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Nonprofit *Alert*®

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

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Appeals Court Reverses Intermediate Sanctions Penalties Citing Valuation Errors

In the first major litigation over the intermediate sanctions law applicable to tax exempt organizations, the Fifth Circuit Court of Appeals reversed a Tax Court decision imposing penalty excise taxes on the conversion of a group of home healthcare agencies from nonprofit to for profit status. The IRS had originally assessed penalty excise taxes based on an alleged $18.5 million excess benefit derived by the owners of the healthcare agencies (who were also the directors of the nonprofit agencies), asserting that the owners had grossly undervalued the agencies' assets in claiming that liabilities exceeded assets at the time of conversion to for profit status. The Tax Court agreed that penalty excise taxes were due, but used its own valuation method in reducing the excess benefit to just over $5 million.

The Fifth Circuit held that the IRS failed to perform a legitimate asset valuation analysis throughout its audit of the conversion. It further held that the Tax Court failed to hold the IRS to its burden of proof that the taxes were correctly assessed. The Fifth Circuit also rejected the Tax Court's method of valuing the assets and liabilities transferred, and concluded that no excess benefit resulted from the conversions.

⇨This case demonstrates the importance of obtaining one or more well-reasoned valuations for transactions between a tax exempt organization and those with substantial influence over the organization. Any excess benefit received by the individuals may result in penalty taxes. For more information on intermediate sanctions excise taxes, order Gammon & Grange's NonProfit Alert Memo, Intermediate Sanctions Law.

Penalties For Disguised Tuition Payment Programs

The IRS has stated in a recent Chief Counsel Advisory that penalties apply for church contribution arrangements that are found to be "disguised tuition payment programs."

The particular practice in question refers to donations some members make to their church that equal or exceed tuition at their child's private school. The school then bills the church, not the parents, for tuition fees.

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Penalties...continued

In addition, the church issues receipts to the donors stating that nothing has been received in exchange for their contributions except intangible religious benefits.

Repercussions for churches participating in this type of conduit scheme include penalties for "aiding and abetting" an understatement of tax and for a failure to acknowledge a "quid pro quo" contribution.

⇨ The "aiding and abetting" penalty can apply whenever a church aids or abets in the preparation of false or fraudulent documents that would result in the understatement of tax. Related to tuition payment schemes, the IRS asserts the penalty can be assessed "because the churches know, or have reason to believe, that members will rely upon the contribution statements the church provides in connection with reporting their tax liability and that the reliance on those statements will result in an understatement of tax."

Penalty: $1,000 for aiding and abetting in the understatement of tax, applying for each member whom the church aids and abets in the understatement of tax through a misleading contribution receipt or some other document. For example, if the church aids 20 members in participating in the same scheme, then the combined penalty could be $20,000.

⇨ A "quid pro quo" contribution involves payment to a charity in exchange for goods or services provided to the donor by the charity. Donee organizations are required to provide to donors contributing more than $75 and receiving a quid pro quo an acknowledgment that provides a good faith estimate of the value of goods and services received. In this case the IRS noted that "a disguised tuition payment program so plainly violates the provisions giving rise to the quid pro quo penalty that we find it difficult to imagine a scenario in which a church could establish reasonable cause based on a misunderstanding of law or fact."

Penalty: $10 for each failure to comply with the quid pro quo receipting requirements.

Finders, Keepers; Losers, Weepers

The childhood maxim "finders, keepers; losers, weepers" is not just for the playground. Consider the law of abandoned property, which states that when the owner of personal property abandons it, that property may be lawfully appropriated by the first taker who "reduced it to possession." In other words, the finder is the keeper. Let the loser weep.

A recent case, Sharpe v. Turley, presented an issue as to whether property disposed of by church employees by placing it in a trash dumpster has been truly abandoned. If so, then the dumpster-scavenging plaintiff had the right to keep the property in question -- diocese records.

Sharpe v. Turley presented an issue as to whether property, disposed of by church employees placing it in a trash dumpster has been truly abandoned.

The plaintiff argued that the church evidenced an intent to abandon the records when it caused them to be placed in the trash dumpster. The court ruled, however, that the church never intended the trash to leave its control or the control of its private agent, the waste disposal company. In addition, the court found that there was no express or implied invitation to the public to enter upon church property in order to remove items placed in the dumpster by church employees.

The final outcome of the case: Since the church had not abandoned the records, the plaintiff was not a "finder" of property, meaning that he could not lawfully reduce the diocese records to his possession and ownership. Who's weeping now?

Combined Federal Campaign Hit from Both Sides

Reports from the Government Accountability Office (GAO) estimate that nearly 1.3 million federal employees donate more than $250 million a year to more than 22,000 national, local and international nonprofit groups included in what is known as the Combined Federal Campaign (CFC).

In order to be considered for inclusion in the brochure of eligible national organizations that is sent out to every federal employee, charities must apply to the Office of Personnel Management (OPM).

> ***The OPM recently came under fire after a GAO report concluded that it was too lax in screening out irresponsible charities.***

As reported in the previous edition of the NPA, the OPM recently came under fire after a GAO report concluded that it was too lax in screening out irresponsible charities. Not only did the GAO discover that nearly 6%—or 1,280—of the charities listed in the CFC brochure owed federal taxes, it found also that the OPM did not independently verify with the IRS that the charities listed continue to qualify as tax-exempt organizations.

Despite these allegations of laxness, a half-dozen charities recently sued the federal government, saying they were unfairly dropped from the national list of organizations eligible to receive donations from federal employees.

In rejecting the charities' applications, the OPM said the organizations did not meet a requirement that charities operate in 15 or more states or in another country, a claim that proved not to be true. Days after the lawsuit was filed, all six charities were reinstated on the CFC list.

Property Tax Exemption Denied Church That Operated For-Profit Child Care Program

In an effort to deflect liabilities associated with the operation of a child care program, members of a Kansas congregation decided to form a for-profit operation, run by two of its own, as a ministry separate and distinct from the church. All profits of the child care corporation were donated to the church.

Shortly thereafter, a local tax assessor denied the church's application for a property tax exemption on the basis that it did not satisfy the exemption standard of buildings "used exclusively as places of public worship … if not leased or otherwise used for the realization of profit."

Since the church received $1,400 each month from the corporation for utilities and rent, the building was found to be used for the realization of profit.

The lesson: Seek tax and legal counsel on all potential ramifications of separately incorporating a particular activity of an exempt organization.

Use of Personality Test Violates Disability Act

A federal appeals court ruled that it was unlawful for a company to administer the Minnesota Multiphasic Personality Inventory (MMPI) as part of a battery of tests given to prospects for upper-management positions. The Court concluded that the MMPI can be classified as a "medical exam," and thus using the test in a way that tends to screen out people with disabilities violates the Americans with Disabilities Act (ADA).

The MMPI can be used in some cases to diagnose certain psychiatric disorders, including depression, hypochondria, hysteria, paranoia, and mania.

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Personality Test...continued

The ADA prohibits employees from using pre-employment medical tests, medical tests that lack job-relatedness and business necessity, and those that screen out or tend to screen out people with disabilities.

⇨Any organization that uses the MMPI or other types of personality tests in making employment decisions should consult with legal counsel. Such use may be in violation of the Americans with Disabilities Act. For more information on the ADA, order Gammon & Grange's NonProfit Alert Memo, Americans with Disabilities Act (ADA): Basic Requirements for Nonprofits.

Buffett Donates Billions to Gates Foundation

In June, Warren E. Buffett agreed to donate 85% of his fortune, or $31 billion, to the Bill & Melinda Gates Foundation.

"We are awed by our friend Warren Buffett's decision to use his fortune to address the world's most challenging inequities, and we are humbled that he has chosen to direct a large portion of it to the Bill & Melinda Gates Foundation," reads the Foundation's homepage.

> ***"We are awed by our friend Warren Buffett's decision to use his fortune to address the world's most challenging inequities..."***

Accordingly, this development has revived debate surrounding the size and influence of the organization, especially when considering that now "one out of every ten foundation dollars spent is going to have the Gates name on it," as mentioned by the National Committee for Responsive Philanthropy Director Rick Cohen.

Foundation officials say they will continue to focus on education and global health while adding a new area: global development in third world countries. In addition, the foundation intends to double its staff and build a new headquarters in Seattle to aid in the distribution of new grants.

UBI on Rental of Rooms

In a recent private letter ruling, the IRS considered the unrelated business income (UBI) implications of the rental of rooms by a tax exempt educational institution. The IRS' analysis focused on whether rental of the rooms to various constituencies had a substantial causal relationship to furthering the organization's exempt purposes.

The IRS concluded that rental to students and faculty of the institution did not result in UBI, as well as rental of temporary living quarters to family members of students and faculty, potential students, family members of potential students, guests who are speakers at the institution, and guests of other non-affiliated nonprofit organizations who are also speakers or musical performers at the institution. However, rental of rooms to the general public would generate unrelated business income (unless the exception to UBI for rental of real property for which no services are provided is applicable).

To Order Memos: Memos referenced in the Nonprofit *Alert* can be purchased for $20 each ($10 for clients) from Gammon & Grange, P.C. Five or more copies of the same memo are bulk priced at $5 each. Visit the **Nonprofit *Alert* Memo Page** for details.
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