



FRATERNAL LAW

A fraternity law periodical
published by Manley Burke
A Legal Professional Association

March 2006

Number 96

LOCAL SORORITY SUES CHICO STATE UNIVERSITY

Alpha Chi, a local sorority at California State University, Chico, filed a lawsuit¹ in January against the University in state court alleging multiple civil rights violations. Alpha Chi, the oldest sorority at Chico State, was recently suspended by the University for attempting to recruit new members during a University imposed campus-wide ban on rush.

As reported in *Fraternal Law*, Matthew Carrington, a pledge of the Chi Tau Fraternity, an unrecognized fraternity at Chico State, died in a hazing incident in February of 2005. Members of the fraternity ordered Mr. Carrington to chug gallons of water. Mr. Carrington drank too much water and died of cardiac dysrhythmia caused by water intoxication. Five members of the fraternity received jail sentences for their roles in Mr. Carrington's death.

The University responded to Mr. Carrington's death swiftly and severely. Last September, the University instituted 59 new recommendations for all sororities and fraternities on campus. The recommendations called for all dry houses all the time for an indefinite time and a complete end to hazing. One of the "recommendations" called for no new member recruitment during the 2005 Fall semester. The stated purpose of this recommendation was to "allow chapters to restructure, rebuild, and recommit to chapter values as their first priority." The College said "significant violation [of the recommendations] will lead to chapter suspension."

Since its founding as a local sorority in 1918 until 2005, Chico State recognized Alpha Chi as a full functioning sorority and member of the Greek system. The complaint alleges that Alpha Chi's sorority house requires at least 31 resident members to meet its basic financial obligations. The complaint continues, Alpha Chi needs approximately 15 new members each semester simply to survive. This is a similar issue for fraternities and sororities across the country, as rush truly is the lifeblood of Greek organizations.

If not permitted to rush new members during the fall 2005 semester, the sorority determined that its future existence would be in jeopardy because 1) they would have to secure twice as many new members in the spring semester, 2) the number crunch would force the sorority to be much less selective in who they admit as members, and 3) simply finding enough acceptable members in the spring semester to pay the expenses of the sorority would not be

feasible. Alpha Chi concluded that in order to sustain itself, it could not afford to take the 2005 fall semester off rush.

Therefore, the sorority attempted to recruit new members at the campus student union during the fall of 2005. The University immediately suspended Alpha Chi for violations of the new "recommendations" for Greek organizations. As part of its suspension, the University no longer recognizes Alpha Chi and the sorority is not entitled to any of the benefits that recognized student groups receive. Such benefits include the use of the student union and other campus facilities and the ability to participate in campus activities such as intramural sports and Greek week.

California Civil Rights attorney Eric Berg sued on behalf of Alpha Chi, alleging that the University is violating the members' civil rights. The suit claims violations of freedoms of expression, assembly, speech, and due process rights. The suit noted that the 59 "recommendations" applied to Greek organizations but not to any other student organization on campus. Specifically, the complaint alleges that the University's "recommendations or rules forbidding recruitment by Greek social organizations on campus was unconstitutional and void to the extent it prevented free speech and assembly and discriminated against organizations in the use of a public, school building on a public campus, funded by Federal and State of California public funds based upon the content of the organization and the content of the speech and assembly."

Alpha Chi is seeking the ability to use campus facilities and resources, to speak to and associate with students on campus, to use campus mail to communicate with students, the same rights and privileges as all other student organizations on campus, an order preventing the University from disciplining any student for participating in the lawsuit, an order granting students the same rights that existed prior to the enactment of the "recommendations," and money damages.

Alpha Chi's motion for preliminary injunction was argued on February 24th. A decision has not yet been announced. *Fraternal Law* will keep you updated on this case as it proceeds.

• Daniel J. McCarthy

¹ Matejka, et al. v. California State University, Chico, et al., Butte County, California, Superior Court, Case No. 136433.

PRIMER ON SET ASIDE PROCEDURES

INTRODUCTION

It has been some time since we reviewed the rules surrounding set asides in this column and with many fraternal organizations' fiscal year ends and tax seasons approaching, this seems like a good time to do so. This article will focus on the procedural aspects of set asides and a future article will deal with the substantive aspects of set asides. First, we will explore the basic underpinnings of the set aside procedure and what is required for a timely and effective set aside to be made, and then we will explore some of the finer points of the set aside rules.

THE BASICS OF SET ASIDES

Under the Internal Revenue Code, college fraternities and sororities exempt under Code Section 501(c)(7) (including local chapters and most house corporations) must pay federal income tax on their investment income of over \$1,000 per year as unrelated business income. Investment income includes dividends on stock, interest on bank accounts, rents, royalties, net capital gains and similar investment income. Expenses directly incurred in the production of the investment income, such as investment advisory fees, may be deducted from gross income to produce the correct net investment income amount. The set aside procedure is one that allows such funds to escape taxation if they are properly set aside to be used for charitable and educational purposes. In such cases and if the funds are used in a proper manner, then no federal income tax is payable. Therefore, any fraternal organization exempt under Code Section 501(c)(7) should consider using the set aside procedure if it has over \$1,000 of investment income of the type described above. Many fraternal organizations routinely use the set aside procedure for all investment income every year, while others choose to set aside a part of their investment income and pay federal income tax on the remainder (this option will be further explained in question 8 below).

The set aside procedure should be instituted by first determining the amount of net investment income that would otherwise be subject to tax. The organization should then adopt a resolution like that below, setting aside the amount of such net investment income (or the desired amount, if less) in a separate bank account, which is identified as a "set aside fund". It is very important that this exact procedure be followed.

SUGGESTED RESOLUTION

At a meeting of the (governing body) of _____ Fraternity, on the _____ day of _____, 200__, after discussion of the net investment income for the organization's fiscal year ending _____, 200__, the following motion was duly made, seconded, and unanimously resolved as follows:

RESOLVED, that the amount of \$ _____ be set aside from the general assets of the _____ Fraternity in a separate bank account to be known as set aside account no. _____ of _____ Fraternity.

RESOLVED, FURTHER, that said amount of \$ _____ may be used only for the following purposes: Religious, charitable, scientific, literary or educational purposes, loans on local chapter housing, or for the prevention of cruelty to children or animals; and for scholarships, student loans, leadership and citizenship schools and services, and similar purposes.

President

This Resolution should be signed and one signed copy should be placed in the organization's corporate minutebook.

This procedure must be followed every year to avoid such taxation for any year that the organization has a total of over \$1,000 in investment income and wishes to avoid taxation thereon. All amounts set aside must first be deposited in a set aside account before being disbursed for qualifying purposes. The account should clearly be labeled as set aside funds and preferably each year's set aside should also be separately designated--e.g., set aside 1-2005; set aside 2-2006, etc. It must not be commingled with an organization's general funds. If the amount is large, it may also be invested in other ways--for example, money market or mutual fund--as long as it is properly segregated and labeled as a set aside fund. However, long term investments that are not readily available should be avoided as set aside funds are supposed to be used within a "reasonable" time. Thus, while set aside funds need not be used in the same year set aside, in general, money in a set aside account should not accumulate for more than two or three years after it was set aside. Therefore, when an organization needs funds for any qualifying purpose, the amount should first be taken from set aside funds and earlier years' set aside funds should be depleted before later years.

It should also be noted that set aside accounts cannot be loaned for general fraternal purposes. In addition, an organization may not pledge the set aside monies or otherwise use them as collateral for a third party loan. If such a transaction occurs, the set aside funds immediately become taxable.

THE FINER POINTS OF SET ASIDE PROCEDURE

Once a fraternal organization and its advisors have become familiar with the basics of the set aside procedure,

there are many pitfalls that need to be avoided in order to manage the organization's set aside procedures effectively. Some of the most commonly asked questions about these finer points of set aside procedure are discussed below in question and answer form.

1. Q. What is the set aside procedure available for investment income that has been debt-financed--for example, rent received on real estate that has a mortgage on it?

A. It has been the IRS' position since the set aside procedure first came into the Internal Revenue Code in 1969 that debt-financed income, such as is described in this question, would not qualify for the set aside procedure and that unrelated business income tax is due thereon under the rules of Code Section 514 relating to debt-financed income of exempt organizations generally.

2. Q. What should a fraternity do if it has a large amount of set aside funds and cannot use all of them in two to three years as indicated above?

A. While the Internal Revenue Service has been quite reasonable in its interpretation of this rule, it is nevertheless important that an organization that cannot use all of its set aside funds in a reasonable period of time show that it is using some of the funds as quickly as it can, and that it has definite plans to use the rest as soon as possible. For example, if the plan is to use all of the set aside funds in a large project which will begin in, say, five years, then it is important for the organization to document carefully in its records detailed plans for the use of the funds and when that project will begin, why it cannot be done earlier, etc.

3. Q. What is the relationship between the set aside rules and the 35% test under which a fraternal organization may lose its exempt status if it receives more than 35% of its gross receipts from non-member income?

A. This is an area of frequent misunderstanding. Since investment income is by far the most common type of non-member receipts for Code Section 501(c)(7)

organizations, the investment income which is set aside counts toward the 35% requirement, even though it is set aside and no tax is paid thereon. It is important to note, however, that if the 35% level is exceeded, then even though tax is paid on the non-member investment income, the organization still has exposure with regard to the possible loss of its exemption--in other words, paying tax does not resolve the 35% test issue.

4. Q. Can capital loss carryover deductions be applied against an organization's current year's investment income in determining the amount of net investment income to be set aside?

A. It should be remembered that the calculation of the set aside amount is directly tied to the amount of income on which the organization would otherwise pay federal income tax. Therefore, for questions of this type, one must always refer back to the calculation of unrelated business income tax of a Code Section 501(c)(7) organization. Since Code Section 165 allows deductions for capital losses to the extent not limited by Section 1211 and 1212, and Section 1212 allows capital losses in excess of capital gains for a year to be carried back three years and forward five years, it seems reasonable to conclude that capital loss carryovers are allowed as deductions from capital gains for purposes of the set aside calculation.

5. Q. Can set asides created in a given fiscal year of the organization be absorbed by qualifying expenses which were incurred in prior years--in other words, can the set aside funds themselves be carried back to prior qualifying expenses?

A. The proposed set aside regulations under Code Section 512 (which were withdrawn but are still often used as a source of guidance on these issues) are drafted in a manner that presupposes the use of set aside funds to pay future qualifying expenses and we have always interpreted these rules in this manner. Further, IRS Publication 598 describes set aside income as "income set aside to be used for religious, charitable, scientific, literary or educational purposes, or for the prevention of cruelty to children or animals" (emphasis added). The use of the future tense indicates an IRS position that set aside amounts must be used for expenses incurred in the current or future tax years. Therefore, amounts treated as set aside and used to pay expenses incurred in prior years likely would not qualify as set aside amounts and would be subject to unrelated business income tax.

6. Q. In computing the amount of set asides, is it permissible to offset ordinary investment income by capital losses?

Update on AEPi's Case Against CSI

Oral argument is set for March 1, 2006 in AEPi's case against City University of New York College of Staten Island ("CSI"). As previously reported here, at issue is whether CSI can legally require all recognized student organizations to accept members of both sexes. AEPi is challenging the constitutionality of the University's policy so that it can maintain its colony on CSI's campus. Look for further updates in our next issue.

A. This question is similar to number 4 above, in that it is answered by reference to the Code Sections wherein a corporation's unrelated business income tax is calculated. Code Section 165(f) provides that capital losses from sales or exchanges of capital assets shall be allowed only to the extent allowed in Code Sections 1211 and 1212. Code Section 1211(a) provides that "[i]n the case of a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of gains from such sales or exchanges." As a result, for purposes of determining the amount of net investment income that can be set aside in a year, capital losses should not be deducted against ordinary investment income.

7. Q. At one time there was some question about the ability to set aside royalties received by a fraternal organization for the use of its logo, Greek letters, etc. on merchandise--is this still the case?

A. Happily this issue has been resolved in favor of the taxpayer organizations. The IRS had been contending that this type of royalty income, which is known as affinity royalty income, was not really royalty income but resulted from the sale of the organization's membership list. If such income was not deemed royalty income, then it would follow that it could not be set aside. After the IRS lost a series of court cases on this issue, it decided not to pursue the issue further and consequently, true affinity royalties may now be set aside by a fraternal organization in the same manner as other investment income.

8. Q. Is the set aside procedure a one time election or can it be made every year? Also, does the set aside procedure have to be used in its entirety or can a partial election be made?

A. There is considerable flexibility for fraternal organizations in the use of the set aside procedure. An organization can use the set aside procedure one year and elect not to use it in the next year and so on, and vice versa. Also, the set aside procedure can be used for a specific amount of investment income and the organization can elect to pay tax on the remainder, thus freeing up such funds for general fraternal uses.

9. Q. What can a fraternal organization do if its governing body is ready to approve the set aside resolution and the amount of investment income has not yet been computed?

A. This is a scenario that is encountered quite frequently. The set aside election, in order to be effective, must be made by the date that the organization's Forms 990 and 990-T are due to be filed, including any extensions. The

amount of set aside income must be computed with accuracy and should be identical on the organization's audited financial statements, tax returns and set aside resolution. Therefore, the proper method is to wait to file the election on the organization's tax return until this amount has been computed with accuracy, even if that means that an extension must be secured to file the return. In other words, filing the organization's tax return too soon with the wrong amount leaves any excess investment income subject to tax, so it is much better to postpone adoption of the resolution and the filing of the tax return until the organization is certain that the set aside amount is accurately computed.

CONCLUSION

Use of the set aside procedure by Code Section 501(c)(7) fraternal organizations is perhaps the most important tool in tax planning for these organizations. Correct use of the set aside procedure can save the organization literally thousands of dollars in tax dollars and, by creating a pool of resources to fund educational programs, free up other dollars that can be used for general fraternal purposes. Thus, all Code Section 501(c)(7) fraternal organizations and their advisors, even those that do not use the set aside procedure regularly, should be extremely familiar with these rules.

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Correction

In the January 2006 issue of *Fraternal Law* the article "Muslim Sorority" incorrectly stated that Alpha Gamma Delta was based "on the traditions and the missionary zeal of Ignatius Loyola, a Jesuit Catholic Priest."

The article should have identified the fraternity as Alpha Delta Gamma. Alpha Delta Gamma is an NIC member. It is a men's organization.

Alpha Gamma Delta is an NPC member women's fraternity. It was founded at Syracuse University in 1904 with its object being "to perpetuate among a group of college women a spirit of mutual assistance and understanding; to maintain high standards of scholarship, to develop womanhood and to strive for the attainment of high ideals in college, community and personal life and to train for leadership and a sense of responsibility for welfare of others."

Fraternal Law apologizes for the confusion created by the juxtaposition of the names.

EDITOR'S NOTE ON A MINISTER'S VIEW OF FRATERNITIES

The following is an article that appeared in the December 2005 - January 2006 issue of *Crossroads*, a publication of the Catholic Campus Ministry Association. The article is reprinted here with permission for two reasons. First, in contrast to usually negative views published in the media on fraternities and sororities, the author offers very positive comments about his experience with fraternity and sorority members. Secondly, the author's observations on the value-base association of Greeks is worth emphasizing. Emphasis on the articulated values and purpose of each fraternity and sorority remain an important part of enforcing the First Amendment Freedom of Association Right of fraternities and sororities. Should a Greek group ever find it necessary to litigate to protect its Freedom of Association rights, courts will look to whether or not their activities qualify the organization as an expressive association. A fraternity and sorority that honors and respects and promotes its values is more far more likely to succeed than a chapter which has ignored them.

GREEK LIFE: A RICH FIELD FOR EVANGELIZATION

By Rev. J. Friedel, Director of Campus Ministry, Southeast Missouri State University, Cape Girardeau, Missouri

"The eye of faith discerns campus ministry where commitment to Christ and care for the academic world meet in purposeful activity to serve and realize the Kingdom of God." These words from *Empowered by the Spirit: Campus Ministry Faces the Future*, encourage a continuous examination of the campus culture in the light of the Gospel, seeking areas where the kingdom has become a reality or where it is painfully absent. Too often, Greek life is summarily dismissed by many administrators and campus ministers as an area that seems to be "more trouble than it is worth." Granted, the approachability of a campus Greek system can be measured by its relative health or disease; however, my experience has taught me that campus ministry can engage with Greek life in ways that are mutually beneficial for all parties concerned.

In my 13 years at Southeast Missouri State University I have come to admire much of what I have experienced in working with the men and women of the various fraternities and sororities represented on

our campus. In working with the members of these Greek letter organizations, I began to notice a pattern emerging. Most of them were highly idealistic, extremely committed and seriously community-minded. Moreover, I soon noticed that an extremely high percentage of these students were Catholic, even if I had never seen them in Church. In short, I could see some of the characteristics of the kingdom being embodied in the life of the Greek community; however, the involvement of many of their members with the Church was negligible. Was there a connection that was being overlooked?

Like Creatures: The Connection

Following many inquiries and much reflection, I was able to make some clear observations. First of all, it should be no surprise that those who were steeped in the values of the Gospel would be drawn to an idealistic life of community, gathered around a common vision and goals, supported and challenged by those who share the same. Greek life, at its best, embodies this; so does our life as Catholics.

Second, many young adults are looking for a deeply intense, radical way of expressing their beliefs. For myriad reasons, these expectations are not always completely met by the Church, leaving some young adults to look for other contexts in which to live out their dreams for a fuller expression. Neither Catholic life nor Greek life will ever be able to fully attain the ideals for which they strive; both embody such lofty ideals that there will always be a certain amount of frustration in reaching toward the standards set. Still, for both Catholics and for Greeks, this becomes a life-long process of continuous growth, and should not be abandoned because the goals are not perfectly attained by us or other members of our community.

Third, it is vital to recognize that Greek life and Catholic life can be totally compatible. I am convinced that to be a good Catholic will be a tremendous blessing in fulfilling the ideals and goals of any fraternity or sorority. I am further convinced that to live out the goals of any of the Greek letter organizations will help to make any young woman or man a better Catholic. We are like creatures, albeit with different starting points. We have much more in common than most people think.

Special Challenges and Opportunities

I am still continually amazed at the number of Catholics that I find in the Greek system. I am also amazed at how many of them do not regularly practice their Catholic faith. Catholic Greeks need to be challenged to remember that they have been initiated into two communities, both of them lifetime commitments. Perhaps the Catholic initiation was not made personally, maybe as an infant; however, the initiation was still valid, and they have been asked to renew that commitment each and every Easter and at each and every Eucharist in which they have chosen to participate. Somehow this connection is not being fully realized.

Greek Catholics need to be reminded of how their fraternity or sorority would suffer if they stopped celebrating their ritual week. Each time this situation is presented the response comes back, without fail, "We would fall apart!" Many of the Catholic members of fraternities and sororities are failing to see that reality in connection with our weekly celebration of the Eucharist. Why do we celebrate our ritual as Catholics every week? Simply put, we need to remember who we are and who we are called to be. Unfortunately, there are many Catholic Greeks who have gone "inactive," without ever having thought about it. The Church has suffered because of it, as would any sorority or fraternity. Both the Church and Greek letter organizations are filled with members who simply "go through the motions" or "wear the letters" without ever really embracing the life. The integrity of both groups demands a better response from its membership.

There is one other aspect of fraternity and sorority life which warrants some attention in the lives of Catholic Greeks. Most of the founders of Greek letter organizations were heavily involved in various types of ministry. It seems that the same ideals that inspired them to form their particular groups later led many of them to lives of public service and/or ministry. Despite much rhetoric about modeling their lives on those of their founders, it is notable that ministerial vocations arise with no greater frequency among Greeks than the general population. It seems that some connection is being overlooked or ignored; moreover, I am convinced that many of the Greek Catholics with whom I have worked would make excellent candidates for ministry.

Benefits Outweigh the Risk

There is a danger in working with some of the "rowdiest" people on campus; many would question the wisdom of doing so. I can't help but wonder, though, whom Jesus would be spending his time with if he worked on a college or university campus today. Greek life is an opportunity ripe for evangelization.

FIRST AMENDMENT DISPUTE

"The vigilant protection of Constitutional freedoms is nowhere more vital than in the community of American schools," so said the United States Supreme Court in *Shelton v. Tucker*, 364 U.S. 479 at 487 (1960). On public college campuses, the right of students to freely associate in fraternities and sororities of their choice is found in the First Amendment to the Constitution of the United States.

Fraternal Law has previously reported on the Foundation for Individual Rights in Education's (FIRE) campaign of litigation against campus speech codes which restrict "a substantial amount of protected speech."

David A. French, the former President of FIRE, now heads the Center for Academic Freedom at the Alliance Defense Fund (ADF), a conservative Christian legal-advocacy group. It recently filed suit against Penn State University on behalf of a Penn State student, challenging University regulations which prohibit "acts of intolerance" and the regulation of free speech to certain "speech zones." ADF described the regulations as speech codes.

According to *The Chronicle of Higher Education* (February 24, 2006), a Penn State spokesman stated "Penn State does not have a speech code. ... [the University] recognizes and vigorously protects the free-speech rights of all members of the University community."

French said in an ADF Press Release, "Universities are supposed to be a marketplace of ideas. Students on campus have the First Amendment right to get a degree *and* maintain their religious and political views. One should not be contingent upon the other."

• Timothy M. Burke

Fluehr v. Penn State Univ., United States District Court, Middle District of Pennsylvania, Case No. 4:06-cv-00394-JFM.

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The goal of *Fraternal Law* is to provide a discussion of fraternity law, but its contents are not intended to provide legal advice for individual problems of Greek organizations. The latter should be obtained from your attorney.

Fraternal Law is published four times yearly as a non-profit service of ManleyBurke, A Legal Professional Association, 225 West Court Street, Cincinnati, Ohio 45202 U.S.A. (513) 721-5525. Please address all editorial inquiries and all subscription correspondence to this address. Individual subscriptions by first class mail are available at \$12.00 per year. Bulk subscriptions are available upon request at reduced rates. Second class postage paid at Cincinnati, Ohio.