# G. UPDATE ON FUNDRAISING

## 1. Introduction

The historical development of the law and the Service position on fundraising organizations was extensively covered in the 1982 CPE book, pp. 103-174. This topic is intended to update the 1982 article, as well as to provide an additional focus on some major recurring themes. Except where otherwise specified, the topic will limit its consideration to fundraising by IRC 501(c)(3) organizations.

## 2. Fundraising and Free Speech

In 1980, the Supreme Court held that a town ordinance that regulated door-to-door or on-street solicitation of contributions was unconstitutionally overbroad. Village of Schaumberg v. Citizens for A Better Environment, 444 U.S. 620 (1980). The ordinance allowed solicitations only if the soliciting organization could show, in applying for a permit, that 75% of its receipts would be used directly for charitable purposes. Salaries or commissions for solicitors and administrative costs and overhead could not be considered as used directly for charitable purposes under the ordinance.

The Court, in an 8-1 decision, concluded that, although soliciting financial support is subject to reasonable regulation, the Schaumberg ordinance was drafted more broadly than reasonably necessary to regulate solicitation. As a result, the ordinance interfered with First and Fourteenth Amendment guarantees of the right of free speech and assembly.

Although it may not be apparent at first how solicitation of funds can be equated with the exercise of free speech, the Court was concerned that the ordinance in Schaumberg would prevent fundraising organizations that necessarily had high administrative costs from disseminating information from door-to-door or on the street. The organization in Schaumberg used a substantial part of its receipts for the salaries of its door-to-door solicitors, who distributed information on environmental issues as they asked for contributions. Without a salaried staff of solicitors, the organization would have been less able to obtain the help needed to make its information available to the public. The strict 75% requirement discouraged fundraising and public contacts by organizations that relied primarily

on paid fundraisers, and consequently was found to inhibit these organizations' rights of free speech unnecessarily.

Upon the same rationale, the Supreme Court struck down a Maryland statute that limited the noncharitable expenses of charities to 25% of the amount raised in Maryland v. Joseph H. Munson Company, Inc., U.S., 81 L. Ed 2d 786, 104 S. Ct. 2839 (1984). The Maryland statute was more flexible than the ordinance of Schaumberg in that it authorized a waiver of the percentage limitation in cases where the limitation would effectively prevent a charity from raising contributions. In a 5-4 decision, the Court decided that this increased flexibility did not remedy the fundamental defect of the percentage limitation. The Court held that even with a waiver provision, the statute created an unnecessary risk of "chilling" free speech.

Schaumberg and Munson should not be construed as allowing IRC 501(c)(3) organizations to engage in political campaigning or in lobbying (other than as permitted by IRC 501(h)) in their fundraising campaigns. In Regan v. Taxation with Representation of Washington, 461 U.S. 540 (1983), the Supreme Court held that the IRC 501(c)(3) statute does not restrict an organization's right of free speech. The Court stated that the statute merely reflected Congressional intent not to subsidize with public funds lobbying by exempt organizations. Although Taxation with Representation indicates that the Court adopts a different free speech standard in the context of a federal tax statute than in state and local criminal or regulatory laws, rulemaking with specific percentage distribution standards should probably be left to Congress alone. The adoption of a general fixed percentage distribution standard for fundraisers by an administrative agency such as the IRS would place the agency in a gray area that would invite, if not guarantee, constitutional attack.

However, Schaumberg and Munson were directed at an ordinance and a statute that regulated only door-to-door and on-the-street direct solicitations. The universe of exempt organization fundraising is clearly much broader. The connection between free speech and, for example, thrift shop sales, weekly bingo contests, and annual golf tournaments for charity is seemingly remote, and it is at least questionable to what extent the Schaumberg and Munson decisions have application in such contexts. We can probably say, but without total certainty, that free speech considerations have greater relevance to organizations that raise their funds primarily through direct solicitation than to organizations that raise funds by means of a trade or business.

3. The Exemption Issue

(A) Purposes and Activities

It is clearly established that an organization with the purpose of distributing funds to other charitable organizations recognized as exempt under IRC 501(c)(3) may itself qualify for IRC 501(c)(3) exemption. Rev. Rul. 67-149, 1967-1 C.B. 133. An organization with a primary purpose of operating an unrelated trade or business, however, will not qualify for IRC 501(c)(3) exemption (Reg. 1.501(c)(3)1(e)(1)), nor will an organization that does not engage primarily in activities that accomplish one or more exempt purposes (Reg. 1.501(c)(3)-1(c)(1)).

Although these rules appear simple, difficulties arise when an organization whose primary activity is an unrelated trade or business maintains that its primary purpose is to distribute the funds it raises to IRC 501(c)(3) charities.

In Rev. Rul. 64-182, 1964-1 C.B. 187, an organization derived its income principally from renting space in a commercial property that it owned and operated. It was held to be exempt under IRC 501(c)(3) because its primary purpose was found to be raising funds for distribution for charitable purposes. Rev. Rul. 64-182 states that an organization that distributes funds for charitable purposes in an amount commensurate to its resources would qualify for IRC 501(c)(3) exemption.

The commensurate test of Rev. Rul. 64-182 remains the basis by which such fundraisers are tested. If this test is met, exemption will not be foreclosed to an organization notwithstanding that its primary fundraising activity in carrying out its purposes is not inherently charitable or is an unrelated trade or business. However, even if the commensurate test is satisfied, exemption may still be defeated if inurement is found, if the facts clearly show other evidence of a primarily private purpose, if political campaigning or substantial lobbying is carried on (other than as permitted by IRC 501(h), or if the organization is a "feeder" organization described in IRC 502.

(B) The Commensurate Test

The problems recently reported in the media concerning some fundraising organizations for African famine relief emphasize the need for reviewing the operations of many fundraisers. Of course, fundraising organizations should not be tax exempt if they are soliciting funds on a fraudulent basis, or if they are

distributing funds to charity year after year only on an insubstantial or nonexistent basis. The difficulties arise in ensuring a sufficient level of charitable distribution to guarantee that the organization's primary purpose is charitable, without at the same time imposing a rigid distribution formula that would ignore the specific facts and circumstances of particular organizations, and without imposing on the rights of free speech of the organizations in violation of Schaumberg and Munson.

We believe that the commensurate test of Rev. Rul. 64-182 is sufficiently flexible to allow even the most garrulous of fundraising organizations its full complement of free speech interests (with the 501(c)(3) limitations against political campaigning and lobbying excepted), and yet ensure that a real and substantial payout to charity is made. Simply stated, the commensurate test requires that an organization with fundraising as its principal activity must carry on a charitable program of grants and contributions commensurate with its financial resources.

Inherent in the application of the commensurate test is a resort to the particular facts and circumstances of each fundraising organization. There is no fixed percentage of income that an organization must pay out for charitable purposes. The financial resources of any organization may be affected by such factors as start-up costs, overhead, scale of operations, whether labor is volunteer or salaried, phone or postal rates, etc.

Clearly, however, an organization that solicits or raises funds for charity and consistently soaks up virtually all of its income through administrative expenses and salaries with little or no distribution to charity cannot reasonably argue that its distributions are commensurate with its financial resources. The charitable program must be real and substantial. Although there is no specific required payout percentage, distribution levels that are extremely low should automatically invite close scrutiny.

Nevertheless, a low payout percentage does not automatically indicate that a fundraising organization has a primary purpose that is not charitable. In each case, it should be ascertained if the failure to make a substantial payout to charitable organizations is due to reasonable cause, and whether the organization has had a reasonable period of time to make real and substantial contributions to charity.

(C) Other Indications of Primary Purpose and Inurement -- Recent Cases

Even if an organization makes a real and substantial contribution to charity commensurate with its financial resources, a substantial private purpose may still

may be found that will disqualify it from IRC 501(c)(3) exemption. For example, the Tax Court recently held that an organization that purported to raise funds for charity by conducting bingo games had a substantial private purpose that disqualified the organization from IRC 501(c)(3) exemption. The bingo games were conducted in a bar owned by the organization's directors. The Court found that a substantial purpose of the organization was to allow the bar to make food and beverage sales to the bingo players for the benefit of the bar's owners. The sufficiency of the organization's charitable distribution program was not discussed in the decision. See P.L.L. Scholarship Fund v. Commissioner, 82 T.C. 196 (1984), discussed later in this topic under "Bingo."

Fundraising commissions may involve inurement. Although a charitable organization's officers may receive reasonable compensation for services rendered, an agreement by the organization to provide an officer with a percentage of funds raised by the officer may constitute inurement of earnings. A contingency fee arrangement may in some circumstances be permissible; however, if no actual services are required for the fee, or if there is no evidence that the amount received is reasonable in relation to the services performed, the contingency fee arrangement constitutes inurement of charitable assets. If the commission is based solely on the amount of the contribution, it is unreasonable per se.

For these reasons, the Service has nonacquiesced to the holding in World Family Corporation v. Commissioner, 81 T.C. 958 (1983), that permitted a contingency fee for the organization's president of up to 20% of the funds he raised. The court found the contingency fee to be reasonable because all fundraisers of the organization, and not merely insiders, were eligible to receive percentage fees. The court reasoned that the commissions were based on services rendered in the sense that they were contingent upon success in procuring funds. In reaching its conclusion, the court distinguished Gemological Institute of America v. Commissioner, 212 F. 2d 205 (9th Cir. 1954), because the contingent fee in Gemological Institute was 50%, and thus "clearly unreasonable." The court also distinguished cases such as Founding Church of Scientology v. U.S., 412 F. 2d 1197 (Ct. Cl. 1969), where the percentage arrangement was not tied to services rendered.

The Service does not accept mere "success" at fundraising as an index of services rendered. Any contingency fee paid to an insider must reflect reasonable compensation for services actually performed.

(D) Feeder Organizations - IRC 502

Although on its face IRC 502 provides an apparently broad basis for denying exemption to many feeder organizations that carry on a trade or business, its actual application has generally been narrowly confined. IRC 502 provides that an organization operated for the primary purpose of carrying on a trade or business for profit will not be exempt from taxation under IRC 501 on the ground that all of its profits are payable to one or more organizations exempt from taxation under IRC 501. Certain exceptions are allowed under IRC 502(b), which provides that the term "trade or business" does not include:

1) the receipt of rents that would be excluded from unrelated business taxable income under IRC 512(b)(3);

2) a trade or business in which substantially all labor is volunteer labor, or

3) a trade or business of selling merchandise, substantially all of which has been donated to the organization.

The 1983 CPE book, pp. 83-106, discusses IRC 502 and indicates how the Service has usually applied that section. Briefly stated, the Service view has been that IRC 502 applies to, and only to, organizations that:

1) carry on a trade or business for profit;

2) must, without discretion by the organizations' governing bodies, turn over their profits to designated charities; and

3) do not themselves carry on any substantial direct charitable activity (Rev. Rul. 73-164, 1973-1 C.B. 223).

This view has had the effect of narrowing the application of IRC 502 to relatively few organizations. Recently, however, the Tax Court held that an organization that conducts bingo games as its sole activity, and that purported to distribute its profits to recognized charities, could not qualify for IRC 501(c)(3) exemption because it was a "feeder" organization described in IRC 502. Piety, Inc. v. Commissioner, 82 T.C. 193 (1984). The circumstance that makes this case unique is that the organization's governing board apparently had discretion to turn over its profits to any IRC 501(c)(3) charity. The Court also stated that an organization must directly serve some exempt purposes before exemption could be

allowed. The Court did not discuss the Service's principal argument that the facts showed that the organization had a primarily private purpose, benefitted private individuals, and distributed inadequate amounts to charity.

Although the holding in Piety is favorable to the Service, it should probably be regarded as something of an aberration. The view that IRC 502 disqualifies only those organizations that have no discretion in turning over their trade or business profits to charities, although not formally published, remains ingrained. Further, the Service has never adopted the rule, stated in Piety, that an IRC 501(c)(3) organization must directly (rather than indirectly) serve an exempt purpose. It is theoretically possible, under the Service view, for an organization to engage in bingo as its sole activity and still qualify for IRC 501(c)(3) exemption, provided that it genuinely serves a charitable purpose by distributing its net income to charities, it retains the power to select those charities, and the amount turned over is commensurate with its financial resources.

Nevertheless, decisions like Piety indicate that some courts do not look favorably upon organizations that claim tax exemption as charities without themselves performing direct charitable activities, and the Service has occasionally in litigation offered IRC 502 as grounds for denial of exemption even where an organization's governing board had discretion to select recipient charities. It remains to be seen whether Piety will be relegated to the status of a mere curiosity, or whether it will herald a broader interpretation of IRC 502. In the absence of more definitive guidance, however, the traditional Service view will continue to be applied.

4. Bingo

The Service has received a number of IRC 501(c)(3) applications from organizations with the primary activity, or even the sole activity, of conducting bingo games. We have also seen a few applications from organizations offering other types of gaming activities.

(A) Exemption

Currently, IRM 7664.31:(8) requires applications from organizations with bingo as their primary activity to be referred to the National Office. Because of the similarity of some issues, applications from organizations conducting other gaming activities as their primary activity may also be considered for referral to the National Office.

As with other fundraising organizations, bingo fundraisers should be tested to see whether their primary purpose is to further one or more exempt purposes. Regardless of the primary purpose, however, no organization conducting bingo games or other gaming activities as a substantial activity will be recognized as exempt if its conduct is in violation of state or local law.

For purposes of the exemption issue, bingo should not be considered to be related to the exempt function of an organization, notwithstanding that IRC 513(f)(1) provides, in the context of determining unrelated trade or business issues, that the conducting of bingo games is not unrelated trade or business. The underlying committee reports to the 1978 enactment of IRC 513(f)(1) indicate that Congress did not intend this legislation to affect exemption considerations. H.R. Rep. No. 95-1608, 95th Cong., 2nd Sess. 7-8 (1978). Consequently, if the primary purpose of an organization is determined to be the mere conduct of bingo games, it cannot qualify for exemption under IRC 501(c)(3). However, if an organization that has as its primary activity the conduct of bingo games can demonstrate by resort to the facts and circumstances and the commensurate test that its primary purpose is to turn over its proceeds to charitable organizations, then IRC 501(c)(3) exemption is not foreclosed.

The conduct of bingo games can be a lucrative enterprise. With a relatively low overhead, a prize distribution subject to the organization's control, and a potentially high profit margin, bingo may attract entrepreneurs of all varieties, some of whom may wish to mask themselves as charities to satisfy state and local gambling laws. Needless to say, the potential for abuse exists, and each case should be examined for evidence of a substantial private purpose or of inurement even if the commensurate test for distributions to charity is otherwise met.

In P.L.L. Scholarship Fund, discussed earlier, an organization with the stated purpose of raising money for scholarship funds conducted bingo games as its primary activity. The games took place in a bar owned by three of the organization's five directors. Two of these three owners conducted the games while sales of food and beverages were solicited and made to the players by employees of the bar. Proceeds of these sales were retained by the bar separate and apart from the bingo proceeds. The Tax Court held that a substantial private purpose of the organization was to attract persons to the bar in the expectation that these persons would purchase food and beverages. Citing Reg. 1.501(c)(3)-1(d)(1)(ii), the Court held that the organization did not qualify for IRC 501(c)(3) exemption.

Other evidence of a substantial private purpose may be exorbitant rents paid by the organization, unnecessary service contracts with undisclosed third parties, or high salaries for the part-time or unskilled positions typical of bingo games.

As discussed earlier, if the organization has the legal duty to turn its earnings over to a specified charity or charities, and conducts no directly charitable activities, IRC 502 will bar exemption. If, on the contrary, the organization selects the recipient charity, IRC 502 is not applicable. But see Piety, discussed above.

(B) Unrelated Business Income

Before 1978, the conduct of bingo games by an IRC 501 organization was considered unrelated trade or business. Unless the activity was so infrequent as not to be considered "regularly carried on," or else substantially all work was performed without compensation so as to trigger the exception of IRC 513(a)(1), exempt organizations conducting bingo games were taxed on their bingo income.

The unrelated business income tax on bingo was unsuccessfully challenged in Smith-Dodd Businessman's Association v. Commissioner, 65 T.C. 620 (1975), and in Clarence La Belle Post No. 217 v. U.S., 580 F. 2d 270 (8th Cir. 1978). In each case, the taxpayers argued that IRC 511 taxation should apply only if the unrelated activity competed with taxable commercial business activities. This position was rejected by the courts.

In 1978, however, Congress rushed to the aid of exempt organization sponsored bingo by enacting IRC 513(f), which exempts bingo from tax under IRC 511 if the conduct of the games is not in violation of state or local law and if bingo is not normally conducted on a commercial basis in the jurisdiction. Reg. 1.513-5(c)(2) defines jurisdiction to mean the relevant state, unless state law permits local jurisdictions to determine whether bingo is a permissible commercial activity for for-profit organizations or unless state law designates local jurisdictions as permissible local bingo areas for for-profit organizations. If state law so permits (or designates), and commercial bingo is, as a result, permitted in the local jurisdiction, then the local jurisdiction is considered the appropriate jurisdiction for determining whether bingo is conducted on a commercial basis.

State and local laws with respect to bingo vary among jurisdictions, and the applicable law should be consulted in considering any bingo case. Although a jurisdiction-by-jurisdiction study of state and local laws is contained in the 1981

CPE book, pp. 288-316, the law in the relevant jurisdiction should be researched to ensure that no recent changes have been made.

If bingo games conducted by an exempt organization violate state or local law, the organization will be considered to be engaged in unrelated trade or business regardless of the degree to which state or local law is enforced. (See Reg. 1.513-5(c)(3), Example (2).)

In section 311 of the Deficit Reduction Act of 1984, Congress exempted certain other games of chance from the unrelated trade or business definition. This change was not incorporated in the Internal Revenue Code. Section 311 of the Act provides that, effective for games conducted after June 30, 1981, for purposes of IRC 513 the term "unrelated trade or business" does not include a trade or business that consists of conducting a game of chance if:

1) the game of chance is conducted by a nonprofit organization;

2) the conducting of the game by the organization does not violate any state or local law; and

3) as of October 5, 1983, there was a state law in effect that permitted the conducting of the game of chance only by a nonprofit organization.

If a state law that was in effect on October 5, 1983, permits the particular game of chance only by nonprofit organizations, and state or local law are not otherwise violated, this provision allows other gambling activities in addition to bingo to be conducted by a nonprofit organization without being considered unrelated trade or business. Where the new law applies, it would appear that organizations would be relieved from strict compliance with the provisions of IRC 513(f)(2)(A) and (B) governing the conduct of bingo games.

Section 311, however, may be limited to games of chance conducted in North Dakota. H.R. 1800, the Technical Corrections Bill of 1985, would amend section 311 to provide that the state law in effect on October 5, 1983, must originally have been enacted on April 22, 1977. This amendment would be effective as if enacted in the original statute and would therefore have retroactive effect. Consequently, for organizations outside of North Dakota, the current tax status of non-bingo gaming activities is uncertain pending the ultimate disposition

of H.R. 1800. Consideration of H.R. 1800 has been held up so that it may be handled concurrently with the Administration's tax simplification proposals.

5. Unrelated Business Income Taxation Developments

(A) Trade or Business - the Low Cost Articles Exception

Reg. 1.513-1(b) provides that where an activity does not possess the characteristics of a trade or business, such as when an organization sends out low cost articles incidental to the solicitation of charitable contributions, the unrelated business income tax does not apply.

The Service interprets this provision to include only items of negligible commercial value. It does not agree with the holding of The Hope School v. U.S., 612 F. 2d 298 (7th Cir. 1980). In Hope School, the organization mailed out boxed greeting cards to persons on its mailing list, included reorder forms and a solicitation letter, and sent follow-up letters to persons who did not respond to the initial appeal. It was held not to be engaged in the trade or business of selling greeting cards because it was within the low-cost articles exception of Reg. 1.513-1(b).

In Hope School, the actual operation of the solicitation program was undertaken by a private business that received $1.10 for each box of cards sold. $2.00 was requested as a "contribution" from the recipient of the mailed items, with the school keeping amounts received in excess of $1.10 from each sale.

In its analysis of the case, the 7th Circuit stated that because the primary purpose of the unrelated business income tax was to discourage unfair competition with commercial enterprises, the tax did not apply in this case. According to the Court, there was no unfair competition. We consider this analysis to be incorrect and at odds with the 8th Circuit's decision in Clarence La Belle and the Tax Court's decision in Smith-Dodd Businessman's Association (both discussed earlier in connection with organizations that conduct bingo games). Regardless of the existence of unfair competition, the Service believes that an organization that regularly carries on a trade or business that is not related to the organization's exempt function is subject to tax under IRC 511.

Recently, the decision in Hope School was followed by Veterans of Foreign Wars of the United States, Department of Missouri, Inc. v. U. S., 601 F. Supp. 7 (W.D. Mo. 1984). The VFW, an organization described in IRC 501(c)(19),

engaged a private business firm to mail boxes of Christmas cards to the VFW membership with a solicitation letter asking for a "contribution" of $3.00. Each box had a wholesale cost of $1.05 and a retail value of $2.00. The Court held that the Hope School decision was controlling, and that the low cost articles exception of Reg. 1.513-1(b) applied. The court did not consider the case to be in conflict with Clarence La Belle apparently because, according to the Court, the greeting card program was not a "trade or business."

The VFW decision was not appealed because Counsel believed the administrative record to be incomplete. However, the Service is now litigating another case with virtually identical issues in Michigan.

More favorable to the Service was Disabled American Veterans v. U.S., 81-1 USTC 9443 (Ct. Cl. 1981), where certain competitively priced mailed articles were held to result in UBI. However, certain other mailed items that were offered at twice their retail value were held not to result in UBI because a "competitive situation" did not exist. The Court stated that it was not necessary for actual unfair competition to be present; however, for a trade or business to exist as a prerequisite to the imposition of unrelated business income tax, the goods must be offered in a "competitive fashion." Although the Service has experienced problems in the courts, the standard continues to be that a trade or business exists if mailed items that accompany solicitations have more than a commercially negligible value.

(B) Regularly Carried On

The Service has acquiesced in the result of Suffolk County Patrolmen's Benevolent Association, Inc., v. Commissioner, 77 T.C. 1314 (1981). The exempt organization contracted with a professional fundraiser to put on performances of a vaudeville show one weekend each year over a period of several years. Commercial advertising was sold in the program guide for the show. Approximately eight to sixteen weeks each year were spent in solicitations for program advertising and in the advance sale of tickets. The organization received 28% of the advertising revenues and 50% of ticket revenues.

The Court held that notwithstanding that the arrangement with the professional fundraiser showed a recurring pattern of activity over several years, the shows themselves were an annual event of short duration encompassed within the "intermittent activity" exceptions of Reg. 1.513-1(c)(2)(ii) and (iii). Consequently, they were not "regularly carried on" and were therefore not subject to taxation under IRC 511.

The Suffolk County case is discussed extensively in the 1984 CPE, pp. 140-147.

(C) The Volunteer Labor Exception of IRC 513(a)(1)

A difficult issue is presented by the furnishing of living expenses to persons who perform otherwise uncompensated labor. St. Joseph Farms of Indiana Brothers of the Congregation of Holy Cross, Southwest Province, Inc. v. Commissioner, 85 T.C.___ (July 1, 1985), held that such expenses are not compensation if they would have been provided regardless of whether labor was performed. The St. Joseph Farms case is discussed in the Update on Churches topic in this CPE book.