



# Nonprofit Alert®

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

## 1. Nonprofit Overview

### 1.1 *Travel Tours: IRS Makes UBIT Limitations Official.*

The IRS has finally issued regulations warning when travel tour activities, conducted by tax exempt organizations, constitute unrelated business activity, subject to taxation (UBIT) on any net income produced. The key is whether the travel tour is substantially related to the exempt purpose of the organization. To make this determination, the IRS will look to:

- all the relevant facts and circumstances of each case;
- whether the activity constitutes a trade or business; and
- in some cases, rely on the "fragmentation rule," which says some tours may be taxable while others by the same organization are not. In other words, the IRS will evaluate each tour individually, even if the tour is offered within a larger sphere of exempt travel tours.

The regs offer several examples that emphasize the necessity of linking the tour to an organization's exempt purpose. For instance, an educational institution should relate the tour to its educational purpose by designing the tour with a scheduled curriculum and instruction. See the related comment at ¶7.1, below. IRS Prop. Reg. 121268-97.

★ These regs represent the IRS's first comprehensive treatment of an issue that has long burdened educational institutions, museums, associations and other nonprofits that offer travel tours (see *NPA*, Feb. '97). Previously, the IRS had only issued individual revenue rulings addressing particular organizations. The regs won't become final until after the IRS receives public comments, but they're a good precursor of the final version.

➡ If your organization offers travel tours of any kind, now is the time to assess your UBIT risks. Order NP9109-1, *Converting Your Annual Audit Into Vital Risk Management* (see back page to order), then contact the attorneys at Gammon & Grange to conduct a thorough audit aimed at preventing UBIT.

1.2 *Internet Taxes Halted by Moratorium Legislation.* Last fall, *Nonprofit Alert* reported attempts by a number of states to enforce sales taxes on both the access to and the sale of items offered over the Internet (*NPA*, Dec. '97). Some of these proposed taxes could apply to products and services offered via

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the Internet by nonprofits. Now, the House Commerce Committee has passed a bill imposing a 3-year moratorium on all new Internet access and/or service taxes. The bill, which passed the committee with a unanimous 41-0 vote, now goes to the House floor for debate.

★ The Senate is also considering a broader bill that would impose a 6-year moratorium on all Internet taxes. Proponents want the Internet to grow unfettered by tax burdens, but opponents say local governments are being deprived of crucial taxes while electronic commerce prospers.

➡ If your organization sells products or services over the Internet, or plans to do so in the future, encourage your congressional representatives to support the Internet tax moratorium. Watch *NPA* for updates!

## 2. Liability & Risk Management

2.1 *Cancer Charity Cleared of Financial Wrongdoing.* The California Attorney General's office has announced that it found no evidence of financial mismanagement or other wrongdoing at The City of Hope, a Duarte, Calif. charity devoted to fighting cancer. Two former employees had accused the organization of mishandling funds. However, one of those employees has reportedly been under FBI investigation since 1996 for allegedly attempting to extort funds from the charity. The charity has an annual budget of about \$250-million. Charity officials say the former employees have threatened to

smear the organization with bad publicity if they don't receive payoffs.

 **NP9106-2, *Accounting and Fiduciary Guidelines for Nonprofits*, can help keep your organization “in the clear.” See back page to order.**

**2.2 Director Personally Liable for Fiduciary Duty to Creditors.** The 1st Circuit says a director can be personally liable for violating a fiduciary duty to creditors if he pursues personal interests that are inconsistent with his duty of loyalty to the corporation. The case involved a corporate director who recommended a radical restructuring of his struggling company so that a bank foreclosure would force its sale of assets to another company and thereby eliminate its debts. After the restructuring, the director collected a \$200,000 consulting fee for his role in the process. One of the creditors then brought suit, alleging the director breached his fiduciary duty by collecting the fee. A lower court disagreed, but the 1st Circuit reversed and found that the consulting fee raised questions of a breach, so the case was remanded. *Ed Peters Jewelry Co., Inc. v. C&J Jewelry Co., Inc.* 124 F.3d 252 (1st Cir. 1997).

 **Practitioners note a judicial trend expanding respondeat superior, making all employers—including nonprofits—liable for more employee activities. Understand the implications with NP9402-1, *Minimizing Liability through Responsible Hiring & Supervision*. See back page to order.**

### 3. Employees & Volunteers

**3.1 Defamation: A \$1.2-Million Yard Sale Bargain?** The Philip Morris company learned a costly lesson when it fired a sales representative for allegedly selling company products at a yard sale. The company relied on written statements by other company employees, which implicated the sales rep in the wrongdoing. But the company never investigated the allegations or gave the rep an opportunity to rebut them. Company policy specifically prohibits employees from selling company products or incentive items at yard sales or other private venues. At trial, evidence revealed that a company supervisor had actually requested certain employees to make the statements, which weren't even written until months after the alleged yard sale. When the sales rep sued for defamation, the company claimed the statements were all intra-office communications protected by a qualified privilege. But the court found that Philip Morris abused the privilege because it “acted with malice” toward the sales rep, making the company liable for lost wages and benefits, mental anguish and

suffering, plus punitive damages all totaling over \$1.2-million. *Gibson v. Philip Morris, Inc.*, 685 N.E. 2d 638 (Ill.App.Ct. 1997).

★ **This case shows how costly a defamation suit can be. Although this dispute involved a large commercial corporation, nonprofits face the same charges—only the outcome can be much worse if a nonprofit's good name is damaged by the publicity such a case generates.**

 **Although a leave of absence may not be required for employees with substance abuse problems, federal law imposes other responsibilities on employers. Know what applies to your organization with NP9706-1, *Substance Abuse Prevention in the Nonprofit Workplace*. See back page to order.**

**3.2 A Meal Ticket to Taxes: Employer Liable For Withholding.** American Airlines owes withholding and FICA taxes on per diem meal payments and credit card vouchers it provided to flight crew members, so ruled the Court of Federal Claims, upholding a six-year old IRS assessment against the airline. The case has implications for all employers, including nonprofits that offer similar benefits to employees. Prior to 1988, American did not report as income or collect withholding taxes on meal tickets, in-flight meals, or credit card vouchers that it gave flight crews, nor were the crew members required to substantiate their expenses. American argued the payments fit any of three characterizations, all of which the court and the IRS rejected because:

- First, they were not per diem payments since they lacked an adequate link between the actual cost of meals and the amounts American paid its employees.
- Second, the payments were now working condition fringe benefits because the airline didn't reasonably believe employees kept records of their expenses so they could be deducted from their incomes; and
- Third, the payments could not qualify as de minimis fringe benefits because the airline didn't demonstrate legitimate administrative impracticabilities in accounting for the payments. *American Airlines, Inc. v. U.S.*, 95-668T (U.S. Ct.Fed. Claims 4/2/98).

 **A model employee expense reimbursement policy addressing these thorny issues is provided in NP9311-2, *Employee Benefits: A Summary for Nonprofit Employers*. See back page to order.**

#### 3.3 Executive Compensation Remains at Forefront.

Establishing reasonable compensation continues to present difficult hurdles for nonprofits, given the restrictions of intermediate sanctions and private inurement laws. One IRS-approved approach is to compare the salaries offered by other similarly situated organizations. But finding reliable data isn't always easy for nonprofits. Now, a commercial database is available to ease the search. Maintained by Executive Compensation Advisory Services, a Springfield, Va. company, the database collects salary information on nonprofit executives, as reported on IRS Form 990's.

 **Access the database at the company's web site: [www.ecronline.com](http://www.ecronline.com) or contact Emily Zasada at (703) 913-7198. Also find helpful information in NP9102-7, *Establishing Reasonable Compensation for Nonprofit Leaders*. See back page to order.**

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## 4. Tax-Exempt News & Issues

### 4.1 Corporation's Gift of Stock Qualifies for Tax Break.

Wealthy donors often take advantage of a tax code provision that allows them to donate "qualified appreciated stock" to a private foundation and claim a tax deduction for the full fair market value, regardless of their lower basis in the stock. Now, the IRS has made it clear that parent corporations can take advantage of the same tax break, even if it's a subsidiary corporation that actually transfers the gift of stock. The case involved a parent company, which owned two subsidiaries. The subsidiaries transferred a gift of stock in an unrelated company to a private foundation, and the IRS allowed a tax deduction for the parent corporation, since it filed a consolidated tax return.

★ **This tax break expires June 30, 1998, but a bill to extend the provision is pending in Congress.**

 **To understand the nuances of this provision, review NP9109-6, *Gifts of Property*. See back page to order.**

**4.2 Veterans Post Loses Exempt Status After Operating Profit-Making Activities.** The IRS has revoked the exempt status of a 501(c)(4) veterans post that operated food services, a bar and gambling activities as profit-making enterprises. The post sold bar memberships separate from its regular memberships. It was also open to the post's ladies auxiliary and members of other veteran's organizations. In addition, the post operated video poker games and conducted bingo games twice weekly.

★ **The IRS said the organization was not primarily concerned with exempt activities, but focused almost completely on profit-making endeavors. IRS LTR 9811003.**

**4.3 Private Foundations Get Clean Bill of Health From IRS.** No more IRS total compliance audits for private foundations, at least in the short term, says Marcus Owens, director of the IRS Exempt Organizations Division. The reason: a recently completed IRS review of small private foundations found most of them in compliance with the tax laws. Owens says the IRS will direct its time and resources to other projects "where we know there are problems." Results of the IRS review of private foundations are scheduled for publication in the next handbook for tax agents, due out sometime this fall, Owens said.

 **Random audits may be on hold, but targeted audits of suspected problems are still a threat. Assess your current practices with NP9102-3, *Preparing the Nonprofit for an IRS Visit*. See**

## 5. State Rules & Regulations

### 5.1 District of Columbia Looks Again to Taxing Exempts.

The District of Columbia Tax Revision Commission is recommending a gross receipts tax on revenues of tax exempt organizations, including educational institutions and trade associations. D.C. has previously considered similar proposals, but has not implemented such a broad-based tax.

**5.2 Hawaii Abandons Tax; Nonprofits Escape Coverage.** A state legislative committee voted down a plan that would have imposed a 1.5% excise tax on the receipts of nonprofits, including educational, medical, and religious institutions. The measure was introduced as a means of offsetting lost revenue from decreases in Asian tourists, who are postponing travel due

## *NPA Highlight of the Month*

### New Legislation Introduced

## *"Charitable Choice" Would Expand to More Social Programs*

Sen. John Ashcroft (R\_MO) has introduced new legislation which, if enacted, would significantly expand the opportunities for faith\_based social service ministries to participate in federally\_funded programs. The "Charitable Choice Expansion Act of 1998" builds on the "charitable choice" concept pioneered by Sen. Ashcroft in the 1996 welfare reform law. Charitable Choice clarifies that it is constitutionally permissible for faith\_based organizations to deliver publicly\_funded services with certain minimal restrictions. Moreover, Charitable Choice prohibits discrimination against faith\_based ministries by requiring federally funded programs (whether administered by federal, state, or local government agencies) to give equal consideration to religious organizations when selecting social service providers, and by expressly prohibiting conditions in contract or voucher programs that would impair the religious character of faith\_based providers. Presently, Charitable Choice applies almost exclusively to the Temporary Assistance for Needy Families programs. Sen. Ashcroft's new legislation would extend it to all but a few federally\_funded social service programs, including substance abuse prevention, low\_income housing, abstinence education, Community Development Block Grants, Social Services Block Grants, etc.

★ **The bill does not, however, relieve religious organizations of complying with any other non-discrimination regulations, such as state and local human rights laws or federal civil rights laws. In this respect, it is practically identical to the original "charitable choice" provisions passed in 1996.**

 **For a complete summary of those original provisions, refer to NP9702-1, *Charitable Choice: Government Funding to Religious Social Service Providers*. See back page to order. If you have questions about how your organization may be affected by or may be able to benefit from Charitable Choice, please call Pete Rathbun or Matthew Szymanski, attorneys at Gammon & Grange, P.C.**

to the economic crisis in their countries.

### 5.3 Tennessee Permits Property Transfers, Despite Tax Liens.

A law recently signed by Gov. Don Sundquist allows local municipalities to transfer certain properties burdened with tax liens, to nonprofit organizations instead of selling the property at traditional tax sales. TN H.B. 2116; Public Chapter 647.

## 6. Gifts & Fundraising

**6.1 Checking Up on Donors: No "Blank" Deductions.** It's a convenience many consumers expect these days; they write out the check and assume the payee will fill in "to the order of" with a prepared stamp or seal. But the 10th Circuit says taxpayers can't claim a tax deduction for checks with blank payee lines. The taxpayer argued the blank checks were all given to charitable organizations, but offered no other substantiation. If, in fact, the payees on the checks were all charities, none of the organizations had stamped, sealed or otherwise completed the payee line to the satisfaction of the court. The taxpayer was denied all charitable deductions for the disputed checks. *Nathaniel Roman v. Commissioner*, Doc. 98-14166 (10th Cir. 1998).

**6.2 Annuity Payouts Should Decline Slightly, Council Suggests.** Charities that offer gift annuities should lower their payout rates since interest rates (on which payouts are partly based) have continued to stay low, says the American Council on Gift Annuities. But the reductions need not be severe to keep pace: only 0.2 to 0.3 percent in most cases, the Council recommends. The actual numbers would result in slight decreases over 1997 payout rates for annuitants, aged 83 and younger. Those over age 84 would see no change under the new rates. Although charities are not required to adopt the Council's recommended rates, surveys released by the Council show that about 60% adopted the recommended rates last year. **★ Even with these suggested reductions, payout rates for charitable gift annuities remain higher than the historical average, which dates back to 1927 when statistics were first kept by the Council.**

➔ Besides rate issues, at least 23 states also impose additional regulatory limitations. NP9403-2, *Guidelines for Charitable Gift Annuities*, offers a concise state-by-state summary, plus basic information for establishing an annuity program in your organization.

➔ For more about payout rates, contact the American Council on Gift Annuities, 233 McCrea St., Suite 400, Indianapolis, IN 46225-1030; (317) 269-6271.

## 7. Executive Items of Interest

**7.1 Quote of the Month.** "THERE HAS ALWAYS BEEN A FACTS AND CIRCUMSTANCES TEST AND THAT'S BEEN REAFFIRMED IN THESE RULES...I DON'T THINK YOU CAN COME UP WITH [ANOTHER] APPROACH. THERE ARE TOO MANY DIFFERENT VARIATIONS..." — Matthew Hamill, Independent Sector, commenting on the IRS's recently proposed UBIT rules for charity-run travel tours. See related story at ¶1.1, above.

**7.2 Software Developer Offers Free Web Space to Nonprofits.** The computer software maker, Quarterdeck Corporation is donating space with links on its Web site to selected charities. The company features only charities that attribute a minimum of 60% of costs toward charitable programs, as published by the National Charities Information Bureau. The site rotates charities frequently.

➔ To submit your charity for consideration, visit:

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June 1998

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