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Nonprofit *Alert*®

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

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Tax Court Ruling:

Ministerial Housing Not Limited to FMV

In a major reversal, the Tax Court has ruled that a ministerial housing allowance isn't includable in taxable income even if the allowance exceeds the fair market value rental of the minister's home. The case involved Rev. Richard Warren, author of popular religious books including *The Purpose Driven Church* and *The Power to Change Your Life.* Warren is also the senior pastor at Saddleback Valley Community Church, which he founded in 1980.

From 1993-1995, Warren received considerable housing allowances from the church, which he excluded from income on his tax returns. However, the amount excluded exceeded the fair rental value of his home by about $20,000 per year.

The IRS claimed the ministerial housing allowance permitted under §170(2) of the tax code is limited to the lesser of the amount actually used to provide a home or the fair market rental value of the home. Thus, the IRS assessed tax deficiencies on over $60,000 and levied penalties against Warren, citing the excess amounts claimed during the three tax years in question.

But the Tax Court disagreed with the IRS, finding that the tax code does not specifically limit the housing allowance to the lesser of fair market rental value of the home or the actual amount used to provide the home. Instead, the court drew a contrast between §170(2), which covers ministerial rental allowances, and §170(1), which covers church-provided parsonages. The court explained, "§170(1) limits the exclusion to the rental value of a home furnished as part of a minister's compensation. In contrast, no fair rental value limit is stated in §170(2) or the regulations issued thereunder."

> **"... neither §170(2), the regulations promulgated thereunder, nor the related legislative history, limits the amount that may be excluded from income as a parsonage allowance under §170(2) to the fair market rental value of the residence occupied."**
> — *Judge John O. Colvin, writing the majority Tax Court opinion .*

The IRS argued that the court's decision would make the two sections of §170 unequal, but the court was unpersuaded. The court pointed out that the IRS's position would impose a compliance burden on ministers who would be required every year to produce an estimate of the rental value of their home in order to know how much was excludable under §170(2). *Richard D. Warren, et al, v. Commissioner,* 114 T.C. 23 (5/16/00).

Do you provide ministerial housing allow-ances? If so, now would be an opportune time to conduct an audit of benefits, eligibility criteria, and documentation. Learn more with Nonprofit *Alert*® Memo, *Ministerial Housing Allowances: Qualifying and Documenting.* See

~ ~ ~ Pace of Charitable Giving Slowing? ~ ~ ~

The annual report by *Giving USA* that tracks trends in America's charitable giving suggests the pace of donations is slowing. In 1999, Americans gave $190 billion to charitable causes, reflecting a 6.7% increase over 1998 totals. However, that increase was somewhat less than the increases from the two prior years (i.e. 9% in 1998 and about 10% in 1997).

For more details about the study, Contact the American Association of Fundraising Counsel Trust for Philanthropy at (888) 544-8464 or on the web at http://www.aafrc.org

Liability & Risk Management

E-Signatures: No Longer Sign on the Dotted Line

Consumers and businesses will soon be able to rely on electronic signatures with the same legal certainty that written signatures provide, under legislation passed last month by the House and Senate. President Clinton supports the measure, but at press time, the bill was awaiting his signature before it becomes law. Under the new measure, consumers may use electronic signatures only after they consent to receiving records over the Internet. Companies must verify that consumers have a functional email address and the technical capacity to receive information before entering consent agreements. The bill does not permit certain legal documents such as eviction notices or health insurance lapses to be transmitted electronically, regardless of the consumer's consent.

Known as the Electronic Signatures in Global and National Commerce Act, the bill is the product of much negotiation between Congressional and administration officials to correlate similar bills passed last year. Read its full text at http://www.house.gov/commerce.

FBI Investigates Charity Officer for Missing $6.9M

The FBI is accusing the chief administrative officer for the American Cancer Society's Ohio division of embezzling $6.9 million from the charity and transferring the funds to an overseas bank account. The FBI alleges that he wired money on May 30 to an Austrian bank with instructions to distribute it as a research grant to a specified beneficiary. Six days later, the FBI discovered that the beneficiary and grants were both fictitious. Upon investigation, they also learned the officer lacked appropriate authority to make wire transfers. An FBI complaint filed in federal court charges the officer with bank fraud, which carries a maximum penalty of 30 years in prison and $1 million in fines.

Cozy Condo Causes Concern; But IRS Says Okay

Directors of a private foundation may donate one of their condominium units to the foundation without incurring any excise taxes or self-dealing penalties, the IRS has ruled. The foundation operates a small art gallery. The two directors purchased a five-unit condominium and planned to donate the largest unit to the foundation so it could relocate and expand its art gallery. The directors planned to use two of the other condo units as their personal offices. Other members of the foundation's board also loaned personal pieces of art for display in the gallery. The IRS ruled that neither the loans of artwork nor the donation of the condo unit would result in any taxable expenditures because both activities were in furtherance of the foundation's educational purposes. IRS LTR 200014040.

Review the private foundation prohibitions against self dealing with Nonprofit *Alert*® Memo, *The Essential Don'ts of Private Inurement*. See back page to order.

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Employees & Volunteers

Chairman's Dual Role Threatens Charitable Gift

Because the attorney who drew up the donor's will was also the chairman of the board at the hospital to which the donor left her entire estate, a New York court has ordered a full trial on the potential conflict so that a jury may decide whether the donor's gift was genuine or the result of fraud and undue influence. The saga began in 1980 when Arlene Edel's lawyer drafted her first will. In 1985, the lawyer joined the board of Olean General Hospital. Later that same year, he drafted another will for Edel, which left a 30% residuary bequest to the hospital. Over the course of the next several years, that same lawyer drew up a total of nine different wills for Edel, with the final one leaving everything to the hospital and disinheriting her only son. When Edel died in 1996, her estranged son and granddaughter challenged the will, claiming the lawyer and the hospital exerted undue influence on Edel and that the lawyer violated his attorney-client privilege. The case is pending trial. *Estate of Edel*, 700 NYS 664, 182 Misc.2d 878 (Surrogate's Ct., Cattaraugus Cty., NY, 12/8/99).

The lesson: If your charity has an active development program, don't permit your development officers to draft gift instruments for donors without first making sure that donors retain their own independent legal counsel.

Supreme Court Flushes 5th Circuit's ADEA Ruling

The Supreme Court has overruled the Fifth Circuit to find in favor of a 57-year old plumbing employee who claimed he lost his job as a result of age discrimination. At trial, Sanderson Plumbing Products, Inc., a manufacturer of toilet seats and supplies, introduced evidence showing that Roger Reeves was terminated for failure to maintain accurate attendance records. The Fifth Circuit accepted the company's argument and rejected Reeves' claim, ruling that the evidence he presented was insufficient to establish age discrimination. But Reeves claimed the company's argument was merely a pretext for age discrimination. He cited numerous derogatory comments made by his supervisor, and also produced evidence showing his record keeping was accurate. In reviewing the record, the Supreme Court reversed the Fifth Circuit and ruled that a plaintiff's prima facie case of discrimination, combined with sufficient evidence for a reasonable fact finder to reject the employer's nondiscriminatory explanation for its decision, may be adequate to sustain a finding of liability for intentional discrimination under the Age Discrimination in Employment Act

(ADEA). *Reeves v. Sanderson Plumbing Products, Inc.*, 197 F.3d 688 (6/12/00).

Employee termination is perhaps the most risk-ladden decision any nonprofit CEO will make. Some 30% to 40% of all nonprofit insurance claims arise from personnel decisions. To review smart steps, order Nonprofit *Alert*® Memo, *Wisely Managing Employee Terminations.* To rehearse the unique nuances of the ADEA, order Nonprofit *Alert*® Memo, *Avoiding Employment Discrimination in the Nonprofit Organization*. See back page to order.

Tax-Exempt Issues

Sharing Assets: The Lawful Union of Two Charities

A park authority, formed as a §501(c)(4) social welfare organization, may keep its exempt status intact even if it establishes a §501(c)(3) public charity to build and manage a convention center on its property and shares its assets for a short time with the charity, the IRS has ruled. The park authority planned to enter an agreement with the charity to share personnel and assets, including office space, equipment and supplies during the construction period for the convention center. The charity agrees to pay a fair price for these assets and has the right to terminate the arrangement on 30 days' notice. The IRS noted that all payments were reasonable; neither party unduly benefitted from the arrangements. As such, the IRS approved the share agreement without any adverse consequences for either party's exempt status or UBIT concerns. IRS LTR 200022056.

A §501(c)(4) social welfare organization can "marry" a §501(c)(3) charity but pre_nuptial planning is essential. All transactions between the two must be arms length. Most importantly, the charity may not lend or grant its resources to indiscriminately benefit the §501(c)(4).

Tea for Two: Good for Marketing; Bad for Taxes

Operating a profitable gift shop and tea room will not jeopardize the exempt status of a charitable womens organization, but it will create taxable unrelated business income, the IRS has ruled. The charity was formed to assist "industrious and meritorious" underprivileged women by providing a marketing and retail source for their handicrafts through a consignment store founded and managed by the charity. In addition, the charity opened a gift shop and tea room adjacent to the consignment shop to attract more customers. The charity admitted that the only purpose for the gift shop and tea room was simply to draw customers, which in turn, increased sales and provided more revenue for the charity to conduct its exempt function. However, neither facility provided any direct assistance to the charity's needy women clients. The gift shop and tea room sold retail merchandise and meals in competition with commercial vendors. The IRS concluded the activities would not "disturb" the charity's exempt status, but because the activities furthered a substantial nonexempt purpose, income generated from them would be subject to UBIT. IRS TAM 200021056.

NPA Highlight of the Month

Charities Tune Into Radio Possibilities

Earlier this year, the Federal Communications Commission (FCC) authorized the creation of two new kinds of low-power, noncommercial radio stations to serve "under represented groups," such as minorities and the underprivileged. Only nonprofit groups including churches, schools and community organizations, would be eligible for licenses. One class of stations would broadcast at 100-watts and reach a geographic area of about 3.5 radius miles, while the other class would broadcast at only 10-watts and reach barely one to two miles. Typical commercial radio stations broadcast at 100 watts or more. The FCC's decision caught the attention of charities nationwide, especially those serving local constituents with whom communications are difficult or limited, like new immigrants and the elderly. The idea was for small charities to use such broadcast tools as an effective, inexpensive way to reach their local communities, but the plan ran into snags almost immediately. In April, the House of Representatives passed a bill that cuts back on the FCC's authority to issue licenses for these low-power stations. The National Association of Broadcasters and National Public Radio have also registered opposition to the plan, claiming the low-power stations could interfere with their members' high-power signals. A compromise bill has been introduced in the Senate that would allow the FCC to license some low-power stations but with additional limitations that address signal interference. Meanwhile, the licensing process, with staggered licensing periods per state, began in May and will continue through February 2001.

To learn more about the FCC's new low-power plan for charity radio stations, visit the FCC's web site at http://www.fcc.gov. Gammon & Grange, P.C. also publishes *Broadcast Alert,* a monthly newsletter highlighting FCC issues and developments important to charity broadcasters. If you'd like to receive a free copy of this newsletter, contact the Gammon & Grange offices at GG@GandGLaw.com or call us at (703) 761-5000 and ask to be placed on the mailing list.

IRS Okays Split-Dollar Deal for Exec Compensation

A private foundation may offer its president a compensation package that includes split-dollar insurance, the IRS has determined. The deal requires the foundation to carry term insurance on the president, providing a death benefit twice the amount of his salary. The foundation will share the cost of paying the insurance premiums with the president. Both the foundation and the president will then receive a portion of the proceeds upon the president's death, if he dies while employed by the foundation. The foundation favors the arrangement because it provides guaranteed insurability and eliminates the need to buy additional insurance every time salaries increase. The foundation also claims the arrangement is less expensive than an alternative group term insurance policy, and the deal does not cause the president's overall compensation package to be unreasonable. The IRS determined that the proposed arrangement would not affect the foundation's exempt status nor create any self-dealing issues. IRS LTR 200020060.

This split-dollar deal is not to be confused with the controversial plan known as "charitable reverse split-dollar insurance," which was recently outlawed by Congress (see *NPA*, Jan'00). Under those prohibited plans, donors made unrestricted "gifts" to charity, which used the gifts to pay insurance premiums for donors, who then took deduction for the "gifts."

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State Rules & Regs

California Bingo Fee Deemed Unconstitutional

The California Court of Appeal recently ruled that counties cannot impose a fee on nonprofit organizations based on the percentage of gross receipts they receive from bingo games. A provision in the state constitution specifically forbids nonprofit license taxes or fees measured by income or gross receipts. The county argued that a bingo fee was not the same as a "license tax or fee" under the statute because bingo was not "a usual and legitimate business." The court rejected this argument, however, and ruled the fee unconstitutional. *Arden Carmichael Inc., et. al. v. County of Sacramento* (CA Ct.App., 4/13/00).

Idaho Taxes School Greenhouses, Despite Teaching

Palouse Hills Adventist School, a private religious school teaching kindergarten through eighth grade, owns greenhouses in which bedding plants and perennials are grown for wholesale to retailers in the local area. The school also uses the greenhouses to teach students about the greenhouse enterprise, including hands-on growing experience and marketing. Total revenues from the sale of plants was nearly $100,000 but only five percent of the proceeds went directly to the school. The remainder paid for the ongoing operation and upkeep of the greenhouses. A local tax board levied property taxes on the greenhouses, and the school appealed. But the state board of tax appeals upheld the tax levy, finding that the greenhouses were not used exclusively for educational purposes since they were also used to grow plants for retail sale. *Appeal of Palouse Hills Adventist School*, (ID Bd.Tax App., 3/2/00).

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