solicit in Pinellas County. Opponents argue the law is unreasonably burdensome and redundant for charities that already comply with state registration. But county officials insist the law is necessary to curb fraudulent fundraising. The law was challenged by American Charities for Reasonable Fundraising, a coalition of national charities and fundraisers.

★ A growing number of cities and counties have adopted similar ordinances in recent years. This case highlights arguments on both sides, but local governments will likely view it as a strong boost of support for city and county registration laws. Expect more local oversight as a result. This means charitable solicitation will no longer depend solely on requirements set by 51 state jurisdictions, but on an additional estimated 7,000 local governments as well.

## Nonprofit Overview

### In Rare Personal Liability Case,

### Trustees Pay \$1.5 M. From Their Own Pockets

Eighteen former trustees of Adelphi University in New York have agreed to pay about \$1.5 million to settle charges that they neglected their fiduciary duties by approving extravagant salaries and spending for the university's former president, Peter Diamandopoulos. The trustees were all removed from office in 1997 by a state board, and their replacements promptly dismissed Diamandopoulos. (NPA, Apr'97). Several protracted lawsuits then followed, including one by the New York Attorney General that sought to hold the trustees personally liable. The lawsuit charged the trustees for a number of failings, including

- neglect of responsibilities and violation of fiduciary duties;
- failure to properly oversee and monitor the president's salary;
- failure to review the president's job performance; and
- misspending "to support a lavish lifestyle" for the president.

★ Although the trustees never admitted any wrongdoing, they did accept personal liability. That alone makes this settlement unusual, since trustees rarely face *personal* risks. Let this be a reminder for all nonprofit leaders to take their fiduciary obligations very seriously.

→ Need help explaining these obligations to your leaders? Order copies of NP9209-1, *Legal Duties of Nonprofit Directors* and NP9107-1, *Responsible Governance* for all your board members and trustees. Ask about discounts on multiple copies when you call Gammon & Grange to order.

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## Liability & Risk Management

### Foundation Agrees to Periodic Review by State AG

The Andy Warhol Foundation for the Visual Arts and the New York Attorney Generals Office have reached a settlement that requires the foundation to open its accounting records for periodic state reviews. The foundation also agreed to reorganize its entire financial management operation. Established by the pop art icon Andy Warhol, the foundation controls millions in art and real estate left after his death in 1987. Although the attorney general had been investigating the foundation since 1990, no criminal charges were filed. Instead, the settlement requires the foundation to take certain drastic steps, including:

- hire a new chief financial officer to oversee the foundation's financial management operations;
- form an audit committee and empower it with appropriate oversight responsibilities;
- adopt stricter internal accounting and control procedures; and
- and submit the foundation's accounting and finance records to periodic review by the state attorney general's office. @Reuters Online, 12/7/98; Phil News Digest, 12/9/98.

**★ Although state investigations like this are fairly common, the settlement provisions are somewhat unusual because they permit what could amount to a significant degree of state oversight and involvement in the foundation's operations.**

→ Whether this signals a trend toward increased state regulatory oversight isn't clear just yet. What is clear, however, is the critical need for nonprofits to implement and enforce appropriate internal controls. NP9106-2, *Accounting and Fiduciary Guidelines* can help. See back page to order.

### Ticket Takers Toil Over Tiny Tax Technicality

If the sales ticket says it includes taxes, then the seller is liable for remitting sales tax, regardless of whether an exemption may actually apply, says the Texas Comptroller of Public Accounts in upholding a surprisingly stringent decision by an administrative law judge. The judge reviewed an audit appeal by a theater owner who had been shouldered with fines, penalties and back taxes on ticket sales to events staged by exempt organizations. The theater contracted with several nonprofit organizations to use its facilities. The nonprofits set their own ticket prices, and all net proceeds from ticket sales went directly to the nonprofits sponsoring the events. The theater printed and issued tickets as

part of its contracted services to the nonprofits. However, the theater used the same ticket stock for exempt and non-exempt events because its equipment (which was industry standard) could not generate different tickets. As a result, each ticket included the language, "Price and taxes incl." Because of that phrase on the tickets, Texas authorities argued the money was collected as a tax and, therefore, belonged to the state. They pointed to a state law that says "any person who receives...any money represented to be a tax...is liable to the state for the full amount collected." The judge ruled, and the state comptroller confirmed, that the theater was liable for taxes despite the fact that the tickets would otherwise have been exempt from sales tax. TX Comp. of Public Accts., Hearing #36,775 (10/20/98). @ EOTR Wkly, 11/30/98, p. 56.

→ **This lesson is so obvious it's often disregarded: Nonprofits that engage in exempt sales or contract with third parties to do so, must carefully review every aspect of the selling activity, right down to something as arcane as ticket language. The activity may be exempt, but the manner of the sale can create a tax liability for you or your contractor.**

## Employees & Volunteers

### ADA Claim Without Disability—A Tricky Question

Even though a plaintiff isn't disabled, he may sue an employer under the Americans With Disabilities Act for asking prohibited questions about disabilities on an employment application, according to the Tenth Circuit. Randy Griffin applied for a job with Steeltek, a manufacturing firm, but was not hired. Griffin filed suit against the firm, alleging an ADA violation because two questions on the employment application were discriminatory. The questions were, "Have you received Worker's Compensation or Disability Income payments..." and "Have you physical defects which preclude you from performing certain jobs..." A lower court granted summary judgement for Steeltek because Griffin was not disabled, did not claim a disability, and therefore could not argue disability discrimination. However, the Tenth Circuit reversed, reasoning that "it makes little sense to require an employee to demonstrate that he has a disability to prevent his employer from inquiring as to whether or not he has a disability." *Griffin v. Steeltek, Inc.*, No. 97-5103 (10th Cir, 10/29/98).

**★ The ADA specifically prohibits employment inquiries about disability-related issues unless the inquiry is job-related or justified by a legitimate business necessity.**

→ **Is your organization's employment application legally compliant? Use NP9306-1, *Updating Your Employment Application* to assess its strengths and weaknesses. See back page to order.**

### Where Does All the Money Go, Employers Wonder

For every dollar employers spend on payroll, they spend another 25 cents on employee benefits, according to the "1998 Survey of Employee Benefits," compiled by the *Business and Legal*

#### Nonprofit Alert®

8280 Greensboro Drive, 7th Floor, McLean, VA 22102-3807  
(703) 761-5000 Facsimile: (703) 761-5023

E-mail: npa@gandglaw.com

Editor-in-Chief ..... George R. Grange, II

Editor ..... Sarah J. Schmidt

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*Report.* That figure doesn't vary much from one region to another, nor does it vary from the profit to for-profit sectors. But it does vary with size, which has special significance for nonprofits since they tend to be small employers.

★ **Nearly 30% of small businesses (i.e. less than 100 employees) including nonprofits, don't offer health insurance, which significantly reduces employee benefit costs.**

## Tax-Exempt Issues

### **Eat, Drink & Be Merry . . . But Don't Expect Exemption!**

Just because a burger and beer joint gives money to charity that it raises from selling lottery tickets doesn't entitle the entity to exempt status, the Second Circuit says. In upholding an earlier Tax Court ruling (*NPA*, Nov.'97), the court refused to overturn an IRS denial of exempt status to KJ's Fund Raisers, Inc., a nonprofit founded by the owners of a bar in Vermont called KJ's Place. Since 1993, the organization sold lottery tickets to bar customers, who also bought food and drinks at the bar. The lottery sales accounted for \$12,000 in salaries to the bar's owners, who were original officers of the organization, plus \$6,000 in rent to the bar. But the organization also distributed over \$12,000 to state and local charities in recent years. Nevertheless, the court said the organization operated primarily

to attract new patrons to KJ's Place and to discourage existing customers from leaving—neither of which constituted a legitimate exempt purpose. *KJ's Fund Raisers v. Commr.*, No. 97-4317, (2nd Cir, 10/29/98). @CCH Std Fed Tax Repts, 12/3/98, para 50869; EOTR Wkly, 11/30/98, p. 53.

→ It was the organization's close relationship with KJ's Place that raised concerns in this case. To avoid private benefit questions like these, nonprofits should closely monitor any arrangements they make with third parties to make sure they're absolutely necessary in advancing their exempt purposes, rather than the private goals of the third party.

### **Stock Appraisals: Savvy Donors Should Know**

Taxpayers cannot claim a charitable deduction for contributions of nonpublicly traded stock they made to a church and a foundation because they did not have the stock appraised. Instead, they claimed deductions based on the stock's fair market value at the time they made the contributions. The taxpayers claimed a total of \$121,000 in deductions over a two year period for donations of stock in an accounting firm, but the IRS only allowed deductions up to the taxpayer's basis in the stock, which amounted to barely a fraction of their claim. The Tax Court accepted the IRS decision, and the Fourth Circuit affirmed, finding that the taxpayers "utterly ignored" the appraisal requirements and failed to make even a good faith attempt to comply with the tax code. *Hewitt v. Commr.*, No. 98-1386 (4th Cir, 11/19/98). @CCH Std Fed Tax Repts, para 50880, 12/3/98.

### **NPA Highlight of the Month**

#### **Although Not Overly Prevalent, Charity Fraud Takes a Toll on Nonprofits**

Despite the media attention to stories about abuses and mismanagement in the charitable world, charity fraud infects only a fraction of the amounts Americans donate to worthwhile causes on an annual basis, according to recent figures released by the Federal Trade Commission (FTC). The danger, however, is in the way most Americans give. An AARP study shows 80% of Americans over the age of 25 made charitable contributions in 1997, but a majority of those donations were made through telephone or mail solicitations. FTC statistics put total charitable contributions made in 1997 at \$143 billion, but only one percent of that amount was tainted by fraud. Taken together, the two studies reveal interesting patterns in giving that may explain some of the criminal motivation for bilking well-meaning donors. The sheer amount in available funds alone is enough to entice most criminal-minded, but coupled with easy access through telephone and mail, it's really surprising that charity fraud accounts for only one percent. The AARP study also revealed that most donors didn't even know what their donation would be used for, how much of their contribution would actually be used for charitable purposes versus administration costs, or whether the solicitors they talked to were legitimate representatives of the organizations they claimed to represent. Charity fraud hurts all nonprofits by creating distrust and frustration among donors. The FTC estimates it's on the increase, as the number of charities grows nationwide. Legitimate charities can help by keeping their own fundraising efforts above board and by educating their donors about fraud. @ Phil Journal Alert, 12/4/98 & 11/18/98.

★ **In the long run, the more your donors know about recognizing fraud and how to report it, the more you'll protect your organization and the nonprofit community. AARP offers these suggestions for donors: (1) always ask phone solicitors their name and employer; if they refuse such information, simply hang up; (2) ask phone solicitors to send confirmation of the organization's exempt status in the mail; and (3) keep in mind that charities rarely send couriers to pick up your contribution or pledge, so don't hand over donations to strangers.**

→ The FTC offers tips for avoiding fraud and an online complaint form for consumers to report suspicious fundraising tactics. Access it at <http://www.ftc.gov/ftc/complaint.htm>. The National Fraud Information Center at <http://www.fraud.org> also provides information on charity scams.

★ Ironically, the taxpayers owned Jackson Hewitt Tax Service, Inc., a profitable East Coast accounting firm, which presumably had extensive professional knowledge of the appraisal rules. Another interesting twist came later when Jackson Hewitt stock began trading on NASDAQ. This alleviated any future needs for appraisals, but it did nothing to relieve the taxpayers' earlier burden.

 The appraisal rule has been in effect since 1984. Donations of nonpublicly traded stock with a claimed value in excess of \$10,000 must be properly appraised in order to claim a tax deduction.

### **IRS Rules Associate Member Dues Not Taxable**

Dues collected by exempt membership organizations from associate members are not taxable as unrelated business income (UBI) so long as the organization hasn't created or used the associate member category solely to produce income, the IRS says in new ruling. The IRS adopted that position as early as 1995, but recently expounded on it in a ruling requested by a professional 501(c)(6) trade association. The association consisted of active members from a certain business community, plus associate members from trades supporting that community such as transportation and equipment dealers. Associates enjoyed all the same membership benefits as active members except they could not vote or hold office. Total associate member dues accounted for less than 20% of the association's overall income from dues. In fact, the association's interest income from savings was actually more than the income it collected from associate members. Because the association provided no special benefits to associates, the IRS concluded the associate member category was not established to produce income and, therefore, did not create UBI. The IRS also noted that associates were encouraged to participate in the association's trade-related activities. IRS TAM 9847001. @ EOTR Wkly, 11/30/98, p. 55; ASAE Inroads, 12/3/98, p. 1.

★ IRS TAMs like this one cannot be used as precedent, but they offer helpful guidance in understanding the issues and facts the IRS considers most pertinent.

### **State Rules & Regs**

#### **California Applies Simplified Religious Exemption**

The state supreme court says an entity need not be organized as a religious corporation in order to qualify for the religious exemption under state employment law. The ruling came in a discrimination case brought by an employee against a hospital owned by the Roman Catholic Church. The hospital claimed a religious exemption, but the employee argued the hospital wasn't even organized under the state's Nonprofit Religious Corporation Law, and could therefore be liable for discrimination. But the court said the exemption didn't depend on religious incorporation or, for that matter, incorporation at all. *McKeon v. Mercy Healthcare Sacramento*, S054783, (CA SCt., 11/9/98). @ N'al Law Journal, 11/30/98, p. B11.

#### **Hawaii Looks to Nonprofits for New Tax Revenue**

A proposal under consideration in the state legislature would impose a general excise tax on all nonprofits. A similar measure failed in past legislative sessions, but this current effort is being led by the new speaker-elect of the house, Rep. Calvin Say (R). @ ASAE Inroads, 12/3/98, p. 2

#### **New Jersey Lifts Taxes on Volunteer-Run Stores**

A new law exempts volunteer-run stores from collecting sales taxes on donated merchandise sold to consumers, if the stores are operated by charitable organizations. Legislators also added language to the state charitable solicitation law that prohibits fund raisers from making statements, even if "literally true," that have the "capacity to mislead consumers." Penalties range from \$7,500 to \$15,000 for each violation. NJ S.158 & S.1055. @ Chron of Phil, 12/3/98, p.30.

**Quote of the Month.** "TAX DEDUCTIONS ARE A MATTER OF LEGISLATIVE GRACE. TAXPAYERS SEEKING THE BENEFIT OF A DEDUCTION MUST SHOW THAT EVERY CONDITION WHICH CONGRESS HAS SEEN FIT TO IMPOSE HAS BEEN FULLY SATISFIED." — *Hewitt v. Commr.*, No. 98-1386 (4th Cir, 11/19/98). See a more detailed discussion of the case, p. 3.

**The Check's In the Mail ... Or Is It?** The IRS reports that over 99,000 refund checks totaling more than \$68 million were returned last year for insufficient or wrong addresses. The average check was \$690. Despite that staggering amount of returned mail, the IRS *did* deliver 82.8 million refund checks averaging \$1,346 each in 1997. @ CCH Std Fed Tax Repts, 12/3/98, p. 7.

 Think one of those checks belonged to you? Call the IRS at (800) 829-1040, then make arrangements to have your next refund check direct deposited!

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