



Nonprofit Alert®

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

1. Nonprofit Overview

1.1 New Tax Proposals Include Provisions Affecting Nonprofits.

Many of the new tax proposals circulating around Capitol Hill could bring significant changes for all tax-exempt organizations. At press time, the House Ways and Means Committee is considering a major tax bill that would amend several UBIT rules, including:

- expanding the definition of "control" by nonprofits of stock subsidiaries to mean 50% ownership (either by vote or value) instead of the current 80%. Any "passive" income (i.e. rent, interest, royalties and annuities) received from "controlled" subsidiaries then creates UBIT for the parent nonprofit.
- tightening the reins on nonprofits that exercise *indirect* control over subsidiaries. The new law would hold a parent organization in control if it owns more than 50% of the voting power or value of a subsidiary, either directly *or* indirectly, thereby triggering UBIT on its passive income.
- clarification that "qualified sponsorship payments" would not subject an organization to UBIT. For example, an organization would not face UBIT if it gave nothing more than insubstantial benefits in return for sponsorship payments. The incidental use or acknowledgment of the sponsor's name, logo, or product lines would not be substantial benefits.

★ The tax bill still has a long way to go before Congress produces a workable product, but look for at least some of these UBIT provisions to survive the debate.

➡ As a perennial issue for nonprofits UBIT arises in a variety of situations. Turn to *Tax-Exempt Issues*, page 2, for more examples.

1.2 Ohio Relieves Charitable Trusts From Banking Laws.

Charities that manage trusts in the state of Ohio have one less burden to bear now that state lawmakers quickly amended a banking law that would have required charities to obtain licenses. A charity serving as trustee of a charitable trust in Ohio is no longer covered by the banking law if it or another charity with a similar charitable purpose is a beneficiary of the trust. Earlier this year, the Ohio Commerce Department attempted to impose the licensing requirement in accordance with a comprehensive set of revisions the legislature made to the state's banking laws. (NPA, Mar. & Apr. 97). Many charities complained, and the legislature responded by extending the licensing deadline. After reconsideration, the legislature amended the law to exclude

groups exempt from taxation under §501(c)(3), §501(c)(13), and §170(c)(2) of the Internal Revenue Code. OH Banking Code §1111.01(G)(3).

★ The exemption for charities is effective immediately, which completely circumvents the licensing deadline that would have been imposed July 1.



➡ For information, contact Steve Clarke at Gammon & Grange, (703) 761-5000 or Pam Grandon, Ohio Commerce Department, (614) 644-7517.

1.3 IRS Waives Penalty For Failure to File Taxes Electronically.

As of July 1, small businesses must file employment taxes electronically, but the IRS is attempting to ease the burden by waiving the 10% noncompliance penalty until the end of the year. A 1993 law requires the IRS to collect all business taxes through electronic fund transfers. Large employers were affected first as the system phased in, but in 1997, small employers owing more than \$50,000 in federal employment taxes during calendar year 1995 came under the system. (NPA, May 97).

★ Earlier, Congress debated two bills that would have delayed or revised the electronic filing requirement for small businesses, but with this latest reprieve from the IRS, no further Congressional action is expected. The issue will likely surface again in 1999, however, when businesses with annual federal payroll taxes of more than \$20,000 will be subject to the law.



➡ For more info or to register for participation in the electronic filing system, call the IRS EFTPS office at (800) 945-8400 or (800) 555-4477.

2. Liability & Risk Management

2.1 Boston University Liable for \$5.7 M. Contract Breach.

Massachusetts' highest court has ordered Boston University to pay \$5.7 million for breach of contract and deceptive trade practices. The court found that the university breached a 1991 agreement with the Linkage Corporation, a Boston company that provided technical training to students. Dr. John Silber, former university chancellor, allegedly told Linkage's president that a preliminary audit gave him cause to terminate their agreement. Silber then insisted that Linkage grant the university a right to hire Linkage's employees. Linkage refused, citing their original contract with the university which forbade such

action for up to a year after the contract expired. Less than a day later, Linkage claimed the university hired 28 of its 32 employees and set them to work under armed security guards at a university facility that Linkage had previously occupied. A lower court decided in favor of Linkage and a jury awarded damages of \$2.4 million. The lower court judge doubled the damages, however, citing it as punishment for the university's "willful and knowing" behavior. The high court agreed, saying the double damages were warranted because the university was "unethical and unscrupulous," and the chancellor's conduct was "unfair, oppressive, and deceptive."

2.2 Nonprofits & Fundraising Firm Hit With Solicitation Penalty. Three AIDS groups based in Philadelphia and their fundraising firm have settled charges brought against them by the Pennsylvania attorney general for violating the state's charitable solicitation laws. Together, they will pay \$134,000 in fines and penalties for violations that occurred while soliciting contributions for the Philadelphia-D.C. AIDS Ride, a widely publicized event that drew more than 20,000 bicyclists. The Attorney General accused the groups of "misrepresenting" their expectations of proceeds because they made extraordinary claims before the ride was scheduled, knowing such profits were unattainable.

★ Charitable solicitation laws vary from state to state. Some require little more than a simple registration, while others (such as Pennsylvania) contain many legal complexities

➔ Be sure your organization understands all the state laws that apply before engaging in solicitation. Check NP9103-4, *Multi-State Summary of Charitable Solicitation Laws* for a look at all 50 states.

2.3 Supreme Court Lets Ruling Stand on Student Harassment. The Supreme Court has refused to hear an appeal of a 5th Circuit ruling that dismissed charges against a Texas school district for failing to stop students from sexually harassing their peers. The case was brought by the mother of a female student who claimed her daughter was repeatedly harassed. The 5th Circuit dismissed the case, relying on precedent set in an earlier lawsuit, which the Supreme Court also refused to hear. In that case, the 5th Circuit said school districts could be liable for student sexual harassment only if the school district responded differently to harassment claims made by males versus females.

➔ Although this case applies only to schools and colleges, more general prohibitions against sexual harassment cover most nonprofits. For details, see NP9201-2, *Sexual Harassment Policy for Nonprofit*

3. Employees & Volunteers

3.1 Congress Considers Revisions to Charitable Mileage Deduction. Sens. Frank H. Murkowski (R-AK) and Thad Cochran (R-MS), have introduced a bill to increase the standard mileage rate deduction for the charitable use of automobiles, and Rep. Sue Kelly (R-NY) has introduced a companion bill in the House. If passed, the bills would increase the deduction from 12 cents to 18 cents per mile and give the Treasury Department authority to continue adjusting the figure for future inflation. The 12 cent rate has been in effect since 1984 with no increases for inflation, while the mileage rate for business use of autos has increased by nearly 50% during that same period.

★ With both sides of Congress generating renewed interest in the charitable mileage rate, it looks as though an increase in the current rate may soon become a reality. This could help nonprofits attract and keep more dedicated volunteers. Be sure you providing all the reimbursements and deductions available for volunteers. Check NP9103-3, *Expense Reimbursement for Volunteers and Employees*, for details.

3.2 Small Businesses, Colleges Targeted for Pension Plans. Only one-fifth of the small businesses in this country with fewer than 100 employees, including nonprofits, offer any kind of pension plan, according to Labor Department statistics. Legislation enacted last year was intended to make it easier for small businesses to set up employee pension plans, such as 401(k)'s, but so far, few have taken action. Now, the Labor Department and the Small Business Administration have kicked off an awareness program to educate businesses on their options.

Additional legislation before the House Committee on Education and the Workforce would also give colleges and universities more flexibility in offering retirement incentives to faculty members without violating the Age Discrimination in Employment Act. The bill would allow colleges to offer early retirement packages with an age cap beyond which faculty members would not be eligible for the additional benefits.

★ The bill is especially attractive to private colleges where most professors participate in defined-contribution plans that provide no incentives for early retirement. For more information about pension plan options for small businesses, contact the Labor Department's hot line, (800) 998-7542, or visit their web site at: <http://www.dol.gov>.

4. Tax-Exempt Issues

4.1 Golf Fees Often Taxable, But IRS Carves Out Exception. Mention "golf course" to the IRS and the first thing that comes to mind isn't luscious green farways, but a gold mine of

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unrelated business income tax. That's because the IRS has levied significant UBIT taxes on various nonprofits over the years for operating golf courses, which were unrelated to the nonprofits' exempt purposes. Now, a vocational training organization has found a loophole. The IRS ruled that fees the organization earned from operating a golf driving range were not subject to UBIT because the driving range was part of the organization's training program for troubled teenagers. Other programs operated by the organization also passed the UBIT test, including a furniture upholstery business and a seasonal produce sale. The IRS recognized the overriding aspect of training inherent in each program and determined they all furthered the organization's exempt purpose. IRS LTR 9718034.

★ **Despite the regularity with which the IRS generally taxes these kinds of activities, this case demonstrates that exceptions are possible when the activities have a legitimate link to an organization's exempt purpose.**

➡ **Engaging in entrepreneurial activities such as these should make an organization especially mindful of UBIT. For more details, order NP9110-1, *Entrepreneurial Activity—A UBIT Primer for Nonprofits*.**

4.2 Watchdog Group Points Partisan Politics Finger at Pastor. Americans United for the Separation of Church and State has accused a Pennsylvania pastor of engaging in partisan politics because he urged members of his congregation to vote for three candidates in a local school board election. The organization has asked the IRS to investigate Rev. Joe Carter of the Mount Calvary Church in Elizabethtown, Pa. Carter allegedly told his congregation that the three candidates had "conservative moral values" and urged their support. Carter denied making

endorsements, and a Mount Calvary spokesman said the church does not endorse candidates.

★ **501(c)(3) organizations are prohibited under the tax code from participating in partisan politics, including the endorsement of political candidates. Accusations by watchdog groups like this have triggered IRS investigations in the past.**

➡ **Clear guidelines for avoiding this mistake are described in NP9101-3, *Nonprofit Lobbying and Political Activity—Know Your Limits*.**

4.3 Management Firm's Loan to Nonprofit Passes IRS Review. The IRS has approved a loan arrangement entered by a nonprofit hospital and an outside management firm under which the hospital receives a loan from the firm to cover capital improvements, and the firm manages the hospital's economic operations. The loan amount was to come from an annual stipend which the firm agreed to pay out of the hospital's cash flow over a five year period. The hospital's board of trustees formulated a plan showing the stipend would always be used to further the hospital's exempt purpose. The IRS ruled the stipend and management agreement were permissible because they did not create private inurement or create unrelated business income. IRS LTR 9715031.

4.4 Nonprofit's Education Classes Augment Exempt Purpose. A nonprofit that promoted civil rights has received the go-ahead from the IRS to offer education classes in engineering and technology. The classes were to be offered through a combination of formal academic instruction and practical experience in a laboratory. Students would pay no tuition, but would receive wages for the time spent in training, similar to an

NPA Highlight of the Month

Internet & Nonprofits: All It's Cracked Up to Be?

Microsoft and The Advertising Council recently teamed up to offer free on-line Internet advertising to nationally recognized 501(c)(3) organizations, and many nonprofits jumped at the opportunity to reach the vast Internet audience at no cost. Observers point out, however, that the project and others like it cater to certain groups, and while they may offer many positive benefits to those groups, they often exclude other nonprofits. For example, the Microsoft program gives priority to nonprofit groups that focus on supporting children, and it specifically excludes political and denominational organizations. Free Internet advertising is one thing, but beware of on-line scams that require nonprofit "membership fees." Earlier this spring, the FTC settled a case against the Global Assistance Network, an on-line pyramid scheme that targeted nonprofits. The network offered nonprofit "memberships" at \$50 per month, which allegedly entitled nonprofits to discount products and services. The FTC charged the network with making false claims and ordered refunds to customers.

★ **The Internet may offer attractive opportunities for your organization, but its novelty shouldn't preclude your use of good business judgement before signing onto any project involving the Internet—even one that is low cost or free for the asking. Investigate all offers before acceptance, and like any other deal, always get it in writing.**

➡ **If your organization meets the requirements, you may be interested in free advertising offered by Microsoft and The Advertising Council. Call the director of the program at (212) 922-1500 or visit their web site at: <http://www.adcouncil.org>. Other companies that offer free ad space to nonprofits include Alta Vista (www.altavista.com), America Online (www.aol.com), and Yahoo (www.yahoo.com).**


apprentice program. Operating income for the program would come from sales of the products developed by the students during training. The IRS ruled this expansion of the nonprofit's education goal was still in line with its exempt purpose, and the sale of student-made products would not result in unrelated business income. IRS LTR 9715041.

5. State Rules & Regulations

5.1 Alabama Proposes Exemptions for Summer Camps. The state Department of Revenue has proposed new sales tax exemptions for nonprofit camps, conference centers, and similar facilities operated for children, students, members and guests of nonprofits. If passed, the proposal would exempt from tax all charges associated with fees, tuition and other lodging costs at such facilities if the costs are related to educational or recreational programs. AL Dept. of Rev. Proposed Amd. to Rule 810-6-5-2.1.

5.2 North Dakota Fails in Linking Exemptions to Income. The state legislature has rejected a bill that would have prohibited property tax exemptions for charitable organizations if they paid more than \$75,000 in annual wages to any employee. (NPA, May 97). Another provision of the bill would have taxed any portion of a charity's property not used exclusively for charitable purposes. The bill died in committee where it met opposition to both clauses.


★ **Although North Dakota's unique approach to granting exemptions based on executive income didn't make it into law, other states may now try similar strategies to raise revenue.**

 **NP9102-7, Establishing Reasonable Compensation for Nonprofit Leaders, offers practical guidance in setting executive salaries.**

5.3 Oregon Requires Written Leases on Exempt Property. New rules implemented by the state Revenue Department now require nonprofits to put all lease agreements in writing to maintain any tax exemptions on the property if it is leased to another nonprofit. The written leases must contain all the terms and conditions of the tenancy to comply with the new rules. OAR 150-307-166.

6. Gifts & Fund Raising


6.1 Contributions Increase At Healthy Rate Over Past Years. Charitable contributions increased by 7.3% last year over 1995 figures, reports the latest edition of *Giving USA*, an annual summary of charitable trends. The increase was well beyond the inflation rate for most charities, pegged at 2.6% by the study. Health organizations and arts groups led the increase with around 10% each, while international aid groups ranked last with an actual decrease in contributions by about 4.6%. Another report by the Council for Aid to Education shows that public and private colleges in the U.S. fared even better than other charitable groups, with an 11.8% increase in contributions during fiscal year 1996.

★ **Both reports attributed the increases to the stock market's strong performance over the last year, which gave donors the ability and incentive to be more generous.**
 **Copies of *Giving USA* are available for \$49.95 from the American Association of Fund Raising Counsel, (800) 544-8464. The latest edition referenced above won't be available until August, however.**

7. Executive Interest

7.1 Quote of the Month. "CORPORATE PHILANTHROPY IS FIRST OF ALL AN ECONOMIC ACT... [BECAUSE IT IS] ORIENTED TO CORPORATE INTERESTS AND PROFIT...BUT IT HAS SOCIAL AND POLITICAL DIMENSIONS AS WELL."—Professor Jerome L. Himmelstein, author of *Looking Good & Doing Good: Corporate Philanthropy and Corporate Power*, quoted in *The Chronicle of Higher Education*.

7.2 IRS Lists Charities on Government Web Site. The IRS web site now lists some 500,000 exempt organizations to which donations are tax deductible. The list incorporates the IRS' annual *Publication 78*, and provides names and addresses for each organization. The list is updated quarterly.

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