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INTRODUCTION TO THE LAW OF FUNDRAISING FOR CHARITY

The purpose of this chapter is to provide a framework consisting of the fundamental elements in federal and state law that shape the rules concerning fundraising for charitable organizations. Thus, this chapter will:

- Provide a definition of the phrase *charitable fundraising*.
- Address the concept of *charitable sales*.
- Explore the definition of the phrase *charitable contribution*.
- Describe the various methods of fundraising.
- Discuss the controversial matter of fundraising costs.
- Summarize the commensurate test.
- Enumerate the several issues pertaining to fundraising compensation.
- Explain the trap that lurks in the step transaction doctrine.
- Summarize the law concerning the enforceability of charitable pledges.
- Correlate the applicability of the public policy doctrine to the charitable giving setting.

DEFINITION OF *CHARITABLE FUNDRAISING*

A common perception is that there is a single type of activity termed *fundraising*, just as there is a prevailing view that all charitable gifts are made in cash. Most state and local, as well as some federal, regulatory approaches seem founded on this perception. An assumption is made that the law amply defines *fundraising*, when in fact it does not. Yet, to raise funds in this setting is to solicit gifts.

State Law

State charitable solicitation acts (see Chapter 3) usually define the word *solicitation*. These definitions generally are encompassing. This fact is evidenced not only by the express language of the definition but also by an expansive definition of the term *charitable* and application of these acts to charitable solicitations conducted, in common parlance, "by any means whatsoever." A solicitation can be oral or written. It can take place by means of a variety of methods of communication (discussed ahead). Debate over the legal consequences of charitable solicitation over the Internet (discussed ahead) highlights the importance and scope of the word *solicitation*.

A most expansive, yet typical, definition of the term *solicit* states that it means any request, directly or indirectly, for money, credit, property, financial assistance, or other thing of any kind or value on the plea or representation that the subject of the gift is to be used to benefit a charitable organization or otherwise be used for a charitable purpose. Usually, the word *solicitation* is used in tandem with the word *contribution* (or gift) (discussed ahead). The term may, however, encompass the pursuit of a *grant* from a private foundation, other nonprofit organization, or a government department or agency. (About a dozen states exclude the process of applying for a government grant from the term *solicitation*; a few similarly exclude the seeking of private foundation grants.) There is no requirement that a solicitation be successful; a solicitation is a solicitation irrespective of whether the request actually results in the making of a gift.

A court created its own definition of the term *solicit* in this setting, writing that the "theme running through all the cases is that to solicit means to 'appeal for something,' 'to ask earnestly,' 'to make petition to,' 'to plead for,' 'to endeavor to obtain by asking,' and other similar expressions." (The court ruled that a state's charitable solicitation act did not apply to gambling activities held to generate funds destined for charitable purposes.)

Federal Lobbying Rules

At the federal level, the definition of fundraising that is most relevant (and accurate) in the charitable setting is found in an odd place: the tax laws restricting legislative activities by public charities. One of the law requirements is that these activities may not be substantial; an elective test provides allowable lobbying expenditures in terms of declining percentages of aggregate program (charitable purpose) expenditures. Exempt purpose expenditures, however, do not include amounts paid to or incurred for (1) a separate fundraising unit of the organization or (2) one or more other organizations, if the amounts are paid or incurred primarily for fundraising. Nonetheless, program expenditures include all other types of fundraising outlays.

An organization's first task in this context is to determine its direct fundraising costs. These costs include such items as payments to fundraising consultants, salaries to employees principally involved in fundraising, and fundraising expenses concerning travel, telephone, postage, and supplies. With respect to these direct items, there may have to be allocations, such as between the educational (program) aspects and the fundraising aspects, of the expenses of creating and delivering printed material. Then, an organization must ascertain its indirect costs, to be apportioned to fundraising, lobbying, and other factors. These costs include items such as salaries of supportive personnel, rent, and utilities.

For the purpose of these rules, the term *fundraising* includes the solicitation of (1) dues or contributions from members of the organization, persons whose dues are in arrears, or the public; (2) grants from businesses or other organizations, including charitable entities; and (3) grants from a governmental unit, or any agency or instrumentality of a governmental unit. (This is a strange definition of *fundraising*, in two respects: (1) normally, the solicitation of *dues* (including those in arrears) is not considered fundraising (dues not being gifts) and (2) businesses make gifts, not grants.)

Internal Revenue Service Reporting Rules

The Internal Revenue Service (IRS) has devised extensive requirements for the reporting of fundraising activities by tax-exempt, primarily charitable organizations (see Chapter 5). In this connection, the agency has defined the term *fundraising activities*. The fundraising profession has long differentiated among gifts of time, treasure, and talent (with only the solicitation of gifts of treasure constituting fundraising). The IRS, however, in its formulation of a sweeping definition of fundraising, has encompassed them all; according to the IRS, fundraising entails "activities undertaken to induce potential donors to contribute money, securities, services, materials, facilities, other assets, or time."

This definition of *fundraising activities* is far too broad (at least from a law standpoint). It is nonsensical to include the solicitation of services or time in a definition of *fundraising*. Fundraising pertains to the solicitation of money and/or other property; it does not relate to solicitations of services or time. If a charitable organization's president asks an individual to serve on the charity's board of trustees, the president has not engaged in fundraising. If a charitable organization's executive director asks an individual to volunteer to assist with a particular project (even a fundraising event), the executive director likewise has not undertaken a form of fundraising. The IRS has overlooked the fact that the concept underlying and the word *fundraising* not only contain the word *fund* but are predicated on it.

CONCEPT OF CHARITABLE SALES

A few state charitable solicitation acts include a definition of the term *sale* (or *sell* or *sold*). A statute may provide that a *sale* means the transfer of any property or the rendition of any service to any person in exchange for consideration. The word *consideration* is the critical element of this definition, inasmuch as it represents the principal dividing line between a sale and a contribution.

Consideration is the core component of a bona fide contract: Both parties to the bargain must, for the contract to be enforceable, receive approximately equal value in exchange for the participation of the other. Consideration is the reason one person enters into a contract with another; the contracting party is motivated or impelled by the benefit to be derived from the contract (goods or services), while the compensation to be received by the other contracting person is that person's inducement to the contract. A transaction that is not supported by adequate consideration cannot be a sale.

Correspondingly, a transaction that is completely supported by consideration cannot be a gift. Some transactions partake of both elements, where the consideration is less than the amount transferred, in which case only the portion in excess of the consideration is a gift. The most common types of these dual character transactions are quid pro quo contributions (see Chapter 8), and transfers by means of charitable remainder trusts and in the form of charitable gift annuities (see Chapter 6).

DEFINITION OF *CHARITABLE CONTRIBUTION*

A *contribution* (or gift or donation) basically is a transfer of money or property in the absence of consideration (discussed previously). The term may be defined in a charitable solicitation act as including a gift, bequest, devise, or other grant of money, credit, financial assistance, or property of any kind or value. The statutory definition may embrace promises to contribute (pledges).

The law on this point is the most developed in, not surprisingly, the federal income tax charitable giving setting. Many years ago, the U.S. Supreme Court observed that a contribution is a transfer motivated by "detached or disinterested generosity." Another observation from the Court was that a "payment of money [or transfer of other property] generally cannot constitute a charitable contribution if the contributor expects a substantial benefit in return." The Court has also referred to a contribution as a transfer made out of "affection, respect, admiration, charity or like impulses."

The Court has adopted use of the reference to consideration in determining what a contribution is. Thus, it wrote: "The *sine qua non* of a charitable contribution is a transfer of money or property without adequate consideration. The taxpayer, therefore, must at a minimum demonstrate that he purposefully contributed money or property in excess of the value of any benefit he received in return." The Court subsequently articulated essentially the same rule, when it ruled that an exchange having an "inherently reciprocal nature" is not a contribution.

Dues, being payments for services, are not contributions. The term *dues* embraces payments by members of an organization in the form of membership dues, fees, assessments, or fines, as well as fees for services rendered to individual members. A loan is not a contribution, including a loan to a charitable organization. If a person makes a loan to a charity and the amount of the loan, or a portion of it, is thereafter forgiven, the amount forgiven becomes a charitable contribution as of the date of the forgiveness.

Essentially, the concept in this context is that a contribution is a payment to a charitable organization where the donor receives nothing of material value in return. Thus, a court ruled that a state's charitable solicitation act did not apply to the solicitation of corporate sponsors for a marathon, stating that the transaction was a "commercial" one, was "not a gift," was a "corporate opportunity," and it had "nothing to do with philanthropy."

METHODS OF FUNDRAISING

Fundraising for charitable ends is a unique form of communication that simultaneously "promotes" and "sells" the product (the charitable cause) and "asks for the order" (the gift). Charitable organizations employ several methods and techniques to solicit contributions. Gifts can be in many forms—money, securities, tangible personal property, real property, and interests in property—all of which are embraced by the word *fundraising*. The one feature shared equally by all the ways to generate gifts is the objective—to ask for a gift that benefits someone else.

The asking part can entail many ways: in person, and by regular (old-fashioned) mail, facsimile, email, telephone, radio, television (and cable), and Web site. Organizing charitable entities to engage in fundraising is complex and requires the careful application and orchestration of many methods of solicitation by volunteers and employees. Each method of fundraising has its characteristics regarding suitability for use, public acceptance, potential or capacity for success, and cost-effectiveness. Likewise, the reporting and enforcement aspects of regulatory systems should, to be fair, distinguish between the varieties of fundraising techniques and their performance. The methods of asking are best understood by dividing them into three areas: annual giving, special-purpose, and estate planning.

Annual Giving Programs

The basic concept underlying charitable annual giving programs is to recruit new donors and renew (and perhaps upgrade) prior donors, whose gifts provide for annual operations. Some programs require a staff professional to manage; most programs require both staff and a volume of volunteer leaders and workers. Charities frequently conduct two or more forms of annual solicitation within a 12-month period; the net effect is to contact the same audience with multiple requests within the year. Some donors prefer one method of giving over the others. Multiple gift requests to present donors will increase net revenues faster than efforts to acquire new donors, inasmuch as present donors are the best prospects for added gifts and donor acquisition can be costly. An organization cannot use every fundraising method (chiefly because of donor resistance or saturation); rational selections are required.

Direct mail/donor acquisition fundraising uses direct mail response advertising (usually third class, bulk rate) in the form of letters to individuals who are not presently donors to the organization, inviting them to participate at modest levels. A small rate of return is likely. This type of "customer development" may require an investment of $1.25 to $1.50 to raise $1.00. The value of new donors is their potential for repeat gifts, and perhaps future leaders, volunteers, and even benefactors.

Direct mail/donor renewal is used to ask previous donors to give again. If there has been some contact since the prior gift, such as a report on the use of gifts, about 50 percent of these donors will give another time. Upgrading, that is, a request for a gift slightly higher than the last gift, works about 15 percent of the time, and has the added value of helping preserve the current giving level.

Telephone calls to prospects and donors permit dialogue and are more successful than direct mail. Response is not high, due in part to the intrusive nature of these calls. *Television solicitation* is, of course, more distant but is the best visual medium to convey the message. Both methods are expensive to initiate and require the instant response of donors.

Special and benefit events are social occasions that use ticket sales and underwriting to generate revenue but incur direct costs for production. While generally popular, these events are typically among the most expensive and least profitable methods of fundraising. Fundraising staff may deplore the energy and hours required to support an event; their great value, however, is in public relations visibility (which is why they are also termed "friend-raisers").

Support groups are used to organize donors in a quasi-independent entity affiliated with the charitable organization. Membership dues and event sponsorship are revenue sources. Valuable for their ability to develop committed annual donors, organize and train volunteers, and promote the charity in the community, support groups also require professional staff management.

Donor clubs and associations are donor-relations vehicles (similar to support groups) that are designed to enhance the link between donor and charity, thereby helping to preserve annual gift support. The clubs' selectivity and privileges (with imaginatively named gift levels) help justify the higher gifts, which are rewarded by access to top officials and other benefits.

Campaign committees are volunteer groups of peers using in-person solicitation methods to recruit the most important annual gifts. These committees are structured as a true campaign, with a chair and division leaders for individual and corporate prospects. Other annual giving methods involve:

Commemorative gifts

Gifts in kind

Advertisements (such as in newspapers and magazines)

Door-to-door solicitations

On-street solicitations

Sweepstakes and lotteries (where legal)

Las Vegas and Monte Carlo Nights

Mailings of unsolicited merchandise

In-plant solicitations

Federated campaigns

Special-Purpose Programs

A successful base of annual giving support permits the charitable organization to conduct more selective programs of fundraising that will secure major gifts, grants, and capital campaigns toward larger and more significant projects. A request for large gifts differs from annual gift solicitation because the request is for a one-time gift, allows for a multiyear pledge, and is directed toward a specific project or urgent need. Likely donors in this context are skillful "investors" who will respond to a major gift request only after researching the organization and determining whether the project justifies their commitment.

It takes courage to ask someone for a *major gift* (such as one million dollars). Current and committed donors are the best prospects. Before the request is made, the charity should engage in careful research to ascertain the prospect's financial capability, enthusiasm for the organization, preparedness to accept this special project, and likely response to the team assembled to make the call. Also important is early resolution of the donor recognition to be offered (such as a seat on the board or name on a building).

Separate skills and tools are required to succeed at *grant-seeking*. Grants are institutional decisions to provide support based on published policy and guidelines that demand careful observance of application procedures and deadlines. Usually, for a grant proposal to be accepted, the charitable organization and its project must perfectly match the goals of the grantor.

A *capital campaign* is clearly the most successful, cost-effective and enjoyable method of fundraising. Everyone is working together toward the same goal, the objective is significant to the future of the organization, major gifts are required, start and end dates are goal markers, and activities and excitement exist. A capital campaign is the culmination of years of effort, both in design and consensus surrounding the organization's master plan for its future, which depends on experienced volunteers and enthusiastic donors.

Planned Gift Programs

An increasingly active area of fundraising involves gifts made in the present, to be realized by the charitable organization in the future. The term *gift planning* best describes this concept. These gifts entail either transfers of assets to the charity at the time of the gift, in exchange for the donor's retention of income for life, or transfers (usually in trust) where the charity receives the remaining assets at the donor's death (or perhaps expiration of a period of time). This planning allows donors to remember their favorite charities in their estate and to plan gifts of their assets, in the present or at death. The four broad areas of planned giving are, from a law perspective, guided by income, gift, and estate tax considerations.

Donors may leave charitable gifts by means of bequests and devises made in their wills and/or trusts. These gifts may be outright transfers from an estate to one or more charitable organizations or may involve funding by means of a charitable trust. Trusts and similar arrangements can be utilized during lifetime or as part of an estate plan. Popular techniques are the use of charitable remainder trusts, charitable gift annuities, and perhaps charitable lead trusts (see Chapter 6).

An individual may name his or her favorite charity as a beneficiary, in whole or in part, of a life insurance policy. A charitable deduction is available for the surrender value of a policy contributed; in appropriate instances, the payments of premiums on a life insurance policy contributed to a charity are deductible gifts. Insurance is also used in the wealth replacement context; the donor uses annual income from a charitable remainder trust (and/or other tax savings induced by the charitable deduction) to purchase a life insurance policy, usually for the value of the asset(s) placed in trust, and names his or her heirs as beneficiaries, thus transferring to heirs the same value on the donor's death.

FUNDRAISING EXPENSES

One of the most important issues arising out of regulation of charitable solicitations, and an intense focus of the regulators' attention, is the matter of fundraising costs incurred by charities—internal expenses, and fees paid to fundraising consultants, professional fundraisers, professional solicitors, and/or other advisers in the realm of fundraising. The general standard is that fundraising expenses must be *reasonable*. Yet there is not much of a consensus as to how to evaluate, or measure, the reasonableness of fundraising costs. Many misstatements of the law are articulated in this context.

Disclosure Dilemma

One of the essential functions of most of the state charitable solicitation acts (see Chapter 3) is to promote disclosure of information to the public. A matter of principal concern among charitable groups, and thoughtful legislators and regulators, is the appropriate mode by which to achieve public disclosure by organizations soliciting financial support for charitable purposes. This issue basically has evolved around two conflicting positions, represented by the catch phrases *point-of-solicitation disclosure* and *disclosure-on-demand*.

Under the point-of-solicitation disclosure concept, certain information must be provided as part of the solicitation process, that is, in the solicitation materials. The solicitation-on-demand approach generally requires that a soliciting charitable organization provide information to the public on request; in some instances, the solicitation materials must bear notice of the availability of this information.

Proponents of the point-of-solicitation disclosure approach insist that it is the only effective way to ensure that the public has at least minimal information about a charitable organization at the time (or around the time) the decision as to whether to contribute is made. They assert that most people will not bother to seek information from charities, with the result being little, if any, meaningful disclosure. (This view, of course, is becoming anachronistic as considerable information about charitable organizations and fundraising by them is readily available by means of the Internet.) These advocates view this matter as one akin to consumer protection, with analogy made to labeling requirements on containers of food, medicine, and the like.

Opponents of the point-of-solicitation disclosure approach (including proponents of the disclosure-on-demand approach) insist that substantive information about a charitable organization (particularly financial data) cannot be presented, in a meaningful and balanced manner, as part of the solicitation process. They note that the purpose of a solicitation is to raise funds; they contend that cluttering a solicitation mailing, broadcast, and the like with statistical and other information only makes the fundraising confusing and less appealing, and hence generates fewer dollars, while simultaneously making the solicitation more expensive. They further assert that useful disclosure cannot be achieved by the mere provision of snippets of data and that this type of a requirement is counterproductive to the intent of the law by enhancing the likelihood that misleading information will be transmitted.

Thus, in designing or evaluating a charitable solicitation law, the mode of disclosure is a threshold issue. In part, the dispute over the two basic disclosure regimes can be resolved or mitigated by the outcome of the decision as to the items of information to be disclosed at the point of solicitation (if any). For example, even the most vehement opponents of general point-of-solicitation disclosure do not object to a requirement that the solicitation literature include a statement about the purpose of the soliciting charitable organization and the intended use of the contributions solicited. By contrast, any requirement that the solicitation materials state the organization's fundraising costs, and perhaps require that these costs be expressed as a percentage of contributions or other receipts, generates considerable controversy and opposition.

Fundraising Cost Percentages

Over 35 years ago, an expert on charitable fundraising observed that, "in the field today, there is no agreed-upon base for determining fundraising cost percentages." Nothing has changed in this regard in the interim. Nonetheless, a most common practice is to try to capture the essence of a charitable organization's fundraising costs in terms of a single percentage. (While it is illegal for a government to forbid a charity to fundraise because of its fundraising cost percentage (see Chapter 9), the watchdog groups whole-heartedly apply these percentages, touting them every chance they get (see Chapter 10).) These costs are usually expressed in relation to total receipts or charitable contributions, using the prior year's financial data.

This approach is popular because it is simple. It is frequently the basis of comparison of charitable groups. For example, an individual reviewing financial data might see one charitable organization's annual gifts of $100,000 and fundraising costs of $15,000, and another charity's annual gifts of $100,000 and fundraising costs of $20,000, and conclude that the organization with fundraising costs of 15 percent is *more qualified* for gift support, or *more efficient*, or *better-managed* than the organization with fundraising costs at 20 percent. (This is the message sent, often quite successfully, by the watchdog groups and others who thrive on this percentage approach.) Moreover, this use of percentages readily lends itself to the disclosure-at-point-of-solicitation approach, inasmuch as a percentage can be easily displayed on solicitation material.

The percentage approach, however, is deficient on two fundamental bases: (1) there is no universal standard for computing fundraising costs, thereby precluding the creation of fair percentages and meaningful comparisons of charitable organizations, and (2) a single percentage is a misleading factor to use in evaluating a charitable organization's fundraising practices and overall eligibility for contributions. For example, in the previous illustration, the organization with a 15 percent fundraising cost percentage may not be including in the base some allocable shares of indirect costs, while the 20 percent organization is doing so. Thus, were the same reporting system being followed, the first organization may have higher fundraising costs than the second. This is not a matter of fraud or cheating but rather a lack of uniformity and understanding about the expense elements to take into account in constructing the ratio.

There may be valid reasons, even assuming identical means of determining the fundraising cost percentages, as to why one organization's solicitation expenses exceed another's—reasons that have nothing to do with efficiency, cost effectiveness, or program merit. Fundraising practices are diverse and unique to various types of charitable organizations. An institution with an established donor base and a range of fundraising methods, including annual giving, planned giving, and a bequest program, will have a lower fundraising cost percentage than a new charity with heavy dependence on direct mail. Another type of organization may be spending most of its money in building a donor base (called *donor acquisition*), relying considerably on special-event fundraising, or championing an unpopular cause; these elements contribute to higher fundraising cost percentages.

An organization that is poorly managed and/or expending excessive sums on fundraising can nonetheless have a low fundraising cost percentage, attributable perhaps to one or more large charitable bequests or unexpected lifetime gifts, or low fundraising costs in one area that offset excessive costs in another area. Also, the fundraising costs for a multiyear capital campaign, which are normally largely incurred in the initial months of the campaign, or in relation to the establishment of a planned giving program, will introduce additional distortions relative to a single fundraising cost percentage based on a lone year's experience.

The realities of the costs of fundraising for charitable purposes are poorly understood by the public and in some instances by government regulators and legislators. The maxim that "it takes money to raise money" is frequently incompatible with the typical individual's view as to how a charitable dollar should be spent. Many charitable organizations understandably fear that the public uses the fundraising cost percentage approach as a ranking system by which to evaluate charities for giving purposes. Those holding this view insist that, at least until a uniform and equitable method for calculating the fundraising cost percentage is in place, such a "batting average" methodology is an inappropriate way to assess the relative worth of charitable entities.

Fundraising Cost Line Item Approach

Opponents of the fundraising cost percentage approach generally contend that the only suitable manner by which to present a charitable organization's fundraising costs is as part of its financial statements. This approach thus envisions an income and expense statement that displays fundraising costs as a line item, treated no differently from any other category of expenses. Proponents of line item treatment of charitable fundraising costs assert that mere fairness dictates this approach: (1) it enables an organization to present its fundraising costs in the context of its overall range of costs, and thus does not place undue emphasis on fundraising expenses by causing them to be evaluated in isolation, as is the case with the percentage approach, and (2) it avoids the unfair and misleading aspects of the percentage regime.

Again, this matter of the proper method of fundraising costs reporting and disclosure is inextricably entwined with the point-of-solicitation disclosure versus disclosure-on-demand conflict. It is much more difficult to graphically convey the amount of an organization's fundraising costs using the line-item approach rather than the percentage-approach, even if a meaningful financial statement is provided at the point of solicitation (which is likely to prove impractical in any event). It is also more difficult to make easy comparisons of organizations' fundraising costs when readers of financial statements have only aggregate sums to consider (although readers can, of course, construct their own fractions and percentages).

Advocates of the line-item approach say that this is as it should be, because fundraising costs computations are a complex and intricate matter, also that fast and easy fundraising expense calculations are not appropriate, and that fundraising cost disclosure cannot meaningfully be achieved at the point of solicitation.

Floating Average Approach

Those who understand the deficiencies of the fundraising cost percentage approach, yet believe that its virtues (principally, its usage in conjunction with point-of-solicitation disclosure) outweigh those of the fundraising cost line item approach, often seek to mitigate the excesses of the annual percentage approach by proposing a floating (or moving) average. This average might reflect fundraising expense performance over a three- or four-year period. Thus, for example, an organization that raised $100,000 in contributions in each of four consecutive years, and incurred fundraising costs of $70,000 in the first year, $50,000 in the second year, $30,000 in the third year, and $10,000 in the fourth year, would, when disclosing its fundraising costs in the fifth year, report that its costs during its previous four years averaged 40 percent rather than having to disclose in year two that its fundraising costs for the prior year were 70 percent.

In this fashion, the same essential facts would be disclosed but in a manner that eliminates (absent consistently "high" fundraising costs) the adverse consequences (such as a fall-off in giving, which exacerbates the problem) of disclosing only the initial months' cost. This approach would smooth out the distortions that can appear in a year-by-year evaluation, such as high start-up costs, unexpected and/or large gifts, and unanticipated gains or failures in the solicitation that can be unique to a single year. There is precedent for this approach in the federal tax law, such as the averaging period for calculating public support (discussed ahead) and the manner of calculating the threshold for the annual information return filing requirement (see Chapter 5).

A fundamental deficiency, however, separates the moving average idea from actual usage: a rule that does not require an organization to report fundraising costs until after, for example, two or three years of existence would be an open invitation for abuse by those who would simply create a new soliciting organization every few years and thus never report fundraising performance. Moreover, a rule that required annual percentage reporting until a floating average period was attained would likely defeat its purpose, particularly for new organizations.

Pluralization Approach

Much thinking has been devoted to the question of the proper method of measuring and reporting charitable fundraising costs. Among the more intriguing of the concepts to emerge is the idea that fundraising costs should be *pluralized* to be meaningful. This approach does not find fault so much with the idea of utilizing a percentage to display fundraising costs as it does with the idea that a true measure of fundraising costs can be captured in a single percentage. Blending in the moving average feature, the pluralization approach is based on the precept that a fair and productive understanding of a charity's fundraising costs, where more than one form of fundraising is used, can be achieved only by looking at the costs for each fundraising activity over a multiyear period (rather than the lumping of all costs over a measuring period).

In truth, there is no such thing as a single expense for something termed *fundraising* because there is, as noted, no lone activity that constitutes *fundraising*. There are many types of fundraising methods (discussed previously) and, while the precise parameters have yet to be documented, each effort carries with it a range of costs expressed as a percentage that may be considered reasonable. Thus, a fundraising cost that is considered reasonable for one fundraising method is not necessarily reasonable for another. The pluralization doctrine calls for a fundraising cost percentage to be assigned to each of an organization's fundraising methods and for abandonment of reliance on a bottom-line ratio.

The pluralization approach is predicated on the fact that there are fundamental categories of fundraising methods: donor acquisition by direct mail, donor renewal by direct mail, capital campaigns, special events, as well as planned giving and bequest programs. (Pluralization models have yet to incorporate website fundraising; those costs are quite low.) This approach postulates that these fundraising methods involve associated costs expressed (as illustrations) in the following reasonable percentages: donor acquisition, about 120 percent; donor renewal, about 10 percent; special events, about 50 percent; capital programs, about 15 percent; and planned giving and bequests programs, about 15 percent.

The singular contribution of the pluralization method of stating charitable fundraising costs is that it exposes the fundamental fallacy of the bottom-line ratio or single percentage approach. That is, the sole percentage disclosure mode can make the fundraising costs of certain organizations appear unreasonable when in fact they are reasonable and—in an outcome perversely counterproductive to the objective of disclosure—can make the fundraising costs of some organizations appear reasonable when in fact they are unreasonable.

The pluralization approach of reporting charitable fundraising costs, while a major contribution to the theory of fundraising costs disclosure, has not been widely adopted. The methodology has, however, facilitated greater understanding of the complexities of measuring and evaluating the fundraising costs of charitable organizations. It is a useful technique by which an organization can make an internal assessment of its fundraising performance. Perhaps of greatest importance is the availability of this approach for demonstrating to those concerned about the matter why a charitable organization's fundraising costs are reasonable in the face of a seemingly high single fundraising cost percentage.

Average Gift Size Factor

A well-intentioned and well-governed charitable organization that is adversely (and thus undoubtedly unfairly) affected by application of set percentage limitations on fundraising costs is likely to have low cost-per-gift and cost-per-solicitation factors. This type of organization, however, is also likely to depend on comparatively small contributions. Thus, an unfair comparison results when the fundraising cost ratios of this type of organization are compared with those of another charitable organization whose average gift size is much higher but whose fundraising cost ratios are relatively smaller when measured by the overall percentage of fundraising costs in relation to contributions. Thus, the former organization appears to have "high" costs of fundraising, while in fact the latter organization has higher fundraising costs per gift.

In illustration of this point, consider Charity A and Charity B, both of which received $1 million in contributions in the year under comparison. While A's total fundraising costs were $450,000, B's were $150,000. Consequently, B's single fundraising cost percentage is 15 percent and A's is 45 percent, perhaps placing A in considerable difficulty with prospective donors, the media, and watchdog agencies. But, this comparison is lacking inasmuch as it fails to reveal an additional and essential factor: the number of gifts, from which can be determined the average gift size and the cost per gift. Assume that Charity A received 200 gifts in the year under review, with an average gift of five dollars and a cost per gift of $2.25; Charity B received 30,000 gifts, with an average gift size of $33.33 and a cost per gift of five dollars.

It is thus inappropriate to compare Charities A and B in this manner. That is, using the single fundraising cost percentage factor as the basis of comparison, B appears more cost-effective than A, but this conclusion is misleading and unfair to A because it has a lower average gift. Conversely, a comparison on the basis of the cost-per-gift factor shows A as the charity that is more cost-effective, but this result is unfair to B because it has a higher average gift. Thus, it can be contended that disclosure of a charitable organization's number of gifts—by category—is essential for a complete and fair evaluation of fundraising costs, and that any comparisons of fundraising performance should occur only among organizations with similar constituencies, based on a number of factors, particularly average gift size.

Reasonableness of Fundraising Costs

There is consensus in some quarters (reflected, for example, in court opinions) as to the most effective means for determining fundraising costs and parameters for assessing the reasonableness of these costs. The law is filled with requirements that something be *reasonable*; how the term is defined in practice depends on the particular circumstances. The factors to be considered in determining the reasonableness of the annual fundraising expenses of a charitable organization include the following.

Period of Existence. The period of time a charitable organization has been in existence needs to be taken into consideration in determining the reasonableness of its fundraising expenses. A new organization, or for that matter, an organization newly undertaking a solicitation, may incur fundraising expenses in the initial years of the solicitation that are higher, in relation to total annual receipts or contributions, than the costs incurred in subsequent years. Part of this aspect of the matter pertains to the development of an organization's donor base or constituency.

Purposes and Programs. The nature of a charitable organization's purposes and programs are to be taken into account in this regard, with particular emphasis on whether the organization advocates one or more causes and disseminates substantive information to the public as part of the same process by which the organization solicits contributions (discussed ahead). Consideration should also be given to whether a charitable organization's purposes and programs involve a subject matter with general public appeal or are sufficiently controversial or unpopular that public support may not readily be forthcoming.

Constituency. The nature and extent to which a charitable organization has an established constituency of donors is to be taken into account in determining the reasonableness of its fundraising expenses. This factor looks to whether the organization has established a broad base of public support or whether it must build such a base as part of its solicitation process.

Methods of Fundraising. The method or methods selected by a charitable organization or available to it to implement its fundraising program (discussed previously) should be evaluated in this regard. Consideration should be given to those organizations that, for one or more reasons, can conduct their fundraising by means of only one method of solicitation (such as direct mail).

Average Gift Size. The size of the average annual contribution received by a charitable organization (discussed previously) should be taken into consideration in determining the reasonableness of its fundraising expenses. The object of this factor is to ascertain the dependency of the organization on small contributions and whether it is nonetheless cost-effective in the management and expenditure of its receipts.

Unforeseen Circumstances. The extent to which the expenses of the solicitation effort or efforts of a charitable organization depend on or are otherwise materially affected by unforeseen circumstances should be taken into consideration in determining reasonableness.

Other Factors. The estimate by a charitable organization of its fundraising expenses and money as well as property to be raised or received during the immediately succeeding 12-month period, and its reasons for the estimate, including any program for reducing its annual fundraising expenses, should be acknowledged as factors. Also of relevance is the extent to which an organization is organized and operated to attract new and additional public or governmental support on a continuous basis (discussed ahead).

These concepts and factors are beginning to receive greater appreciation in the courts. One court was critical of a state's disclosure statute triggered when a charitable organization's program outlays were less than 70 percent of funds collected. This court observed that "many charities operate below the 70 percent threshold during the early years when they are engaged in building a substantial donor base." Also: "Their financial allocations to 'program services' may be low simply because they are just getting operations under way and attempting to fulfill a need that is unmet by other organizations." And: "Charities or nonprofit groups may also expend more on fundraising or management costs relative to program services because they serve unpopular causes." The court wrote that "it cannot be said that the organization [involved in the case] is either fraudulent or less 'efficient' in meeting charitable purposes than others with relatively low fundraising or management costs and consequently higher percentage allocations to program services."

This court placed this matter of fundraising costs in the constitutional law setting where, for law purposes, the issue festers the most (see Chapter 9). It stated that the "very organizations most deserving of First Amendment [free speech] protections—those involved in the dissemination of information, discussion, and advocacy of public issues . . . are likely to have relatively high solicitation or fundraising costs (and therefore lower percentages of donations allocated to program services), not because they are fraudulent or any less efficient in furthering their causes than other nonprofit or charitable organizations, but because the very nature of their activities cause these costs to be high." The disclosure statute was held to be unconstitutional; the court wrote that, "[g]iven these fundamental flaws in the design and operation" of the contested provision, "it is only fortuitous that, in some of its applications, this statute might accomplish the State's goals of preventing fraud and providing information to prospective donors about the effectiveness of their contributions in furthering charitable purposes."

Cost Allocations

The accounting profession set forth financial accounting standards for properly accounting for costs associated with joint activities; these standards apply to all nonprofit organizations and all state and local governmental entities that solicit contributions (Statement of Position (SOP) 98-2, published by the American Institute of Certified Public Accountants).

The essence of SOP 98-2 is that costs associated with joint activities should be allocated between fundraising and the appropriate program or management function when the criteria of purpose, audience, and content are met for a particular joint activity. The criterion of purpose is met if the joint activity furthers the charity's program or management functions. Program functions may be accomplished when the activity requests specific action by the audience in furtherance of the charity's mission. Requests for contributions are not considered a specific action that furthers a charity's mission.

Purpose Criterion. SOP 98-2 provides the following factors to consider when determining if the purpose criterion has been met: (1) whether compensation or fees for performing the activity are based on contributions raised; (2) whether a similar program or management and general activity is conducted separately and on a similar or greater scale; and (3) other evidence. These factors are to be considered in the order provided. The SOP provides further guidance as to what *other evidence* might be considered, including (1) measuring program results and accomplishments of the activity; (2) the medium—the program component of the joint activity calls for specific action by the recipient that will help accomplish the organization's mission and if the organization conducts the program component without a significant fundraising component in a different medium; (3) the relationship between evaluation and compensation; (4) evaluation of the measured results of the activity; (5) qualifications of those performing the joint activity; and (6) tangible evidence of intent.

Audience Criterion. If the audience includes prior donors or is selected based on the ability or likelihood of the recipients to make a contribution to the charity, it is presumed that the audience criterion is not met. To overcome this presumption, the audience must also be selected for one of the following reasons: (1) the audience's need to use or reasonable potential to take the specific action called for by the program's component of the joint activity; (2) the audience's ability to take specific action to assist the organization in meeting the goals of the program component of the joint activity; or (3) the organization's requirement to direct the management and general component of the joint activity to the particular audience or the audience has reasonable potential for use of the management and general component. The organization should compare the extent to which the audience was selected based on its ability or likelihood to contribute with the extent it was selected for one or more of the above-referenced factors to determine if the audience criterion has been met.

Content Criterion. If the joint activity supports program or management and general functions, then the criterion for content is satisfied. To support the program function, the joint activity must call for specific action that helps the organization accomplish its mission. To support the management and general function, a component of the joint activity must fulfill one or more of the organization's management and general responsibilities.

When an organization determines that allocation of costs for a joint activity is appropriate, it should apply the method of allocation in a reasonable and consistent manner. Organizations that allocate costs for joint activities should include the following in the notes to their financial statements: types of activities incurring joint costs; a statement that costs have been allocated; and the total amount allocated to each functional expense category.

As an illustration of the inconsistencies in reporting of fundraising costs, one of the watchdog agencies (see Chapter 10)—the American Institute of Philanthropy—refuses to follow the SOP 98-2 criteria, insisting that communications directed by a charity at donors can never simultaneously serve a fundraising purpose and a valid program purpose. (The Institute follows the criteria when it is applied to a tax-exempt social welfare agency.) Thus, when the Institute encounters charities that have allocated expenses between fundraising and program costs, it will disregard the allocation and apply all of the expenses to fundraising. The Institute's position in this regard is contrary to the views of other watchdog agencies, the IRS, and, of course, the accounting profession, all of which consider it a customary practice for a charity to apportion its expenses partly for program and partly for fundraising—particularly where the charity's communications serve a dual purpose of soliciting funds while simultaneously educating the public about the organization, its mission and programs, its accomplishments, as well as its goals.

COMMENSURATE TEST

A little-known, little-used standard in the federal tax law pertaining to tax-exempt, charitable organizations is termed the *commensurate test*. With this test, the fact-finder (the IRS or a court) assesses whether an organization is maintaining program activities at a level that is commensurate in scope with its revenue and assets. As the IRS stated, this test "requires that organizations have a charitable program that is both real and, taking the organization's circumstances and financial resources into account, substantial." When this rule was first articulated by the IRS (in 1964), the organization involved derived most of its income in the form of rents, yet was successful in preserving its exempt status because it satisfied the test, in that it was engaging in an adequate amount of charitable functions notwithstanding the extent of its rental activities.

The commensurate test has long been entangled with the matter of charitable fundraising expenses. On one extremely controversial occasion, the IRS revoked the tax-exempt status of a charitable organization using a variety of rationales, including the ground that its fundraising costs were too high. (Never before had the amount of fundraising costs been a criterion for eligibility for exemption.) The IRS concluded that the test was transgressed because the charity, during the two years examined, expended, according to the IRS, only about 1 percent of its revenue for charitable purposes; the balance was allegedly spent for fundraising (98 percent) and administration (1 percent). (This matter was ultimately resolved in court, albeit without application of the commensurate test.)

The IRS's lawyers have written that the commensurate test "does not lend itself to a rigid numerical distribution formula—there is no fixed percentage of income that an organization must pay out for charitable purposes." In each case, said the IRS, "it should be ascertained whether the failure to make real and substantial contributions for charitable purposes is due to reasonable cause." Therefore, the IRS continued, an organization that "raises funds for charitable purposes but consistently uses virtually all its income for administrative and promotional expenses with little or no direct charitable accomplishments cannot reasonably argue that its charitable program is commensurate with its financial resources and capabilities."

There have been a few IRS rulings over the years applying the commensurate test. In one, a charitable organization was allowed to retain its tax-exempt status while receiving 98 percent of its support from (passive) unrelated business income, since 41 percent of the organization's programs was charitable in nature. By contrast, an organization that began devoting a considerable portion of its efforts in conducting bingo games and generating gaming income, with little of it spent for charitable purposes, lost its exempt status.

The IRS is stepping up its use of the commensurate test. In late 2008, the agency announced, as one of its new compliance initiatives for fiscal year

2009, a *charitable spending initiative*. This is a "long-range study to learn more about sources and uses of funds in the charitable sector and their impact on the accomplishment of charitable purposes." The IRS said it will be looking at fundraising, contributions, grants, revenue from related and unrelated businesses, types and amounts of direct and indirect unrelated business expenses, and officer compensation, and the effect each of these elements has on funds available for charitable activities. The first stage of this initiative will focus on "organizations with unusual fundraising levels and organizations that report unrelated trade or business activity and relatively low levels of program service expenditures."

FUNDRAISING COMPENSATION ISSUES

The IRS and the courts tend to focus intently on the levels of compensation paid to executives and others by public charities. This concerns compensatory payments to employees and independent contractors (usually consultants). Consequently, compensation paid in the fundraising setting often is a matter of intense scrutiny from a federal tax law standpoint. There are three bodies of law that relate directly to this subject, all emphasizing the requirement that fundraising compensation must be *reasonable*.

Private Inurement

Charitable organizations must, to be tax-exempt, be operated so that they do not cause any inurement of their net earnings to certain persons in their private capacity. The private inurement doctrine is the principle of law that essentially separates nonprofit organizations from for-profit organizations. An organization that is operated *for profit* is one where the profits are destined for those who are the owners of the business, such as shareholders of a corporation who receive the profits of the enterprise (net earnings) by means of dividends. A nonprofit organization, by contrast, is expected to retain its profits (excess of revenue over expenses) at the entity level; to be exempt, a nonprofit organization cannot allow its net earnings to be passed along (inure) to those who control it (the substantive equivalent of owners). The private inurement doctrine is basically applicable only with respect to an exempt organization that it subject to the doctrine and those who have some special relationship to it (often referred to as *insiders*). A form of private inurement is the payment of excessive (unreasonable) compensation to a control person. The sanction for engaging in an act of private inurement is denial or revocation of exempt status. (See Chapter 2.)

Private Benefit

The private benefit doctrine derives from the rule that a charitable organization must be primarily organized and operated for the advancement of charitable ends. Operations for unwarranted private benefit obviously are not the conduct of activities that serve charitable objectives. This doctrine has greater breadth than the private inurement doctrine, principally because its application is not confined to those who are insiders with respect to an organization. The payment of excessive compensation is a form of private benefit; the sanction for engaging in an act of private benefit is denial or revocation of exempt status (*id.*).

Intermediate Sanctions

Pursuant to the intermediate sanctions rules, tax sanctions—structured as penalty excise taxes—may be imposed on the disqualified persons who improperly benefited from the transaction or arrangement and on the organization managers who participated in the transaction or arrangement knowing that it was improper. These rules, which basically require that the terms and conditions of a transaction or arrangement be reasonable, apply with respect to tax-exempt public charities and social welfare organizations (*id.*).

Fundraisers as Disqualified Persons

Generally, a fundraising executive is not a disqualified person with respect to the charitable organization being served. He or she is not normally in a position to exercise substantial influence over the affairs of the organization. This is usually the case where the fundraiser is an employee of the organization (such as a director of development) or a consultant to the organization.

There are, nonetheless, situations where the fundraising professional is a disqualified person. The fundraiser may be an organization manager. If the fundraising function is in a related entity, such as a foundation directly affiliated with a public charity, and the fundraiser is the chief executive officer of that foundation, he or she would be a disqualified person with respect to the foundation. Occasionally, a fundraiser will be a disqualified person by virtue of being a member of a family that includes a disqualified person.

An independent fundraising person may be considered a disqualified person. This is particularly the case where the person has control over a charitable organization's fundraising program that is a meaningful source of the organization's revenue. The fact that a person manages a discrete segment or activity of an organization, that represents a substantial portion of the activities, assets, income, or expenses of the organization, tends to lead to the conclusion that the person is a disqualified person.

Payment of Compensation

Because of these bodies of law, a charitable organization may not, without endangering its tax-exempt status or triggering other sanctions, pay a person engaged in fundraising for it (employee or consultant) an amount that is excessive or unreasonable. This matter of excessiveness of compensation is largely a question of fact. Whether a particular amount of compensation is excessive essentially depends on salaries or fees paid in the community for comparable services, the experience of the individual(s) involved, the individual's education and training, the type of fundraising, the resources and size of the charitable organization, and the nature (e.g., popularity or unpopularity) of the charitable cause.

Questions about the propriety of compensation to a fundraising employee or independent contractor may not have as much to do with the amount being paid as the manner in which it is determined. This is particularly true with respect to compensation that is ascertained on the basis of a percentage of the charitable organization's revenue stream or is otherwise cast as a commission. Although the IRS is suspicious of fundraising compensation that is based, in whole or in part, on percentages of contributions received, the courts are rather tolerant, sometimes supportive, of the practice.

In one instance, a compensation arrangement based on a percentage of gross receipts was held by a court to constitute private inurement, where the facts were somewhat egregious in nature and there was no upper limit as to total compensation. Nonetheless, this same court subsequently restricted the reach of its earlier decision by holding that private inurement did not occur when a tax-exempt organization paid its president a commission determined by a percentage of contributions obtained by him. The court held that the standard is whether the compensation is reasonable, not the manner in which it is ascertained.

In this latter case, fundraising commissions that are "directly contingent on success in procuring funds" were held to be an "incentive well-suited to the budget of a fledgling organization." In reaching this conclusion, the court reviewed states' charitable solicitation acts governing payments to professional solicitors (see Chapter 3), which the court characterized as "sanction[ing] such commissions and in many cases endors[ing] percentage commissions higher than" the percentage commission paid by the organization involved in the case. In another case, a court observed that "there is nothing insidious or evil about a commission-based compensation system." There, an arrangement whereby those who successfully procured contributions to a charitable organization were paid a percentage of the gifts received was judged "reasonable," despite the absence of any limit as to an absolute amount of compensation. Nonetheless, it is a good practice to ascertain the amount or range of fundraising compensation that is reasonable, then place a cap on the payment of compensation that may be in excess of that amount or range.

If the fundraising executive or consultant is a disqualified person with respect to a charitable organization, and excessive compensation is paid, the body of law most likely to be applied by the IRS is the intermediate sanctions regime. Some fundraisers are compensated, in whole or in part, on the basis of the revenue flow of the charitable organization involved. This arrangement may be structured as a commission or some other form of percentage-based compensation; this is certain to be a revenue-sharing arrangement. The fact that a revenue-sharing arrangement is subject to a cap is a relevant factor in determining the reasonableness of the compensation.

The initial contract exception can be of considerable utility in the fundraising setting. It is available when a charitable organization hires a fundraising professional, whether as an employee or independent contractor, where the person was not a disqualified person immediately before entering into the contract. When the parameters of this exception are satisfied, the compensation arrangement is totally exempted from the intermediate sanctions law penalties.

The rebuttable presumption of reasonableness can also be useful for the fundraising professional, particularly in circumstances where the initial contract exception cannot apply. The fundraiser, who is a disqualified person, should endeavor to be certain that the various elements of the presumption are satisfied, to shift the burden of proof, as to the reasonableness of compensation, to the IRS in the event of a challenge to the amount or method of calculation of the compensation.

It is sometimes said that the intermediate sanctions rules are a concern only to disqualified persons and not to the charitable organization involved or other persons who are not disqualified persons; this, however, is often not the case. From a fundraising perspective, a charitable organization embroiled in an excess benefit transaction is expected to report that transaction on its annual information return, which is a public document (see Chapter 8). The result, at a minimum, can be adverse publicity, which can harm the programs of the charity and perhaps fundraisers who are not disqualified persons.

If a fundraising professional, who is a disqualified person with respect to a charitable organization and hired by that charity, is paid excessive compensation, the arrangement would be a taxable excess benefit transaction, assuming inapplicability of the initial contract exception. Assume, as an illustration, that this fundraising professional was paid an annual compensation package of $200,000 for a three-year period. Following audit, the IRS concluded that this individual's services were worth only $100,000 annually. This fundraising executive would then owe initial excise taxes totaling $75,000 (a $25,000 tax per year on the excess benefit of $100,000). Also, this compensation arrangement would have to be corrected by the fundraiser, by means of payment of $300,000 to the charitable organization, plus suitable interest. If these steps were not timely taken, the fundraiser may have additional taxes imposed, totaling $600,000. The total obligation of the fundraiser would be $975,000, not including penalties, interest, and legal fees (presumably a stiff financial burden for one making $200,000 a year). A board member of this charity, who approved this compensation package, knowing it to be excessive, would be liable for $10,000 in taxes and perhaps the taxes of one or more other board members.

Statute of Limitations

In general, the statute of limitations for assessing an intermediate sanctions excise tax is three years. The statute of limitations begins to run, on the later of the dates the tax-exempt organization files the annual information return involved or the due date for the return.

Third-Party Summons

If a fundraising professional (or anyone else) is a disqualified person and the IRS is investigating the possibility of that person's participation in an excess benefit transaction, the IRS may issue a third-party summons to the charitable organization involved in pursuit of facts. The disqualified person may object to the summons if it is issued after the three-year statute of limitations has run. According to a court, that is not a basis for quashing the summons. All that is required to sustain the validity of the summons is that the IRS must show that, in the words of the U.S. Supreme Court in an earlier case, the "investigation will be conducted pursuant to a legitimate purpose, that the inquiry may be relevant to the purpose, that the information sought is not already within the [IRS's] possession, and that the administrative steps required by the [Internal Revenue] Code have been followed." Consequently, the court declined to quash a summons issued, after the statute of limitations with respect to a charitable organization had run, seeking information from the organization as to whether a disqualified person participated in an excess benefit transaction.

STEP TRANSACTION DOCTRINE

As a general rule, a contribution of appreciated capital gain property to a public charitable organization is deductible on the basis of the fair market value of the property and the capital gain element is not taxable to the donor (see Chapter 6). There is, however, a huge trap in this context, one that has snared many unsuspecting fundraisers and unwitting donors. This ambush is embedded in the *step transaction doctrine*.

It is all too easy for a donor and donee to succumb to these temptations. The charitable donee usually does not want to hold the gift property and thus is delighted that a prospective buyer is present. The donor may see the prearranged sale as a favor to the charity, saving the charity the need to pursue purchasers of the property. The step transaction doctrine is of no consequence in law to the charitable donee (absent fraud); the donor, however, can have what looks like a large appreciated property charitable deduction undone.

General Principles

If the donee charitable organization sells the property soon after the contribution is made, the donor may be placed in the position of having to recognize, for federal income tax purposes, the capital gain element. This can happen when, under the facts and circumstances surrounding the gift, the donee was legally obligated to sell the gift property to a purchaser that was prearranged by the donor. In this situation, the law regards the transaction as a sale of the property by the "donor" to the third-party purchaser and a gift of the after-tax sales proceeds to the charitable organization.

Pursuant to this step transaction doctrine, two or more ostensibly independent transactions (here, the gift to and subsequent sale by the donee) are consolidated and treated as a single transaction for federal tax purposes. The key to avoiding this tax-adverse outcome is to be certain that the charitable organization was not legally bound at the time of the gift to sell the property to the prospective purchaser.

This sidestep of the step transaction doctrine has its origins in a famous court case, where a gift of stock in a closely held corporation was made to a charitable organization, followed by a prearranged redemption. The transaction was not recharacterized as a redemption between the donor and the redeeming corporation and a later gift of the redemption proceeds to the charity. This was the outcome, although the donor held voting control over both the corporation and the charitable organization. The IRS lost this case because the charity was not legally bound to redeem the stock, nor was the corporation in a position to compel the redemption.

Illustrative Litigation

The step transaction rule has been and continues to be the subject of considerable litigation. Several court opinions illustrate the nature of this controversy. In one instance, a court ruled that a gift to a charitable organization of the long-term capital gains in certain commodity futures contracts gave rise to a charitable contribution deduction, and that the gifts and subsequent sales of the contracts were not step transactions within a unified plan.

This case concerned an individual who formed a private operating foundation in the early 1970s and had been president of it since it was established. From time to time, he contributed futures contracts to the foundation and claimed charitable contribution deductions for these gifts. In 1974, he obtained a private letter ruling from the IRS that the charitable contributions deductions were proper and that no gain need be recognized when the foundation sold the contracts.

In 1981, however, the federal tax law was changed. Beginning with that year, all commodities futures contracts acquired and positions established had to be marked to market at year-end and the gains (or losses) had to be characterized as being 60 percent long-term capital gains (or losses) and 40 percent short-term gains (or losses), regardless of how long the contracts had been held. This revision in the law posed a problem for this individual because the charitable deduction for a gift of short-term capital gain property is confined to the donor's basis in the property; there is no deduction for the full fair market value of the property (as there is for most gifts of long-term capital gain property). He solved the dilemma by donating only the long-term gain portion of the futures contracts.

In 1982, this individual entered into an agreement under which he contributed the long-term gains of selected futures contracts from his personal accounts at a brokerage house and retained for himself the short-term capital gains. For the most part, the selected contracts were sold on the same day the gift was made, and the portions of the proceeds representing the long-term capital gains were transferred to an account of the foundation at the same brokerage house. The donor chose the futures contracts to be donated according to the funding needs of the foundation and the amount of unrealized long-term capital gains inherent in the contracts. Once the contracts were transferred to a special account, they were to be immediately sold, pursuant to a standing instruction. On audit for 1982, the IRS took the position that the full amount of the capital gains on the sales of these contracts was includable in this individual's taxable income; the IRS also disallowed the charitable deductions for that year and prior years. The IRS's position rested on two arguments: (1) the transfers of a portion of the gain to the foundation were a taxable anticipatory assignment of income; and (2) the step transaction doctrine should apply, thereby collapsing separate interrelated transactions into a single transaction for tax purposes.

The step transaction doctrine was inapplicable in this instance, the individual argued, because no prearrangements were made with respect to the gifts. He maintained that he donated all of his interest in the long-term capital gain portions of the futures contracts, free and clear. The IRS, by contrast, contended that the gift transfers should be treated together with the later future sales and division of proceeds as a single transaction. The government argued that this individual's plan was to meet the foundation's operating needs by selling selected futures contracts with unrealized appreciation of equal amounts. Rather than donating cash, this argument went, he tried to donate the futures contracts with a restriction that he would keep the short-term capital gains on their sale.

The court said that the question in the case was "[h]ow related were the decisions to sell the futures to their donation?" The court looked to the matter of control and found that the donation agreements and powers of attorney executed by the individual supported his position that the trustees of the foundation had control over the sale of the futures contracts once they were transferred into the broker's special account. Thus, the court concluded that the issue of the donor's control over the sale of the contracts "was not such that the donations and sales could be viewed as step transactions encompassed within a unified plan."

As this case illustrated, the question posed by the step transaction doctrine involves the relationship among various seemingly independent transactions. In this case, the question was: How related were the decisions to sell the futures contracts to the contributions of them? Had some prearrangement existed by which the individual donated selected contracts to cover the charitable organization's operating expenses, and had he received in return short-term gains without having to pay taxes on the full amount of the futures contracts, the transfers could have been viewed as a step transaction within a larger plan. In this connection, one court held that "if, by means of restrictions on a gift to a charitable donee, either explicitly formulated or implied or understood, the donor so restricts the discretion of the donee that all that remains to be done is to carry out the donor's prearranged plan for designation of the stock, the donor had effectively realized the gain inherent in the appreciated property."

As to this case, the individual claimed that the sales were not prearranged but rather were the prudent acts of the trustees of a charitable organization in need of operating funds. The IRS argued that the standing instruction reflected a prearranged plan to use the charity to sell the futures contracts, cover its needs with the long-term gains, and enable the individual to keep the short-term gains without having to pay taxes on the entire proceeds of the sale. The court held, however, that there was no evidence to suggest that the individual was the source of the standing instruction, and thus that his control over the sale of the contracts was not such that the contributions and sales could be viewed as step transactions encompassed within a unified plan.

In a similar case, a court held that contribution of appreciated futures contracts to a charitable organization controlled by an individual did not result in income to the individual when the contracts were sold shortly after they had been donated. The court dismissed the importance of control between the business and the recipient charitable organization and the fact that everyone involved anticipated that the gifted property would be sold or otherwise liquidated. The court wrote: "Only through such a step could the purpose of the charitable contribution be achieved."

In another instance, an individual made annual gifts, for ten consecutive years, to a university of closely held stock in a corporation of which he was the majority shareholder, an officer, and a director. He retained a life interest in the gift property and confined his charitable contribution deduction to the value of the remainder interest (see Chapter 6). Each year the university tendered stock to the corporation for redemption; each year the corporation redeemed it. There was no contract evidencing this cycle of events. The university invested the redemption proceeds in income-producing securities and made quarterly disbursements to the donor.

The IRS asserted that the donor employed the university as a tax-free conduit for withdrawing funds from the corporation and that the redemption payments by the corporation to the university were in reality constructive dividend payments to the donor. The court on appeal nicely framed the dispute: "Our aim is to determine whether [the donor's] gifts of the [c]orporation's shares [to the university] prior to redemption should be given independent significance or whether they should be regarded as meaningless intervening steps in a single, integrated transaction designed to avoid tax liability by the use of mere formalisms."

The IRS wanted the court to "infer from the systematic nature of the gift-redemption cycle" that the donor and donee had "reached a mutually beneficial understanding." But the court declined to find any informal agreement between the parties; it also refused to base tax liability on a "fictional one" created by the IRS. The court so held even though the donor was the majority shareholder of the corporation, so that his vote alone was sufficient to ensure redemption of the university's shares. The court wrote that "foresight and planning do not transform a nontaxable event into one that is taxable."

In still another instance, an individual donated promissory notes issued by a company he controlled to three charitable foundations several weeks prior to redemption of the notes. A court held that he did not realize income in connection with these gifts or the subsequent redemption of the notes by the company. The court observed: "A gift of appreciated property does not result in income to the donor so long as he gives the property away absolutely and parts with title thereto before the property gives rise to income by way of a sale."

In one more instance involving facts of this nature, a court took note of the fact that the concept of a charitable organization originated before and independently of the sale, the deed of trust for the property contributed was executed before and independent of the sale, and at the time the deed of trust was executed, "no mutual understanding or meeting of the minds or contract existed between the parties."

There are cases to the contrary, however, holding that the transfer of the property to a charitable organization "served no business purpose other than an attempt at tax avoidance."

In the end, perhaps the matter of the step transaction doctrine comes down to this observation by a court: "Useful as the step transaction doctrine may be in the interpretation of equivocal contracts and ambiguous events, it cannot generate events which never took place just so an additional tax liability might be asserted."

IRS Rulings

The step transaction doctrine occasionally appears in IRS private letter rulings. In one instance, an individual planned to fund a charitable remainder trust (see Chapter 6) with a significant block of stock of a corporation. It was anticipated that the trust would sell most, if not all, of this stock in order to diversify its assets. The stock first had to be offered to the corporation to redeem the stock for its fair market value. The donor was the sole initial trustee of the trust.

The IRS focused, in this instance, on whether the trust would be legally bound to redeem the stock. Although it did not answer that question, the agency assumed that to be the case and also assumed that the trust could not be compelled by the corporation to redeem the stock. Thus, the IRS held that the transfer of the stock by the donor to the trust, followed by the redemption, would not be recharacterized for federal income tax purposes as a redemption of the stock by the corporation followed by a contribution of the redemption proceeds to the trust. The IRS also held that the same principles would apply if the stock were sold rather than redeemed. This holding assumed that the donor had not prearranged a sale of the stock before contributing it to the trust under circumstances in which the trust would be obligated to complete the sales transaction.

In another situation, an individual planned to contribute a musical instrument to a charitable remainder trust. The instrument was used in the donor's profession; the donor was not a dealer in this type of instrument, nor was the instrument depreciated for tax purposes. Again, the issue was presented: If the trust subsequently sold the instrument for a gain, would that gain have to be recognized by the donor? The IRS presumed that there was no prearranged sales contract legally requiring the trust to sell the instrument following the gift. With this presumption, the IRS was able to hold that any later gain on a sale of the instrument would not be taxable to the donor.

CHARITABLE PLEDGES

The making of a charitable pledge—a promise to make a charitable contribution—does not give rise to an income tax charitable contribution deduction. Any deduction that is occasioned by the pledge, such as it may be, is determined at the time the pledge is satisfied.

The enforceability of a charitable pledge is a matter of state law. Some states require the existence of consideration as a prerequisite to the existence of an enforceable pledge. Other states will enforce a charitable pledge on broader, social grounds, such as reliance. A typical circumstance concerning the latter approach arises where a person pledges a significant gift to a charity for a building and the charity commences construction of it in reliance on the forthcoming gift.

Usually, a pledge is made by a potential donor in the form of a written statement—a promise to the potential charitable donee of one or more contributions to be made sometime in the future. Pursuant to a *funding agreement*, a person may commit in writing to make multiple contributions to a charitable organization over a stated period for purposes such as general operations or endowment; the charitable contribution (and resulting deduction) arises in each year of actual payment. A variation on this approach is a pledge to charity of a stock option. The pledge then produces an income tax charitable deduction in the year in which the charitable donee, having acquired the option, exercises it.

PUBLIC POLICY CONSIDERATIONS

A doctrine in the law of nonprofit organizations states that an entity cannot be tax-exempt as a charitable one if it engages in an activity that is contrary to public policy. For example, the U.S. Supreme Court held that it is contrary to federal public policy for a private school to engage in racially discriminatory practices as to its student body and faculty; this type of discrimination was found to bar tax exemption of the school as a charitable or educational organization. This doctrine is occasionally applied in the charitable giving setting.

In one case, an individual contributed certain Native American artifacts to a museum; a portion of the collection consisted of items covered by eagle and migratory bird protection laws. The IRS contended that there should not be any charitable deduction for these gifts, on the ground that acquisition of the items was contrary to public policy. Nonetheless, a court held that these donors had a sufficient ownership interest in these items to contribute them to the museum, even though the donors may have violated federal law when they acquired the items.

There are other aspects of the public policy doctrine; one concerns the efficacy of the imposition of certain conditions subsequent on the terms and conditions of a gift. In the principal case, an individual transferred certain property interests to a trust benefiting his children. The instrument making the gift provided that, should there be a final determination that any part of the transfer was subject to gift tax, all the parties agreed that the excess property decreed to be subject to the tax would automatically be deemed not included in the conveyance and be the sole property of the individual, free of trust.

The court held that this provision was a condition subsequent that was void because it was contrary to public policy. It wrote that "[w]e do not think that the gift tax can be avoided by any such device as this." A contrary holding, wrote the court, would mean that, "upon a decision that the gift was subject to tax, the court making such decision must hold it not a gift and therefore not subject to tax." This holding would be made in the context of litigation to which the donees of the property were not parties, so the decision would not be binding on them and they would be able to enforce the gift notwithstanding the court's decision. Then wrote the court: "It is manifest that a condition which involves this sort of trifling with the judicial process cannot be sustained."

This condition subsequently was found to be contrary to public policy for three reasons. First, "it has a tendency to discourage the collection of the [gift] tax by the public officials charged with its collection, since the only effect of an attempt to enforce the tax would be to defeat the gift."

Second, the "effect of the condition would be to obstruct the administration of justice by requiring the courts to pass upon a moot case." That is, if the condition "were valid and the gift were held subject to tax, the only effect of the holding would be to defeat the gift so that it would not be subject to tax." The consequence would be that the donor "would thus secure the opinion of the court as to the taxability of the gift, when there would be before the court no controversy whatever with the taxing authorities which the court could decide, the only possible controversy being as to the validity of the gift and being between the donor and persons not before the court."

Third, the condition "is to the effect that the final judgment of a court is to be held for naught because of the provision of an indenture necessarily before the court when the judgment is rendered." The court noted that gift tax liability cannot be the subject of a federal court declaratory judgment. The condition thus "could not be given the effect of invalidating a judgment which had been rendered when the instrument containing the condition was before the court, since all matters are merged in the judgment." The court rephrased its distress with the voided condition: The condition "is not to become operative until there has been a judgment; but after the judgment has been rendered it cannot become operative because the matter involved is concluded by the judgment."

In a similar case, a husband and wife transferred shares of stock to their three children. At the time of the gifts, these individuals executed a gift adjustment agreement that was intended to ensure that the parents' gift tax liability for the stock transfers would not exceed the unified credit against tax to which they were entitled at the time. This agreement stated that, if it should be finally determined for federal gift tax purposes that the fair market value of the transferred stock either was less than or greater than $2,000 per share, an adjustment would be made to the number of shares conveyed, so that each donor would have transferred $50,000 worth of stock to each donee.

The court in this case declined to give effect to the gift adjustment agreement, inasmuch as honoring the agreement would run counter to public policy concerns. It wrote that a "condition that causes a part of a gift to lapse if it is determined for Federal gift tax purposes that the value of the gift exceeds a given amount, so as to avoid a gift tax deficiency," involves a "trifling with the judicial process." If valid, this type of condition would "compel" the court to "issue, in effect, a declaratory judgment as to the stock's value, while rendering the case moot as a consequence." Yet there was "no assurance that the [parents] will actually reclaim a portion of the stock previously conveyed to their sons, and our decision on the question of valuation in a gift tax suit is not binding upon the sons, who are not parties to this action." The sons, the court added, "may yet enforce the gifts."

There is another line of law, captured by this quotation: "The purpose of Congress in providing deductions for charitable gifts was to encourage gifts for charitable purposes; and in order to make such purposes effective, there must be a reasonable probability that the charity actually will receive the use and benefit of the gift, for which the deduction is claimed." A dissenting opinion in a court case stitched these aspects of the case law together in an attempt to defeat charitable contributions that the dissenter viewed as caused by an increase in value of property facilitated by the court majority. The dissent concluded that the "possibility of an increased charitable deduction serves to discourage [the IRS] from collecting tax on the transaction because any attempt to enforce the tax due on the transaction is of no advantage to the fisc." It argued that the charity involved would never be able to benefit from the gifts, and characterized the charitable deduction as "against public policy" and "plainly wrong."

Perhaps the best application of the public policy doctrine in the charitable giving setting occurred when the IRS issued regulations concerning charitable lead trusts (see Chapter 6) in an effort to stop the practice of using the lives of seriously ill individuals to measure the income interest period, so as to move income and assets away from charitable beneficiaries prematurely and to private beneficiaries instead. The IRS observed that, "similar to the vulture, the promoters of this form of charitable lead trust circle in on mortally ill people," thus giving rise to the term *vulture* or *ghoul* charitable lead trust. The agency stated: "Marketing schemes that exploit the misfortunes of some for the benefit of others are contrary to public policy."

SUMMARY

This chapter provided an introduction to the law of fundraising for charitable organizations, with a summary of the concepts of charitable fundraising and charitable sales, a definition of *charitable contribution*, a description of the methods of fundraising, an analysis of the matter of fundraising expenses, a summary of the commensurate test, a survey of fundraising compensation issues, a discussion of the step transaction doctrine, a summary of the law on charitable pledges, and an analysis of the public policy considerations that can apply in the charitable fundraising setting.