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Nonprofit *Alert*®

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

Inside This Issue:

Legal List

Plus...

NPA Highlight of the Month:

"So Long, Charitable Split Dollar Plans"

— page 3 —

Intermediate Sanctions

IRS Fines Health Care Nonprofits $83 Million

Wielding its taxing power under the intermediate sanctions law, the IRS has imposed $83 million in fines on three tax-exempt health care companies and five of their officers for grossly undervaluing the companies before selling them to a for-profit organization, which was controlled by the nonprofits' officers. The officers filed eight lawsuits in tax court, claiming a CPA valued the conversion transactions fairly and reasonably. But, IRS Exempt Organizations Division Director Marcus Owens called it "a looting of the charities by individuals with substantial influence over them."

As a result, the IRS also retroactively revoked the companies' tax exemptions. Congress passed the intermediate sanctions lawin 1996, expanding the IRS's revocation powers to include the imposition of additional penalties on a tax-exempt organization and its managers if excessive benefits inure from the organization to insiders. The law allows the IRS to tax managers at 10% of the excess benefit, up to $10,000. Recipients of excess benefits are taxed at 25%, plus another 200% if the offense continues

Before approving transactions with insiders, nonprofit boards should follow the IRS-prescribed process for establishing a "presumption of reasonableness" described in Nonprofit *Alert*® Memo 9608-1, *Avoiding the Snares of Intermediate Sanctions.* See back page to order.

Trust Pays IRS $9 Million; Retains Exempt Status

The Bishop Trust, one of the wealthiest trusts in the U.S., will pay more than $9 million to settle a tax dispute with the IRS. In exchange, the trust will retain its tax-exempt status.

Trustees of the estate allegedly paid themselves exorbitant salaries and diverted $350 million to unrelated business ventures, many of which benefitted the trustees and their families. They reportedly neglected the trust's only beneficiary, the Kamehameha School for students of native Hawaiian ancestry.

The settlement requires the trust to establish checks and balances, including a conflicts of interest policy and an annual audit to limit trustee power. The trustees will provide fiduciary oversight but will no longer handle daily operations. The trust also agreed to refrain from prohibited political campaign activity and to document all its communications with legislators or legislative offices.

Founded by Hawaii's last princess in 1883, the Bishop Trust is estimated at $10-billion with wide-ranging investments from real estate to banking (*NPA*, Nov. '98). The settlement does not resolve all the trust's legal problems. The IRS may yet impose penalties on trustees who derived excess benefits. The trust's profit-making ventures could also face sanc-

® ® ® ® New Trademark Rates ® ® ® ®

Beginning this month, the U.S. Patent & Trademark Office (PTO) increases several trademark filing fees. The following fees are *effective January 10, 2000*: Application for Registration, per class – $325; Request for an Extension of Time to File a Statement of Use, per class – $150; Section 9 Renewal Application, per class – $400; Section 15 Affidavit of Incontestability, per class – $200; Petition for Cancellation, per class – $300; Notice of Opposition, per class – $300. All other fees remain unchanged.

Liability & Risk Management

Mormon Copyright Decision Weakens Internet Links

A federal court in Utah has temporarily enjoined two critics of the Mormon Church from posting Internet addresses on their web site. The judge ruled that the critics engaged in contributory copyright infringement when they posted the addresses of web sites featuring pirated copies of the Mormon Church Handbook of Instructions. Although it did not provide direct links to the other sites, the disputed web site "actively encouraged" browsers to infringe the Church's copyright, the judge decided. This ruling could severely curtail the freedom of many web site operators and may ultimately stifle the common practice of web site linking. However, this decision is only binding in the federal district of Utah. As such, it does not necessarily reflect how other courts would decide similar cases involving Internet linkage.

Nevertheless, it is a good practice to seek permission before posting web site addresses or links on your web site. Carefully evaluate all linked sites to ensure they do not make unauthorized use of any copyrighted material. For more information about general principles of copyright law, see Nonprofit *Alert*®Memo 9208-2, *Copyright Law: Your Rights and Responsibilities.* Turn to the back page to order.

Church Liable for Volunteer Offenses Off-Premises

A church in Washington state was found liable for failing to supervise a church deacon who sexually abused several children at the church. At least one elder of the church knew the deacon had been accused of molesting children at his previous church, but did not take any preventive action. The church allowed the deacon to work with children and did not screen or supervise him. The church argued it should not be held liable for incidents that occurred off the church premises, but the court disagreed. The church had a special duty to protect its children against acts of abuse, the court ruled. "[W]here a special protective relationship exists, a principal is not free to ignore the risk posed by its agents, place such agents into association with vulnerable persons it would otherwise be required to protect, and then escape liability simply because the harm was accomplished off premises or after hours," the court said.

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Responding to the church's First Amendment defense, the court stated, "The First Amendment does not provide churches with absolute immunity to engage in tortious conduct." *C.J.C. v. Corp. of Catholic Bishop of Yakima*, 985 P.2d 262 (1999).

The court also discussed the elder's statutory duty to report known or suspected childabuse to state authorities. Nonprofit *Alert*®Memo 9611-2, *State Child Abuse Reporting Laws*, provides an overview of these reporting laws. For general preventive principles regarding hiring and supervising employees and volunteers, review 9611-1, *Preventing the Risk of Child Abuse*, and 9402-1, *Minimizing Liability in the Employment Process*. See ordering instruction in the box on the back page to order one or all three memos.

Eviction Ensues in Greater Ministries Pyramid Saga

Greater Ministries International (GMI), a church in Tampa, Florida that ran an alleged pyramid scheme, has been evicted from its offices by a Florida court and forced into bankruptcy. As **Nonprofit *Alert*®** reported previously, GMI allegedly defrauded thousands of investors by promising to double their "gifts" within two years. Instead, church insiders allegedly used investors' money to pay themselves inflated commissions and reimburse other investors. Seven GMI leaders face federal trial on 20 counts of fraud, money laundering, and conspiracy. Two GMI officials have already been sentenced to ten-year prison terms. According to the *Tampa Tribune*, a bankruptcy trustee, court-ordered receiver, and the U.S. Attorney's Office are all working to track down some $500 million invested with GMI, which they fear is stashed in overseas accounts, buried, or otherwise impossible to find.

To follow continuing developments in this story, visit the *Tampa Tribune* web site at www.tampatrib.com.

Employees & Volunteers

Sick Leave Smolders in the Ashes of Employment

Three firefighters in Sullivan, Indiana, voluntarily resigned from their employment, then asked the city to compensate them for 1,500 hours of accrued sick leave. When the city refused, the firefighters sued. An Indiana court ruled the firefighters were not entitled to compensation, pointing to the city's sick leave policy, which allowed a firefighter to use sick leave only when ill, injured, or when immediate family was ill or injured. The court concluded that sick leave is not a benefit that **automatically vests when earned.** *Killion v. City of Sullivan*, No. 77A01-9711-CV 379 (Ind. Ct. App., 1998).

State law generally determines whether employees are entitled to compensation for accrued sick leave. Otherwise, written contracts and/or employee policies may resolve the question. An organization's sick leave

policy should address which employees are eligible for sick leave, what conditions trigger an employee's right to sick leave, and whether an employee's sick leave can accumulate and carry over from year to year.

First Amendment Trumps Anti-Discrimination Law

A federal appellate court has ruled that the First Amendment prevents a clergy member of a church from bringing a discrimination claim against the church, even if the church's actions are not based on religious doctrine. A former associate minister of a United Methodist church was fired after taking maternity leave in 1996. Because of complications with the pregnancy, the minister required additional time off. Upon her return to work, she was informed that her position had been terminated. She filed a complaint with the Equal Employment Opportunity Commission (EEOC), which dismissed her complaint but granted her the right to sue. The minister argued she was fired on grounds that involved discrimination. But the court saw it differently. The constitutional mandate to preserve the separation of church and state overrides the congressional mandate to eliminate discrimination in the workplace, the court decided. Critical to the ruling was the court's determination that this case dealt with the church's internal management rather than an individual's practice of faith. "A church must have the freedom to select those who will carry out it's mission," the court concluded. *Combs v. Central Texas Annual Conf. of United Methodist Church,* 173 F.3d 343 (5th Cir. 1999).

The constitutional protection churches enjoy from government interference in employment matters does not extend to most other religious organizations, which are prohibited under the Civil Rights Act of 1964 from discriminating on the basis of sex, race, or national origin. Some religious organizations are entitled to make employment decisions solely on the basis of religion, but this exemption is very narrow. For details, review Nonprofit *Alert*®Memo 9103-1, *The Right of Religious Employers to Select Employees on the Basis of Religion.* To order memos, see info on the back page.

Tax-Exempt Issues

IRS Seeking Greater Web Site Consciousness

Nowadays, it seems like everyone has a web site. The rapid increase in Internet activity by tax-exempt organizations has the IRS reassessing its rules. IRS officials recently announced they will review how unrelated business income tax and corporate sponsorship rules should apply to advertisements, pricing information, sponsorship banners, and links to for-profit organizations that nonprofits post on their own web sites. Current tax laws are largely silent regarding electronic communications of these types. An announcement providing Internet-related guidance and asking for input from the exempt community may be forthcoming from the IRS in the next few weeks. Robert Harper, Chief of IRS Technical Branch, emphasized that current tax-exempt rules still apply to exempt organizations that operate exclusively on the Internet, including the obligation to apply for IRS recognition of exempt status. He suggested that an "online church" likely would not qualify as a "bona fide church" under IRS rules and, therefore, would probably be required to apply for recognition of exemption.

NPA Highlight of the Month

Legislation Bans Charitable Split Dollar Plans

The controversial insurance plan known as "charitable reverse split dollar insurance" has drawn political disfavor and may be nearing its demise. Congress recently passed legislation (H.R.1180) that effectively abolishes such insurance plans, and at press time, President Clinton was expected to sign the bill. Under a typical plan, the donor makes an unrestricted "gift" to a charity, which uses the gift (usually the exact amount of the gift) to pay life insurance premiums for the donor's life insurance policy. The donor takes a tax deduction for the "gift." The charity ultimately collects a portion of the insurance proceeds at the donor's death. The new legislation prohibits tax deductions for donors who contribute to split dollar plans if there is "an understanding or expectation" that a charity or any other third party will directly or indirectly pay any premium on any insurance policy owned or connected with the donor. The legislation would subject a participating nonprofit to an excise tax on the premiums paid by the nonprofit on "any life insurance, annuity, or endowment contract" connected with the donor. The IRS has questioned the legality of charitable split dollar plans and has even denied tax-exempt status to an organization that intended to finance its operations through such plans. (*NPA*, Mar. '99).

In all transactions with donors, a nonprofit must receive sufficient value without generating private benefit to its donors. Otherwise, the charity could incur excise taxes under the intermediate sanctions law. Although charitable reverse split dollar plans may disappear from the market, they will surely be followed by other tax planners' creative attempts to use charities as tax sheltering vehicles for their clients' wealth. Before a nonprofit participates in such a novel arrangement, it should first check with legal counsel to assess the potential risks involved (*e.g.*, excise taxes, revocation of exemption, loss of donor's tax deduction, etc.).

Pending further IRS guidance, nonprofits should assume that income-producing activities, paid advertisements, joint ventures with for-profit partners, and/or web site links to for-profit organizations could result in UBIT, intermediate sanctions, or even the loss of exempt status. Thus, nonprofits should either avoid these activities until further IRS guidance is available or consult legal counsel before proceeding.

Parking Garage Sends UBIT Underground

A medical school may build a parking garage and collect reasonable parking fees without generating unrelated business income (UBI) or jeopardizing its exempt status. The IRS determined that the school would be operating the garage primarily for the convenience of its students, faculty and patients, rather than for its own profit. Thus, the parking garage contributed importantly to the school's exempt purpose and did not violate tax law or generate taxable UBI. IRS LTR 199949045.

For more information on how to determine whether a nonprofit's entrepreneurial activities generate unrelated business income, see Nonprofit *Alert*® Memo 91109-1, *A UBIT Primer for Nonprofits.*

State Rules & Regs

Missouri: Summer Camps Swim in Sales Taxes

The Missouri Supreme Court has ruled that five summer camps operated by a nonprofit organization are subject to sales tax because they are places of recreation. Each of the camps' activities is designed to teach Christian principles in addition to improving athletic skills. The organization argued that because its primary purpose is educational, its camps should not be subject to sales taxes. The court pointed out, however, that much of the organization's promotional literature touted "perfecting the art of having fun," and described camper recreation rather than education. *Kanakuk-Kanakomo Kamps, Inc. v. Director of Revenue*, No. SC81365 (MO, 12/7/99).

Texas: Making A Legal List and Checking It Twice

Texas has denied a sales tax exemption to a §501(c)(3) charitable organization because a defect in its organizing documents violated both state and federal law. The organization's bylaws provided that upon dissolution, the organization's assets would be distributed at fair market value to any for-profit organization or individual. This was prohibited by state and federal law. Instead, the documents should have stated that upon dissolution, the organization's assets would be transferred to the state or to an educational, religious, charitable, or other similar organization qualified under §501(c)(3) of the Internal Revenue Code. *Texas VOA Elderly Housing, Inc. v. Montgomery County Appraisal Dist.*, 990 S.W.2d 938 (Tex. App. 1999).

To qualify for both state and federal tax exemption, nonprofit organizing documents should comply with applicable law and recite certain tax-exempt restrictions and requirements. IRS Publication 557, *Tax-Exempt Status for Your Organization,* describes language the IRS requires to be included in organizing documents before it will recognize exempt status. Order this publication from the IRS at (877) 829-5500.

Ordering Information: Memos referenced in the ***Nonprofit Alert*** are $20 per memo *prepaid* ($10 for firm clients). Five or more copies of the same memo are bulk priced at $5 each.
Subscription Information: Subscriptions to the ***Nonprofit Alert*** are $75/year, $130/two years. Additional subscriptions to the same organization are $25 each/year. Subscriptions for 100 or more may qualify for additional bulk discounts. Send inquiries to: Editor, ***Nonprofit Alert***, 8280 Greensboro Dr., 7th Floor, McLean, VA 22102-3807;(703) 761-5000; npa@gandglaw.com.

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