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Nonprofit Alert®

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

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Intermediate Sanctions

Nonprofit's Directors Pay $5 M. in Penalties

The directors and officers of a nonprofit home healthcare organization must pay more than $5 million in penalty excise taxes for their participation in an excess benefit transaction, the Tax Court has ruled.

The long-awaited ruling consolidated several pending cases involving the Sta-Home Health Agency of Jackson, Miss., which challenged the IRS's assessment of taxes on various disqualified individuals stemming from Sta-Home's conversion to a for-profit corporation.

Conversion to For-Profit

Established in 1976 by Joyce & Victor Caracci, the Sta-Home organization operated successfully for more than 20 years as a nonprofit, growing into the leading home healthcare provider in Mississippi. In 1995, following changes to Medicare payment rules, Sta-Home decided that conversion to a for-profit would better preserve the organization's financial stability and make it competitive in the changing healthcare environment.

Sta-Home's attorney obtained two appraisals before commencing the conversion, although neither appraisal addressed the value of intangible assets. Members of the Caracci family were named as officers and directors of the nonprofit. All assets and liabilities of the nonprofit were transferred to the new corporation, in exchange for payments that Sta-Home executives believed met or exceeded fair market value, based on the appraisals.

Intermediate sanctions provide adequate penalties and afford the corrections necessary for "undoing the excess benefits" . . .

Fair Market Value Dispute

On subsequent review, the IRS determined that the fair market value of Sta-Home's assets far exceeded the consideration paid by the for-profit corporation because intangible assets and other issues were not properly assessed. This produced an excess benefit transaction for the family members, resulting in a $42 million IRS assessment of sanctions, penalties, and interest.

Sta-Home presented testimony from a valuation expert that directly contradicted the IRS's valuation results. After a lengthy and complex analysis of various valuation methods—and without wholeheartedly embracing either party's approach—the court concluded that Sta-Home's fair market value had been underestimated.

The court's ruling resulted in personal liability for each of Sta-Home's officers and directors for payment of some $5,164,000 in excess benefits. The for-profit corporation was also held liable for payment of the taxes and penalties owed.

No Revocation of Exemption

However, the court stopped short of revoking Sta-Home's prior tax exemption (which could have created even greater tax liabilities). Instead, the court determined that the intermediate sanctions penalties were adequate in this case because they afforded the corrections necessary for "undoing the excess benefits." The court noted that leaving Sta-Home's tax exemption intact provided the officers and directors

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… Tax Exempt Organizations Increasing Steadily …

The number of 501(c)(3) organizations increased by 5.6% last year, according to the IRS. In 2001, 865,096 charitable organizations were registered with the IRS, up from 819,008 in 2000. That number doesn't include most churches and other religious organizations because they aren't required to register, although some religious groups voluntarily register with the IRS. See more at www.irs.gov/taxstats.

Liability & Risk Management

Shelters Spared Liability for Resident's Misconduct

A federal district court in New York has relieved two homeless shelters of liability for injuries a pedestrian received when a resident of the shelters pushed him in front of a subway train. The resident had been diagnosed as a paranoid schizophrenic, undergoing treatment shortly before the incident occurred. The ppedestrian claimed the shelters and the mental health professionals who treated the resident should've recognized the danger and made reasonable attempts to protect the public. But the court said the shelters had no duty to the public because they lacked control over the resident and, therefore, were not responsible for his behavior. The court allowed the pedestrian's claims against the health professionals to proceed, however, because a question of fact existed regarding their level of control over the resident and whether they could have predicted his behavior. The professionals were not associated with the homeless shelters, but provided treatment in a separate facility. *Rivera v. NYC Health & Hospitals Corp.,* No. 00 Civ. 5279 (2002).

A "special relationship" can create the duty to warn the public about a dangerous person.

Whenever an organization undertakes an obligation, a duty may arise to protect others from harm, but this depends on the extent of the responsibility, the expectations created, and whether the harm can reasonably be foreseen. When a nonprofit begins a program, it should consult legal counsel and insurers to evaluate any risk for harm that might forseeably arise and determine what duty may be triggered.

Unfavorable Feedback: Statutory Immunity Protects Nonprofit CEO Acting in Good Faith

The president of a nonprofit corporation is protected from legal liability by statutory immunity when sued for actions that arise out of his official duties, a state appeals court in Georgia has ruled. The president had been sued for tortuous interference with an employment contract after he complained about an insurance agent, who was eventually transferred to another position because of poor performance. The president's complaints were central to the agent's bad job ratings, causing the agent to claim the president intentionally interfered with his employment. However, the president acted only at the request of his organization's board, which had voted unanimously to request another insurance agent because the agent in question was not serving the organization's needs. The court ruled that statutory immunity protected the president from liability in this case because he was acting only in the performance of his official duties in making the complaint that led to the agent's transfer. The court found no wrongful intent and determined that the president acted only in good faith. *Culpepper v. Thompson,* A02A0887, (GA Ct.App., 4th Div., 2002).

Many states provide some sort of statutory immunity for nonprofit executives acting in their official capacities, but the lines are often drawn tightly and include requirements of good faith. With competent counsel, review statutory immunity in your state, and consider adjusting D&O insurance appropriately.

Employees & Volunteers

Hostile Workplace Charges Aren't Time Sensitive

The Supreme Court has ruled that discrimination claims alleging a hostile work environment are not limited to the statutory filing deadlines if, among all the acts that contribute to the hostile environment, at least one occurs within the deadlines for filing the claim. But discrete acts of discrimination or retaliation that occur outside the statutory time period are not actionable alone, the Court ruled. The case involved an Amtrak employee who alleged specific instances of racial discrimination and hostile environment, throughout his career. Most of the alleged acts, including racial jokes and epithets, fell outside the filing period, but some occurred within the period. The Court ruled that it does not matter if some acts fall outside the statutory filing period because a hostile environment claim—unlike other discrimination claims— "consists of separate acts that collectively constitute one 'unlawful employment practice'." "Provided that an act contributing to the claim occurs within the filing period, the entire time period of the hostile environment may be considered," the Court concluded. *N'al Railroad Passenger Corp. v. Morgan,* No. 00-1614 (6/10/02).

A hostile environment claim can proceed, so long as the hostile behavior continued into the filing period.

Title VII requires a plaintiff to file a charge within either 180 or 300 days (depending on whether a state agency is involved) of the date the alleged discrimination occurred. As with many areas of prohibited discrimination, prudent employers must work with legal counsel to adopt policies that expressly prohibit all forms of discrimination. See Nonprofit Alert® Memo, *Employment Discrimination: Steering Clear in the Nonprofit Organization,* for help. Ordering instructions appear on page 4.

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State Court Affirms Rights of Religious Employers

Upholding a long line of religious freedom cases, the California Supreme Court has ruled that a Catholic organization may fire an employee for espousing views that, while common to many Christian denominations, were deemed inconsistent with the institution's religious message and practices. The court ruled unanimously that the CHW Medical Foundation, a Catholic-run hospital, could lawfully discharge a file clerk who repeatedly disobeyed his supervisor's instructions to stop trying to "save souls" at his workplace. The employee had claimed religious discrimination and won over $150,000 in damages from a lower court, but an appeals court later overturned the ruling. The state supreme court rejected his claim, relying on the ample body of law upholding the constitutional right of religious organizations "to define themselves and their religious message." That fundamental right includes the right to hire and fire employees based on what the court called their "objectionable religious speech in the workplace." Although this case sets no new precedent, it is important because California courts are often thought to narrowly construe the rights of religious organizations.

Silo v. CHW Medical Foundation, 02 C.D.O.S. 4236 (5/16/02).

This judicial interpretation could have far-reaching implications for other religious workplace policies, such as employer-required statements of morality or behavior. For this reason, religious organizations should carefully review their organizing documents, policies, and practices to ensure they are on firm ground when asking employees to refrain from activities contrary to the religious beliefs of the organization. Consult Nonprofit Alert® Memo, *Hiring & Firing: Rights of Religious Employers*, for a more detailed explanation of what religious employers can and cannot require. See back page to order.

At-Will Employee Wins on Retaliatory Discharge

An anesthesiologist associate, employed by a medical firm, has won damages for lost wages and emotional distress arising from a retaliatory discharge, the 7th Circuit held. The associate discovered that the firm's shareholders were falsifying Medicare billing reports to collect higher reimbursements. When he mentioned this to the shareholders, he was given an unsatisfactory performance review. He documented additional discrepancies and raised the issues again with the shareholders, who told him he would be discharged at the end of the year. He then threatened to report the alleged fraud, and the shareholders terminated his employment immediately, telling him he was an at-will employee and they could discharge him at anytime. Claiming retaliatory discharge, the associate sued and was awarded damages, but the court vacated the verdict and dismissed his complaint. On appeal, the 7th Circuit ruled the associate was entitled to the damages, even though he was an at-will employee, because his discharge was in violation of public policy—namely, retaliation for discovering unlawful conduct. *Brandon v. Anesthesia & Pain Mgt. Assoc., Ltd.,* 2002 WL 63796 (7th Cir. 2002).

At-will employees serve "at the will" of their employers, meaning they may be discharged at any time without cause. However, courts balance this doctrine with certain countervailing principles, such

NPA Highlight of the Month

Supreme Court Strikes Down Local Solicitation Ordinance

A local ordinance requiring organizations to register and obtain permits before conducting door-to-door canvassing violates the First Amendment, the Supreme Court ruled last month in a case that had been closely watched by the nonprofit community. The Village of Stratton, Ohio, passed an ordinance in 1998 prohibiting "canvassers" and others from "going in and upon" private residential property to promote any "cause" without first obtaining a "Solicitation Permit."

Watchtower Bible & Tract Society, a Jehovah's Witness organization, challenged the ordinance on constitutional grounds, claiming it was overbroad and restrictive. A lower court allowed the village to amend the ordinance and narrow its reach, then upheld it as amended. The 6th Circuit affirmed, but the Supreme Court disagreed.

Relying on a long line of historical case rulings that protect the right of religious, political and other groups to canvass door-to-door, the Court said the breadth of speech affected by the ordinance and the nature of the regulation itself made it unconstitutional. The interests the village sought to serve in passing the ordinance—namely the protection of its residents against fraud, crime and invasion of privacy—were legitimate government interests, but their importance did not outweigh the preservation of First Amendment rights, the Court said. *Watchtower Bible & Tract Society of New York, Inc. v. Village of Stratton,* No. 00-1737 (6/17/02).

Interestingly, the Court said it might have ruled differently had the ordinance "been construed to apply only to commercial activities and the solicitation of funds." In that instance, the Court said the government interests of fraud, crime and privacy protection would arguably justify the ordinance. That dicta seems to suggest the Court distinguishes between door-to-door advocacy and solicitation, although in practice, the lines often blur between the two. Consider, for example, the organization that conducts an annual membership drive by canvassing communities with literature describing its charitable mission, and in that context, also describes its need for financial support. Would the Court more likely uphold a restrictive solicitation ordinance against that organization as opposed to the Jehovah's Witnesses here?

as the public policy that protects whistleblowers, which is what worked in the employee's favor here.

Tax-Exempt Issues

Good Food, Good Fit: Restaurant Compliments Nonprofit Maritime Village's Mission

A restaurant and meeting hall, operated by a charity that also maintains a reconstructed 19th century maritime village, will not endanger the charity's exempt status, the IRS has ruled. Both facilities were open to the public, but were operated in tandem with the maritime village. The restaurant helped attract visitors and enabled the village to operate more efficiently by allowing employees to remain on its premises for meals. The IRS said this contributed importantly to the village's exempt function and would, therefore, not produce liability for unrelated business income tax (UBIT). The meeting hall also produced rental income, which did not generate UBIT, so long as any additional services provided were "those usually and customarily rendered in connection with the rental of rooms or other space for occupancy only." IRS LTR 20022030.

Foundation's Rural Grants Aren't Taxable, IRS Says

Grants that a private foundation makes to individuals for projects in rural communities do not create any tax problems for the foundation, the IRS has ruled. The foundation planned to select up to 25 individuals annually to receive grants that would help fund various charitable projects being conducted in the individuals' communities. The grants could not be used for personal gain, wages, salary, or educational costs, but they could be used for a wide variety of other costs associated with the charitable activities, including supplies and travel. Grant recipients were required to account separately for the money received and submit annual financial statements to the foundation. Additional periodical reports were also required, including status updates on the progress of the charitable programs to which the grants were applied. Because the grants were all carefully structured to fund only charitable programs, the IRS said they presented no adverse tax consequences for the foundation. The grants were not considered taxable expenditures, nor did they constitute an act of self-dealing, the IRS concluded. IRS LTR 200221051.

Intermediate Sanctions ..... *(continued from p. 1)*

with "a means of correction" whereby the excess benefits could be transferred back to the exempt entity, placing it "in a financial position not worse than it would be if the disqualified persons had observed the proper standards." Michael T. Caracci, et.ux., et al. v. Commissioner, 118 T.C. 25 (5/22/02).

Does your organization give proper attention to excess benefit transactions and the potential liabilities they create for disqualified individuals? Learn more with Nonprofit Alert® Memo, *Intermediate Sanctions Law,* available from Gammon & Grange, P.C. See ordering instructions below.

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