



Nonprofit Alert®

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

1. Nonprofit Overview

1.1 New Tax Law Brings Good & Bad News for Exempt Orgs.

The tax bill President Clinton signed last month directly affects nonprofit organizations in both positive and negative ways. The most significant impacts on nonprofits are:

✓ *Charitable Mileage:* The standard deductible rate for charitable use of an auto increases from 12 cents to 14 cents per mile, effective January 1, 1998. This is an added incentive for volunteers, considering that the old rate had not been changed since 1984.

✓ *Employer-Provided Education (§127):* The deadline for excluding employer-provided educational assistance programs from employees' income was extended until May 31, 2000, and retroactively covers the period during which the provision expired earlier this year. It applies only to undergraduate level education, however; no extension was included for graduate expenses, despite extensive lobbying.

✓ *Corporate Sponsorships:* Certain corporate sponsorship payments will no longer subject an exempt organization to unrelated business income tax if the organization gives only insubstantial benefits in return for the sponsorship payments, such as the incidental use of a sponsor's name or logo. This effectively writes into law a recent IRS ruling on the same subject.

✗ *Capital-Gains & Estate Taxes:* Capital-gains tax drops to 20%, and the estate tax exemption increases to \$1-million over the next decade. With these more favorable rates, donors may be less inclined to leave appreciated property to charity. But another provision retroactively extends the \$170 tax break for donations of appreciated stock to private foundations until June 30, 1998.

✗ *"Control" Test:* The IRS test to determine whether a taxable subsidiary is "controlled" by an exempt organization lowers from 80% to 50% ownership by vote or value. This means nonprofits that now "control" 50% or more of a subsidiary would be taxed on any royalties, rents, and interest received from the subsidiary.

➡ **Several Nonprofit Alert® Memos, available from Gammon & Grange, P.C., address these issues: NP9103-3, *Expense Reimbursement for Volunteers and Employees* details charitable mileage rates and other deductible and reimbursable expenses; NP9103-2, *Employee Educational Assistance Programs* provides information on this important employee benefit; NP9109-6, *Gifts of Property* explains appreciated property donations; and NP9304-1, *Organizing the Nonprofit and Its Subsidiaries* discusses the "control" test. See back page to order all memos.**

Don't Miss . . .

- ★ **New Era Settlement Nets \$61 Million ¶2.1**
- ★ **"No-Rehire" Escapes Defamation ¶3.1**
- ★ **Trade Show Triggers UBIT ¶4.1**
- ★ **Son Inherits House, But Not Deductions. . ¶6.1**

...In This Issue of NPA

1.2 Court Sides With Church; Orders IRS to Release Records.

A nonprofit organization may access its own IRS tax records, along with statistics on IRS investigations of other nonprofits, a U.S. district judge has ruled. Branch Ministries of Vestal, NY, which operates the Church at Pierce Creek, sued the IRS to release its records, along with statistical data compiled since 1980 against churches and other religious groups that the IRS has investigated for political activity. During 1992, the church ran large ads in two national newspapers opposing Clinton for President, which prompted the IRS to revoke the church's exempt status. The IRS claimed that releasing any data would reveal the government's deliberative processes, but the court said evidence suggested the IRS discriminated against Branch Ministries since other religious groups under investigation were not severely punished. *Branch Ministries Inc. v. Richardson*, No. 95-0724 (D.D.C. 1997).



To avoid the political activity that led to Pierce Creek's problems, order NP9101-3, *Nonprofit Lobbying and Political Activity—Know Your Limits*.

2. Liability & Risk Management

2.1 Federal Judge Approves \$61 Million to New Era Victims.

The New Era bankruptcy saga draws to a close as a federal judge approved a settlement giving nonprofit creditors about 71 cents on every dollar lost, for a total of \$61 million. This settlement supplements another \$30 million already distributed to the creditors last December. (*NPA*, Dec. 96). Nonprofits lost a total of \$105 million in 1995 when the Foundation for New Era Philanthropy went bankrupt after operating an illegal

pyramid scheme. This latest settlement includes \$45 million, which the bankruptcy trustee recovered from other organizations that received grants from New Era, plus an additional \$15.9 million from the settlement of four lawsuits against Prudential Securities, Inc., the company that managed New Era's accounts.

★ **Lawsuits are still pending against 350 other organizations and individuals who benefited from New Era. The bankruptcy trustee estimates a settlement in those cases could produce another \$10 million, but it is probably years away.**

2.2 Historic Landmark Sued for Child Molestation. The Bruton Parish Church, a historic landmark in Colonial Williamsburg, Virginia, and the Episcopal diocese that oversees the church may be liable for multiple child molestations that occurred in the church nursery. A baby sitter, hired by the church, was convicted of multiple sex crimes against 14 children and sentenced to 73 years in prison in 1995. Now, the victims have brought suit against the church and diocese, and a Virginia court has allowed the case against the church to go forward, despite the church's argument that state law does not impose liability on an employer for acts that are outside the scope of the employee's duties. The court said if the actions of the employee are "a great and unusual deviation" from his assigned duties, then the court could decide there is no liability. But when the actions are not so far outside the employee's duties, a jury must decide if the employer is liable. *Doe v. Bruton Parish Church*, VLW 097-8-286.

★ **The plaintiffs' lawyer argued that the very nature of the baby sitter's job—changing diapers, helping children go to the bathroom, etc.—gave him many opportunities to have physical contact with the children, so that his actions were well within the scope of his employment.**

➡ **The potential for liability is serious with any employee or volunteer who has this kind of contact with children. Learn how to protect your organization and those you serve with the newly updated NP9611-1, *Preventing the Risk of Child Abuse*.**

3. Employees & Volunteers

3.1 Employer Escapes Defamation Based on Rehire Statement.

After a workplace surveillance camera caught Cherita Hayes under-charging a fellow employee for a purchase, Walmart terminated her employment and designated her a "no-rehire" for personnel purposes, meaning Walmart would never hire her again at any of its stores. Hayes later applied for a job elsewhere and listed Walmart as a reference. When her new supervisor called Walmart, he was told that Hayes would never work at Walmart again. Hayes sued for defamation, but the court ruled for Walmart

because the statement was true since she had been designated a "no-rehire." The court said the statement did not accuse Hayes of wrongdoing or "impugn her reputation in any way." It merely stated a documented fact. *Hayes v. Walmart Stores, Inc.*, 953 F.Supp. 1334 (M.D. AL 1996).

★ **Although this case involved a commercial business, the potential for slander and defamation claims by disgruntled employees or agents is the same for nonprofits.**

➡ **Avoid claims like this by implementing the policies and practices recommended in NP9206-1, *Developing a Defamation Policy for Nonprofits*.**

3.2 Officer's Salary Reasonable, Based on Company's Success.

A recent Tax Court case highlights the many factors that determine reasonable compensation. The case involved a California masonry company and its founding shareholder who served as president for two years and received a \$1 million salary. The IRS denied a deduction to the company for the salary it paid to the president. The officer had no formal training, although he routinely participated in professional development. The officer also devised the company's successful corporate strategy and served in a number of roles, including CEO and CFO, but the IRS said his salary was too inflated for his experience. The Tax Court disagreed after looking at five factors: (1) the employee's role in the company; (2) a comparison of salaries in the industry; (3) the nature and financial situation of the company; (4) whether any conflict of interest existed between the employee and the company; and (5) the internal relationship of the company's employee salaries. Based on these factors, the court found the president was primarily responsible for the company's remarkable growth and success, which made his large salary reasonable despite his lack of formal business training. *Ginger Masonry Inc. v. Commissioner*, T.C. Memo 1997-251.

➡ **Learn more about what courts and the IRS look for in settling compensation issues with nonprofits by ordering NP9102-7, *Establishing Reasonable Compensation for Nonprofit Leaders*.**

4. Tax-Exempt Issues

4.1 Trade Show Advertising Produces UBIT, Despite Content.

Advertising proceeds from a nonprofit organization's monthly publication and trade show directory produced unrelated business income, the IRS recently ruled, despite their beneficial and informative nature. Ads in the monthly publication did not qualify as educational, although they were somewhat instructional. The IRS ruled they bore no pronounced relationship to the editorial content of the publication, and thus, could not legitimately relate to the organization's exempt purpose. Regarding the trade show directory ads, the IRS recognized that publishing the directory was a traditional activity for the organization, but said the ads were nothing more than an exploitation of the convention, which made their proceeds taxable to the organization. IRS TAM 9724006.

★ **Before you embark on selling ads for any publication or event that your organization sponsors, consider the UBIT implications. Unless there is an extremely close relationship between the ads and your exempt purpose, the ads will most likely produce taxable income.**

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More general issues for nonprofits to consider when receiving inventory like computers are detailed in NP9109-6, *Gifts of Property*. See related story, ¶7.1.

4.2 Public Services Coincide With Exempt Purpose. The IRS has ruled that data entry services, provided by a tax exempt organization to the general public, qualify as handicapped rehabilitation and training that is well within the organization's exempt purpose. The services are performed by handicapped individuals under the auspices of the organization's training supervisors. The program affords gainful employment and independent living opportunities to the handicapped. The program does not jeopardize the organization's exempt status, and proceeds generated by the data entry service do not create taxable income. IRS LTR 9728034.

★ **Entrepreneurial activities, like the data entry service here, typically draw IRS scrutiny. But when they are legitimately linked to programs that foster exempt purposes, UBIT may be avoided. Another training program that involved troubled teens who operated a golf course recently passed IRS muster on similar grounds. (NPA, July 97).**

4.3 Museum's Sale of Educational Toys Exempt From Tax. A nonprofit museum must pay unrelated business income tax on sales it made from its adjoining gift shop and restaurant, but sales of certain children's items in the gift shop are not taxable, the IRS recently ruled. The exempt items included kaleidoscopes, paint sets, and other items "designed to develop fine art skills or a child's awareness of his or her artistic ability." Since these were primarily educational in nature, they related directly to the

museum's exempt purpose. However, the IRS rejected other items such as building blocks because they only develop a child's general knowledge and are not expressly educational in nature. IRS TAM 972002.

5. State Rules & Regulations

5.1 Illinois Suspends Tax Audits of New Nonprofits. Effective immediately, the Illinois Department of Revenue has announced a moratorium on sales tax audits against new nonprofits so these organizations can become familiar with the state's tax laws. Nonprofits in Illinois are required to collect sales tax on any sale of tangible personal property at retail. DOR Bulletin FY 97-23.

5.2 New Jersey Rejects Parsonage Exemption for Rabbi. A Rabbi's home does not qualify for property tax exemption as a parsonage, the New Jersey Tax Court has ruled, because the Rabbi is not an "officiating clergyman." The Rabbi routinely conducted Bible (Torah) classes at his home, and assisted in a local synagogue. He also held religious services each week at a local nursing home. However, the court said he was not the "spiritual overseer" of a congregation and lacked supervisory responsibilities of a congregational leader. The court also noted many of his teaching responsibilities were sometimes performed by volunteers. *Friends of Ahi Ezer Congregation, Inc. v. City of Long Branch*, Doc. 97-21062 (NJ Tax Ct. 6/19/97).

★ **The court's mention of the fact that volunteers sometimes performed the Rabbi's services is particularly troublesome, since denominational differences often dictate the involvement of volunteers in various capacities—a religious nuance that may be difficult for courts to ascertain.**

NPA Highlight of the Month

Discrimination Laws Just Got Tougher for Small Employers

You're a small employer, so you're probably not covered by federal discrimination laws, right? Think again! A little-publicized ruling handed down earlier this year by the Supreme Court has changed the way those laws apply to small employers, including nonprofits. Under Title VII of the Civil Rights Act, employers who engage 15 or more employees are subject to federal laws prohibiting workplace discrimination on the basis of race, sex, color, national origin and religion. (An exception allows churches and religious organizations to discriminate solely on the basis of religion). The statute doesn't define exactly how to count those employees, however, leaving some small employers to assume that unless they were actually compensating an individual on a given work day, then that individual didn't count as an employee working that week. Over the years, various courts have interpreted the issue differently. In *Walters v. Metropolitan Educational Enterprises, Inc.*, 1997 WL 9783 (1997), the Supreme Court finally settled the debate by adopting what is known as the "payroll method" for counting employees. That method requires an employee to be counted if the employer has any sort of employment relationship with the employee, regardless of when compensation is paid. This means employees who start work during the middle of the week still count, as do employees who take mid-week leave or stop working before the end of the week.

★ **Before nonprofits dismiss this as a simple accounting problem for their payroll managers to handle, consider the implications: employers with payrolls that hover around 15 or more employees may now be subject to liability under federal discrimination laws that previously didn't cover them. One expert estimates this ruling brings nearly 500,000 small employers (including many nonprofits) under Title VII. The "payroll method" will likely become the standard for determining if employers are subject to other federal discrimination laws too, like the Americans with Disabilities Act, which applies to employers with 15 or more employees. Nonprofits are not per se exempt from discrimination laws.**



If you're a small employer in this category, consult legal counsel immediately to determine your compliance obligation. Then, review a complete outline of Title VII and its provisions in NP9312-1, *Avoiding Employment Discrimination in the Nonprofit Organization*, along with NP9109-3, *Basic Requirements Under the Americans With Disabilities Act*. See back page to order.

➡ **Some states develop their own criteria, but most follow IRS' standards for parsonage allowances. NP9101-5, *Ministerial Housing Allowances: Qualifying and Documenting* provides details.**

6. Gifts & Fund Raising

6.1 *Son's Inheritance Transfers Without Deductions.* Excess charitable contributions cannot be carried over from one taxpayer to the next if the donor dies, the Tax Court has clarified. Ordinarily, a taxpayer may carry over excess contributions for up to five years, but in this case, the taxpayer died before claiming all his excess contributions made to a private foundation. His contributions consisted of the use of several rooms in a house that he owned. Upon his death, his son inherited the house, but the IRS said he did not also inherit the right to use the excesses of his father's charitable contribution. The Tax Court upheld the IRS' decision, but relieved the son of penalties because he showed a reasonable attempt to comply with the tax code. *Dieter Stussy v. Commissioner*, T.C. Memo. 1997-293 (6/26/97).

6.2 *Charitable Giving Highest Among Utah Citizens.* For several years running, taxpayers in Utah have been the most generous, according to statistics released by the IRS. The latest figures show that Utahns give \$4,593 on average (compared with Rhode Islanders, who give the least, at \$1,547 on average). The national average is \$2,449, but that number includes only taxpayers who itemize, which is only about one in four taxpayers.

➡ **The newsletter is at: <http://www.ramsfie.com/opportunity.htm>. Follow the instructions given on the screen to receive a free subscription.**

7. Executive Items of Interest

7.1 *Quote of the Month.* "THE IRS HAD A NUMBER OF OPTIONS SHORT OF REVOCATION—INCLUDING WARNINGS, FINES, AND SUSPENSIONS—BUT CHOSE THE MOST DRASTIC OPTION." . . . Federal District Judge Paul L. Friedman, in ruling that the IRS must release its records to the Church at Pierce Creek in a case where the church is challenging the revocation of its exempt status. (See related story at ¶1.2, above).

7.2 *More Charities Qualify for Combined Federal Campaign.* The upcoming Combined Federal Campaign, the government's workplace giving program, will include 1,158 charities this year, up 4.1% over the number eligible to participate in last year's program. To qualify, charities must operate in at least 15 states and spend no more than 25% of their budgets on administrative expenses.

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7.3 *Updated IRS Per Diem Pub Now Available.* The IRS has released an updated version of Publication 1542, which lists per diem rates and the high-low substantiation method employers use in reimbursing employees and volunteers for travel and business expenses.

➡ **NP9103-3, *Expense Reimbursement for Volunteers and Employees* contains an updated explanation of the reimbursement issues nonprofit employers routinely face.**

7.4 *Private Foundations Enjoy Boom in Asset Growth.* The Foundation Center reports U.S. foundations saw a 16% growth in their 1995 assets, and preliminary figures for 1996 show similar indications, thanks primarily to the surging stock market. The report also shows gifts to foundations were up by 27% for a total of \$10.3 billion in 1995.

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