

# nonprofit Navigator

## Fundraising in the Internet Age

### Some of the Risks and Legal Obligations of Web-Based Fundraising

In this second of two parts [see NN, 5/00, p1], we discuss some of the risks and legal obligations associated with more complex methods of generating income on the web: affinity shopping agreements, sweepstakes and online auctions.

As always, organizations engaging in these or other web-based fundraising activities should consult an experienced attorney for further guidance.

#### Affinity Shopping Agreements

Under the most common online shopping arrangements, a nonprofit may permit a for-profit to use its name to promote the sale of an item or the nonprofit may promote a commercial product directly on its own web site in the hope of capturing a small percentage of any sales revenue. Nonprofits should be aware that both of these online shopping arrangements may generate Unrelated Business Taxable Income and raise questions concerning the deductibility of the payments made by purchasers.

One of the most common types of merchant affiliate programs involve co-ventures with online booksellers. Under this arrangement, an organization recommends particular books to users and provides links on its website to a bookseller. Some links state that the organization will receive a royalty on books

purchased through the bookseller. Under some arrangements, the online bookseller may indicate to users that a particular book is recommended by the nonprofit. When users buy books, the exempt organization earns a percentage on purchases made through the referring link.

*Online shopping arrangements may generate UBTI and raise questions concerning the deductibility of the payment made by purchasers.*

An IRS official recently commented that the IRS may view the income from the sale of books related to an organization's purpose as tax exempt, while viewing as taxable income any revenue from the sale of books unrelated to the organization's purpose. For example, organizations committed to the protection of wildlife may receive tax-free revenue from sales by an online bookseller of books related to wildlife, but payments related to other books may be taxed if the link is considered active involvement by the nonprofit in the sales program.

Another common type of merchant affiliate program, the online charity mall, such as

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# Fundraising Focus

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<www.igive.com> and <www.shop4change.com>, permits online member shoppers to designate a favorite charity and shop at affiliated vendors through links or sites. For each purchase the shopper makes, the vendor agrees to remit an agreed-upon percentage of the purchase price to the designated charity through the charity mall operator. Some malls claim to pass all of the designated funds to the designated charities, while others indicate that they may retain a small percentage of the proceeds for site maintenance and development.

A nonprofit's relationship with a charity mall can be problematic since nonprofits have no way to verify receipts, and in fact may find that they have little control over the site's use of the organization's name. In addition, because often there is no written agreement between the charity and charity mall operator, it may be difficult to categorize the income for UBIT purposes.

Customers of both charity malls and for-profit sites involved in co-ventures generally will find that none of their payment is tax deductible. With few exceptions, transactions are set up so that it is the for-profit entity, not the purchaser, who makes the contributions—in the form of a royalty payment—to charity.

### Online Auctions

Auctions allow organizations to convert material donations into cash. Normally, certain donations to charity are tax deductible and selling donated merchandise is not taxed as an unrelated trade or business. However, online auctions may run into tax problems.

Charities that turn to outside service providers to conduct online auctions may experience problems with the deductibility of contributions. To be deductible, a contribution must be made "to" or "for the use" of a

charity, a determination which is based on whether the donee organization has full control of the donation and discretion as to its use. If the charity does not sufficiently control the auction, donated items and payments in excess of fair market value may not be tax deductible. Agreements with auction providers should be scrutinized closely to ensure that the charity is not merely lending the use of its name to a commercial operation.

*Charities should not just lend their name to online auctioneers.*

If contributions are deductible, charities must provide acknowledgment to both donors and auction bidders [NN, 11/98, p.3, 5/00, p.1]. Bidders who know the fair market value of an item in advance may deduct as a contribution any excess portion of the purchase price. Presumably, electronic disclosure should be sufficient for an online auction, although the IRS has not officially blessed electronic disclosure and substantiation.

Turning to outside providers to conduct online auctions can also have regrettable UBIT implications. Unless the event is performed as part of a distinctively charitable fundraising event, and the nonprofit retains primary responsibility for the marketing and conduct of the auction, the IRS may view income from the auction as taxable income from an unrelated business.

### Online Sweepstakes

The explosion of online sweepstakes in the for-profit world [see, for example, <www.buybargainsonline.com/sweepstakes\_contest.html> and <www.sweepstakesonline.com>] is likely soon to draw interest from the nonprofit

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## IRS Proposes Rules Prohibiting “Vulture” Trusts

The IRS recently proposed rules prohibiting an abusive form of charitable trust—so-called vulture trusts—that allows wealthy donors to avoid income and estate taxes by taking advantage of gravely ill people.

*These trusts allow wealthy donors to profit at a charity’s expense.*

In charitable lead trusts, a common vehicle for charitable giving, donated assets are invested and a percentage is paid to charity until the death of a designated individual (the donor or some other selected person), after which time the funds remaining in the trust go to people chosen by the donor. Because the trust benefits charity, donors get a tax break on federal income, gift and estate taxes. The tax break is calculated using actuarial tables that gauge the life expectancy of the designated measuring individual. The longer the individual is expected to live, the more the trust is expected to give to charity and thus the larger the tax deduction.

Some donors have taken advantage of this giving technique by using seriously ill, unrelated individuals as the measuring life. Because the actuarial tables used to determine the tax deduction take into account the life expectancies of all individuals of the same age as the individual who is the measuring life, when the measuring individual dies prematurely, the amount the charity actually receives winds up being significantly less than the amount on which the charitable deduction is based.

Charitable lead trusts are currently being marketed in packages including the names of seriously ill individuals and access to the individual’s medical records. Typically, a token payment is made to the ill individual who serves as the measuring life.

The proposed rules, which would affect trusts created on or after April 4, 2000, are designed to end this abuse by limiting the people upon whose life expectancies such a trust can be based. Only the donor, the donor’s spouse, and a lineal ancestor of all the remainder beneficiaries of the trust would qualify.

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## Fundraising in the Internet Age, cont.

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world. Nonprofits engaged in online sweepstakes should keep in mind several tax issues relevant to these programs.

Charitable sweepstakes or raffle participants generally may not claim a tax deduction for entry fees. The “donation” is treated as payment for a chance to win a valuable prize rather than a genuine gift. A recent ruling, however, explained that if sweepstakes organizers make it clear that it is possible to enter and win the sweepstakes without contributing any money, participants who do contribute will be able to deduct the payment [NN, 5/00, p.2].

State business laws as well as federal law regulate various aspects of sweepstakes operations [NN, 4/00, p.4]. Many of the existing prohibitions apply to transactions conducted via mail or within the jurisdiction of a state, so their application to the Internet is unclear. However, with regulators and legislators increasingly concerned about online gambling, U.S. nonprofits would be wise to be wary.

Especially when entering into an agreement with a for-profit raffle site, do your research carefully. Just because a site is currently operating does not mean it is doing so legally.

## Express Advocacy Prohibition Not For Show Branch Ministries Loses Appeal on (c)(3) Revocation for 1992 Anti-Clinton Ad

A few days before the 1992 presidential election, the Church at Pierce Creek (operated by Branch Ministries, Inc.) vaulted into the national spotlight by buying a full-page ad in *USA Today* and the *Washington Times*. The ad featured the ominous headline “Christians Beware,” and asked how Christians could vote for then-candidate Bill Clinton, given his views on abortion, sexual orientation and the like, which were “contrary to Biblical teachings.”

*Left unclear is whether ministers electioneering from the pulpit cross the express advocacy line.*

The IRS also saw the advertisement and revoked the church’s 1983 determination letter, calling the ad impermissible political activity under section 501 of the Code. [TM, 5/95 p. 1]. The church sued, and lost on summary judgment in 1997. [NN 10/97, p. 6] The D.C. Circuit affirmed in May.

Unfortunately for the exempt organization community, the decision fails to answer the difficult questions about political speech by 501(c)(3)s. Here, exempt status revocation was based on express advocacy for the defeat of a candidate for federal office in the form of a newspaper advertisement distributed all over the country. Left unclear is whether ministers electioneering from the pulpit or communications below the express-advocacy bar can result in revocation. The line between permissible and impermissible remains vague, although it is once again clear that the First

Amendment right to free speech is not compromised by a refusal to subsidize it through the tax code.

Nonetheless, the decision is significant in that it marks the first time a bona-fide church, as opposed to the 1960s-era television program controversies, has lost its exemption for political activities. Churches enjoy special protection in IRS investigations, requiring the Service to jump through several procedural hoops before advancing to a audit-like church tax examination. The court rejected the church’s claims of disparate treatment at the hands of the IRS, arguing that no other church had crossed the line from pulpit pounding to mass advertising. (Incidentally, the recent bipartisan Joint Committee on Taxation report found no evidence of politically motivated bias in IRS enforcement cases [NN, 4/00, p. 5].)

*The church could set up a (c)(4) which could in turn form a political arm.*

The court suggested that the church could organize a 501(c)(4) which could, in turn, form a political action arm to intervene in campaigns. The court also noted that a church’s loss of 501(c)(3) status recognition is less disastrous than it would be for another organization, as churches are presumptively treated as (c)(3)s, with the attendant deductibility of contributions, provided they act as such.

All in all, the exempt community will have to wait for some of the more difficult cases on political activity by (c)(3)s to come down the pike.

## Christian Coalition Pays For Political Activities FEC Collects \$45,000 For Improper Mailing and List Transfer

After years of fighting the FEC, the Christian Coalition recently agreed to pay a civil penalty of \$45,000 for certain political activities it conducted in 1994. The settlement follows a decision by the U.S. District Court for the District of Columbia issued last year [NN, 9/99, p.2] that was widely seen as a victory for the Coalition and brings to a close

*Last year's court decision did not give nonprofits a green light for all types of electoral activities.*

the long battle between the FEC and the Coalition over the permissibility of certain electoral activities. It should remind nonprofit organizations that despite the apparent wide latitude last year's court decision gave nonprofits to conduct electoral activities, there are still limits.

Although the District Court's decision last year rejected many of the FEC's claims of improper coordination and express advocacy, it also found that the Coalition, a nonprofit corporation, made improper campaign contributions on two occasions in 1994. In one instance, the Coalition sent a mass mailing containing speech that was tantamount to express advocacy: it indicated that the enclosed voter guide was "to help you prepare for your trip to the voting booth" and that "Newt Gingrich [is] a Christian Coalition 100 percent." On another occasion, the Coalition provided the Oliver North campaign with a valuable mailing list of potential delegates to the Virginia Republican convention. The court deemed each of these activities an improper corporate contribution and ruled that the FEC was entitled to assess penalties.

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## Done: UCC Settles With IRS

It's finally over. After years of litigation, the United Cancer Council and the IRS have settled their battle over the UCC's tax-exempt status. The UCC's fate should remind nonprofits to be careful about how they structure fundraising agreements, no matter how dire the straits.

In the midst of a financial crisis, in 1984 the UCC entered into a 5-year contract with the for-profit fundraising firm Watson & Hughey. The contract had a number of terms which were highly favorable to W&H. In 1990, the IRS revoked the UCC's tax exemption retroactively to 1984 on the theory (later rebuked by the 7<sup>th</sup> Circuit) that the UCC had been used for the private inurement of W&H [NN, 3/99 p. 1; NN, 1/98 p. 1].

Under the terms of the settlement, the UCC has lost its exemption from 1986 – 1989, but managed to keep its exemption from 1990

*Be careful about how fundraising agreements are structured, no matter how dire the straits.*

on. However, the organization's activities are restricted to accepting charitable bequests and distributing those bequests to its local cancer councils for the direct care of cancer patients. Such amounts may not, however, be distributed to 501(c)(3)s that have ever had a relationship with W&H.

# Capitol Letters

## 501(c)(4)s May Be Able to Sue for Exempt Status

The Taxpayer Bill of Rights Act of 2000, recently passed by the House, gives prospective 501(c)(4)s and other non-(c)(3) exempt organizations the opportunity to bring suit against the IRS to receive judicial determination of their exempt status. Previously, only 501(c)(3)s have had this ability. The right would arise if the Service denies a 1024 application or does not make the determination on its own within nine months of the filing of a complete application.

The bill, which is awaiting action in the Senate as of this printing, came on the heels of the Christian Coalition's notorious failed bid for (c)(4) recognition, a fight which took several years [NN, 6/99, p. 1].

Technically, the bill classifies a delay of more than nine months as an effective exhaustion of IRS-level remedies. In order to qualify, however, organizations must show that they have taken all reasonable steps in a timely manner to secure a determination from the Service.

In the event of a transfer of the determination request from one IRS office to another (typically to the national office), a new provision applying to all 501(c) organizations would allow organizations to seek relief under the same terms if no response is forthcoming from the transferee within six months of the transfer.

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## Proxy Tax Litigation Reaches Conclusion

The U.S. Supreme Court recently declined to hear an appeal of a lower court decision [NN, 1/00, p.7] upholding the constitutionality of the "lobby tax" provisions in the Omnibus Budget Reconciliation Act of 1993 ("the Act") designed to ensure that no contributor could deduct any portion of dues ultimately used for lobbying by non-501(c)(3) exempt organizations.

The U.S. Court of Appeals for the District of Columbia upheld the validity of the provisions last November.

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# Election Connection

## FEC Late Fees

Beginning in July, in an effort to encourage more timely filing of disclosure reports, the Federal Election Commission will assess fines for candidates and political committees that miss filing deadlines.

The fines will be set on a sliding scale from \$125 for committees with financial activity of less than \$25,000 to \$16,000 for the largest committees. Repeat offenders will be subject to additional penalties. Committees

may appeal a fine within 30 days in federal district court.

The rule, described as a "traffic ticket" system, marks an attempt by the FEC to encourage compliance with definite penalties, rather than the somewhat random and lackadaisical enforcement efforts of years past. Congress specifically authorized the FEC to assess fines for late-filers late last year.

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# Book Review

## Economies of Scale

### Book Surveys Fundraising Regulations of the 50 States

Despite the potential of the Internet to revolutionize national fundraising (see page 1), larger charities raise the vast majority of their funds using more traditional strategies, such as direct mail and telephone solicitations.

But fundraising across the country is a perilous exercise without a very detailed road map to the registration requirements, filing fees and paperwork of each state's regulatory regime. *Fund-raising Regulation: A State-by-State Handbook of Registration Forms, Requirements and Procedures* (Wiley 1999) provides exactly that.

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#### **Fund-raising Regulation: A State-by-State Handbook of Registration Forms, Requirements and Procedures (Wiley 1999) (\$395)**

Each state (except, lamentably, the District of Columbia) receives its own section, including the applicable regulations, forms, deadlines, filing fees and addresses. *Fund-raising Regulation* pays detailed attention to areas of the law where the state's rules differ. States are particularly inconsistent when it comes to exemptions from reporting requirements, basing the decision on either the amount of funds to be raised or the type of organization, or both. As each state treats the use of professional solicitors differently, that, too, gets a section.

For the charity planning a major national push, most of the requirements for all the states are listed in a table up front. The book is a loose-leaf two-volume set with a periodic subscription update service.

*Fund-raising Regulation* also includes a helpful discussion of the rise of the commer-

cial co-venture (and other varieties of cause-related marketing) and how to comply with state laws governing such arrangements. This practice of using a charity's "endorsement" of a product in advertising in exchange for a percentage of the purchase price or some other consideration is the subject of an evolving and controversial effort by the states to regulate charities' use of their pent-up goodwill [NN, 5/00 p. 5].

While local charities which do their work and fundraising in one jurisdiction do not have to worry about running afoul of the rules far from home, larger charities, and possibly those raising funds on the Internet, will do well to heed *Fund-raising Regulation's* advice.

*E-Advocacy for Nonprofits: The Law of Lobbying and Election-Related Activity on the Net*, by the *Navigator's* own Elizabeth Kingsley and Gail Harmon, and John Pomeranz and Kay Guinane of the Alliance's Nonprofit Advocacy Project, is now available online free of charge at <http://www.afj.org/index.htm>, the webpage of the Alliance for Justice. The book examines the application of traditional concepts and laws developed in the days of hard copy and postage stamps to advocacy and policy activities of nonprofits in the Internet era. The online version, which is designed for easy browsing, contains links to cross-referenced sections throughout.

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## Getting to Know Harmon, Curran, Spielberg & Eisenberg, LLP

### About the Firm

Harmon, Curran, Spielberg & Eisenberg, L.L.P. specializes in providing legal Harmon, Curran, Spielberg & Eisenberg, L.L.P. specializes in providing legal advice to nonprofit organizations and individuals in the areas of advice to nonprofit organizations and individuals in the areas of:

- Nonprofit Organization Tax law
- Election law
- Employment law
- Environmental law

For more than 25 years, we have successfully served the legal needs of a wide variety of nonprofit organizations and citizen groups, political action committees, and individuals.

We pride ourselves on providing individualized attention and services tailored to the unique requirements of each client. We work closely with clients to identify and prioritize their legal needs and develop effective strategies for working within the scope of their resources. The firm is dedicated to helping clients use the legal system to enhance the effectiveness of citizen advocacy, vindicate civil rights, and promote environmental protection.

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