THE NONPROFIT TIMES™
The Leading Business Publication For Nonprofit Management www.nptimes.com JUNE 15, 2006
DIRECT RESPONSE FUNDRAISING EDITION

Fundraising In Cyberspace

The current state of Internet law, fundraising and revenue generation

Editor's Note: *This is part one of a two-part series on charitable registration and enforcement. The second part will run in the July 15 issue.*

The Internet has driven extraordinary growth in organizational advocacy and fundraising during the past decade. The most recent industry statistics show that Internet donations increased by more than 40 percent during the last quarter of 2005, when factoring out gifts made for disaster relief during 2004.

Although online gifts still account for only a small percentage of most charities' overall revenue, fundraising experts predict that the Internet will eventually become the primary vehicle for small gift donations.

The explosive growth in Internet transactions has also increased government scrutiny hunting for Internet crimes. According to the Feb. 10, 2006 edition of *The Wall Street Journal,* the Federal Bureau of Investigation (FBI) has made Internet fraud the agency's third-highest priority, after counter-terrorism and counter-intelligence.

Charity regulators have focused on Internet fundraising and revenue generation, thus it has become imperative that all those participating in these online activities take note of how the potential regulatory environment may affect their efforts to effectively use this "first of its kind" global medium.

Regulatory jurisdiction

Although existing laws are, to a large extent, sufficient to regulate Internet activities, a key question that continues to challenge regulators is how federal and state courts and regulatory agencies can obtain jurisdiction over those entities participating in online activities.

There are two key jurisdictional questions that affect the work of nonprofits online. The first issue is whether a court has the power to adjudicate claims against an organization for its conduct on the Web. For example, can a homeless shelter in Atlanta, with no ties to Illinois other than maintaining a Web site that is accessible by Illinois residents, be brought before a state court in Illinois for allegedly posting fraudulent information on the charity's Web site?

The second jurisdictional issue involves the extent of statutory authority given to state or federal regulatory agencies. Can the Illinois attorney general require the homeless shelter in Atlanta to register in Illinois simply because its Web site is accessible to Illinois residents?

The question of personal jurisdiction is as critical to nonprofits that engage in Internet fundraising and revenue-generating activities as it is to for-profits. If merely setting up a Web site that is available nationwide triggers registration and reporting requirements in every jurisdiction in the United States that imposes them, this would create an insurmountable burden for the vast majority of charities that are small community-based organizations.

Although the philanthropic community recognizes the need for a reasonable level of regulatory oversight, any regulatory plan should take a balanced approach that will not discourage the development and use of this medium to expand the charitable activities of nonprofits large and small.

For a state to obtain jurisdiction to impose its regulations upon online solicitors, it must comply with the constitutional standards set forth in the seminal U.S., Supreme Court case, *International Shoe v. Washington.* The constitutional standard of "minimum contacts" sets forth the minimum amount of contacts necessary for a state to exercise jurisdiction over a person or entity. To meet the constitutional minimum contact standard: (1) the defendant must purposefully avail himself of the privilege of doing business in the state; (2) the cause of action or regulation must relate to the defendant's activities with the state; and (3) the exercise of jurisdiction must be reasonable in light of the various interests at stake.

The "minimum contacts" standard established by the U.S. Supreme Court provides the outer reaches of jurisdiction over a person or entity. However, each state is further limited by its own law, known as a "long-arm statute," to determine whether it can obtain jurisdiction of the Internet conduct of out-of-state persons or entities. A state statute may define its jurisdiction more narrowly, thereby limiting the court's ability to reach certain entities whose actions may have satisfied the constitutional mini-

mum established by the U.S. Supreme Court.

For example, New York's long-arm statute provides for narrower jurisdiction than the constitutional limit. In *Bensusan Restaurant Corporation vs. Richard B. King, individually and d/b/a The Blue Note,* the so-called *Blue Note* case, the U.S. Court of Appeals for the Second Circuit declined to exercise jurisdiction over a jazz club in Missouri when the only contact with New York was that its Web site was accessible in the state. The Appeals Court held that the Missouri Blue Note's maintenance of a Web site accessible to New York residents did not create the level of contacts required to exercise jurisdiction under New York's long-arm statute.

The exact opposite result was found that same year in Connecticut under almost identical facts. In *Inset Systems, Inc. v. Instruction Set, Inc.,* the U.S. District Court for the District of Connecticut found that the state could constitutionally assert jurisdiction over the Massachusetts Web site host because "advertising via the Internet" both satisfied the Connecticut long-arm statute covering solicitation of business in-state and the Supreme Court's constitutional minimum contacts standard.

The *Inset* court's ruling represents the outer limits of jurisdiction over Internet activities and allows a passive Web site to create sufficient contacts for the state to obtain jurisdiction over the Web site owner. Several states have taken a similar expansive view of personal jurisdiction, including Virginia, Missouri and Minnesota.

In 1997, the federal district court in Pennsylvania developed a sliding scale approach for determining whether the court has jurisdiction over Internet activities. In the *Zippo Mfg. Co. v. Zippo Dot Com, Inc.,* (the *Zippo case)* the U.S. District Court for the Western District of Pennsylvania ruled that "the likelihood that personal jurisdiction can be constitutionally exercised is directly proportionate to the nature and quality of commercial activity that an entity conducts over the Internet." It then posited a scale that places Web sites on a continuum, from those that actively solicit and do business to those that passively convey information. Between these two ends of the spectrum lie Web sites where "a user can exchange information with the host computer . . . [and] the exercise of jurisdiction is determined by examining the level of interactivity and commercial nature of the exchange of information that occurs on the Web site."

The vast majority of states have adopted Pennsylvania's sliding scale approach including California, Indiana, Maryland, Illinois and Texas.

What does this mean for charities using the Internet? During the late 1990s, as charities increasingly began conducting charitable solicitations over the Internet, state regulators sought to regulate this method just as they did other forms of solicitation. However, they faced jurisdictional obstacles in applying their charitable solicitation schemes to entities whose only in-state presence was through the Internet. Discussions among state regulators culminated in the creation of the Charleston Principles, a set of non-binding guidelines that seek to provide an analytical framework for determining whether a state can impose its regulations on an entity engaged in Internet charitable solicitations.

State regulation of Internet fundraising

Of all the legal issues facing nonprofits that engage in Internet communications, charitable solicitation regulation is the area most significantly affected. Charitable solicitation is primarily regulated at the state level. There are approximately 45 states that have statutory systems dealing with solicitation activity within their state. These statutory systems typically include registration, filing and disclosure requirements. They are imposed on nonprofits, professional solicitors, professional fundraising counsel and commercial co-venturers. While a certain level of regulation can be beneficial to increase donor confidence and fight fraudulent solicitations, the inconsistency in reporting and disclosure requirements among the states creates a significant burden for nonprofits, in particular for smaller charities.

The First Amendment

The government's interests in regulating charitable solicitation are to ensure that the funds raised are in fact used for charitable purposes, to protect citizens from fraudulent solicitations, and to protect the privacy interests of prospective donors. Charities, on the other hand, typically engage in solicitation to both disseminate information about, and seek funding for, their charitable causes. The U.S. Supreme Court has noted that charitable solicitations are inextricably intertwined with informative and persuasive speech, which is protected by the First Amendment.

During the 1980s, when the interests of the government and charities clashed, the U.S. Supreme Court resolved the conflicts in a trilogy of cases, striking down state regulations that limited the percentage of fees that charities could pay fundraisers and which required fundraisers to make pre-solicitation disclosures regarding prior fundraising costs. Although these First Amendment issues are central to the development of reasonable fundraising regulation, they have not yet played a prominent role in the development of Internet fundraising regulation.

The Charleston Principles (and its progeny?)

In October, 1999, members of the National Association of State Charities Officials (NASCO) and the National Association of Attorneys General (NAAG) met in Charleston, S.C., and agreed to adopt a set of principles to clarify the applicability of states' charitable solicitation regulations to Internet fundraising. In March 2001, the "Charleston Principles" were published as advisory guidelines for state charity officials.

The Charleston Principles assert that

 For subscription information, please visit www.nptimes.com

existing registration statutes, of their own terms, encompass and apply to Internet solicitation. The Charleston Principles help bridge the application of existing laws to this new frontier by defining and limiting the circumstances in which a nonprofit solicitor must register with a given state based on their Internet contacts with the state.

According to the Principles, state registration and reporting regimes apply only to: (1) entities domiciled within the state; (2) out-of-state entities whose non-Internet activities would require registration in the state (e.g., direct mail or telephone solicitation into the state); and (3) out-of-state entities that solicit through an interactive or non-interactive Web site and either specifically target persons physically located in the state, or receive contributions from the state on a repeated and ongoing, or substantial basis through or in response to the Web site solicitation.

The jurisdictional analysis offered by the principles is similar to the *Zippo* sliding scale approach, but adds a marker to the scale that would explicitly require registration for passive Web sites that request only offline donations when certain additional ties exist (i.e., targeting the state's residents or receiving contributions from the state on a repeated and ongoing, or substantial basis).

The requirement that an out-of-state entity specifically target persons physically located in the state raises questions when applied to emails. A person will be "specifically targeted" if the sender knows or reasonably should know the recipient is physically located in the state. The "knows or reasonably should know" standard is difficult to apply to an email sent to a state resident because email addresses do not generally include geographic identifiers. The Principles suggest that there are ways an entity reasonably should know where an email is being directed, including email addresses linked to a prior credit card donation; other prior forms of communication; Web site information tracking, and cross-references to external databases.

One of the problematic standards contained in the Principles that would allow the states to acquire jurisdiction involves an organization that receives contributions from a state on a "repeated and ongoing" or "substantial" basis. The terms "repeated and ongoing" (referring to the number of separate contributions) and "substantial" (referring to the total dollar amount of contributions) lack any definite numbers that nonprofits can use to determine whether they need to register and comply with a state's regulations. The Annotations to the Principles recognize that for the Principles to be useful, "states must draw a bright line, even if that line is somewhat arbitrary and even if it is not the same in all states." Concrete guidance in this regard is especially important for out-of-state charities using non-interactive Web sites whose contacts with the state may be minimal at best.

The Principles would generally not require registration of service providers that solely provide administrative, supportive or technical services. However, if their services include the kinds of activities that characterize a fundraising counsel, commercial co-venturer or professional solicitor, they would be required to register. In contrast, mere technical services in processing online transactions, similar to a bank processing checks or credit card transactions received in response to a fundraising campaign, would not trigger registration.

To date, no state has explicitly adopted the Charleston Principles as its framework for determining whether a nonprofit whose only contact with the state is via the Internet must register. The only state that has provided any public, written guidance on Internet solicitation is Arkansas. In a written opinion published in August, 2005, Attorney General Mike Beebe cited the *Zippo* sliding scale approach as the standard that would be applied to determine whether a nonprofit must register when conducting Internet solicitations in the state.

Despite the lack of specific state policies for regulating Internet solicitations, state regulatory agencies have nevertheless been attempting to impose their existing registration requirements on charities and their vendors for Internet solicitation activities, sometimes under circumstances where the entity in question has little, if any, involvement with the actual online solicitation.

Registration issues often arise when a charity files its vendor's contract with the state. Technical or ambiguous contractual language may cause state regulators to presume that the vendor's involvement with solicitation activities requires registration. Further complicating matters is the fact that states do not cite the Charleston Principles when seeking to enforce their regulations.

Instead, states cite their existing solicitation laws, which use broad language that does not provide clear guidance as to whether the services provided by these vendors trigger the registration requirements. Even when states do cite the Charleston Principles, they are not strictly applied as controlling law, but rather as suggestions for determining whether an entity must comply with their state regulations. Because of this lack of certainty in guidance, charities and their vendors are left to figure out how to fit their square pegs into round holes. DRFE

Seth Perlman is a senior partner at Perlman and Perlman. He is author of Fund-Raising Regulation. His email is seth@perlmanandperlman.com. Karen I. Chang is an associate with the firm. Her email is karen@perlmanandperlman.com

 For subscription information, please visit www.nptimes.com

THE NONPROFIT TIMES
The Leading Business Publication For Nonprofit Management www.nptimes.com JULY 15, 2006
DIRECT RESPONSE FUNDRAISING EDITION

Fundraising In Cyberspace

The law of Internet charitable fundraising and revenue generation

Editor's Note: This is the second of two parts on the topic of legal issues surrounding fundraising on the Web. The first installment ran in the June 15, 2006 issue.

At the end of the 20th century, the Internet began rapidly changing the way people communicate, educate, and buy and sell goods and services. Under the administration of President Bill Clinton, an interagency Working Group on Unlawful Conduct on the Internet was convened to provide an analysis of the legal and policy issues created by use of the Internet to commit crimes.

The overall regulatory policy regarding the Internet was to ensure the safety and security of those who use the Internet, while seeking to promote private sector leadership, technology-neutral laws and regulation and an appreciation of the Internet as an important medium for commerce and communication.

The Working Group issued a report in March 2000, recommending that any regulation of unlawful conduct involving the use of the Internet should be analyzed through a policy framework that ensures that online conduct is treated in a manner that:

- Is consistent with the way offline conduct is treated;
- Is technology-neutral; and,
- Accounts for other important societal interests, such as privacy and protection of civil liberties.

Federal vs. state regulation

A threshold question for regulators is whether Internet activities should be regulated at the federal or state level. Consistent with the Working Group's recommendation that regulation of unlawful Internet activity be treated in a manner consistent with the way offline conduct is treated, federal and state regulators are, by and large, simply applying existing laws to Internet activities, including those carried on by nonprofits.This approach is sensible because the Internet essentially provides a new medium for doing tasks that charities have long been conducting – communicating with their members and supporters, soliciting funds, and initiating public calls to action. For more information on state regulation of Internet fundraising, see Part I of this Article published in the Juny 15 edition.

Federal tax issues

In 1999, the Internal Revenue Service (IRS) stated that "use of the Internet to accomplish a particular task does not change the way the tax laws apply to that task." The IRS further noted that while it had not yet determined its official position with regard to Internet activities,"it is reasonable to assume that ... it will remain consistent with our position with respect to advertising and merchandising and publishing in the off-line world."

The two primary tax issues that arise with nonprofits' use of the Internet relate to maintenance of their tax-exempt status and liability for unrelated business income tax (UBIT). To maintain its 501(c)(3) exemption, a nonprofit must meet an organizational test and an operational test. To satisfy the organizational test, the nonprofit's organizing documents must limit the purposes of the organization to one or more exempt purposes, and must not authorize the organization to engage more than insubstantially in any activities which are not in furtherance of their exempt purposes. To satisfy the operational test, an organization must be deemed to operate "exclusively" for its specified exempt purposes.

"Exclusively" has regularly been interpreted as "primarily," thereby allowing for a limited amount of activities that do not further the exempt purposes. The IRS is particularly concerned about satisfaction of the operational test when nonprofits engage in revenue-generating activities on the Internet. Nonprofits should ensure that their Internet revenue-generating activities do not become substantial in relation to their activities taken as a whole, unless those activities are primarily related to the nonprofit's exempt purposes.

Even though an organization is tax exempt, it still might be liable for tax on its unrelated business taxable income. This is income from a trade or business, regularly carried on, that is not substantially related to the organization's exempt purpose or function except to the extent that the organization benefits from the profits derived from the activity. Activities that could trigger UBIT include the use of hyperlinks as advertising, corporate spon-

sorships, or link and banner exchanges; and various forms of merchandising, including online storefronts, auctions, charity malls, and merchant affiliate programs.

Hyperlinks and banner exchanges

Internet hyperlinks to other entities raise the question of whether the links constitute "advertising," which is subject to UBIT. "Advertising" is defined as those messages that contain qualitative or comparative language, price information, or other indications of savings or value, endorsements and inducements to purchase, sell or use the products or services.

Corporate sponsorships, however, also commonly displayed as hyperlinks or banners, are viewed by the IRS as a charitable contribution that is not subject to UBIT. The caveat is that such payments must be given with no expectation that the sponsor will receive a substantial return benefit. When the arrangement would provide the sponsor with valuable marketing (i.e., advertising) and other services in return for their support, such sponsorship payments may subject the charity to UBIT.

To avoid UBIT, Web site and email acknowledgments of corporate sponsors can't contain language that endorses or induces site visitors to purchase, sell or use the products or services. Regulations published by the IRS in 2002 made clear that the mere presence of a banner or Web link to a corporate sponsor's Web site would not constitute taxable advertising, so long as the restrictions for sponsorship acknowledgments are followed.

The IRS suggested that a moving banner is more likely to be classified as an advertisement, but this classification was not incorporated into any subsequent regulations published on UBIT, so the status remains unclear.

In analyzing whether a link or banner exchange with another entity is subject to UBIT, the IRS looks to the purpose of the exchange, and whether it is an exchange of advertising, or merely an attempt to refer the site visitor to additional information in furtherance of the organization's exempt purposes and activities. An organization dedicated to helping people quit smoking that exchanges links or banners with a for-profit entity featuring retail products that help people quit smoking generally would not be subject to UBIT for including such a link.

Merchandising

Many organizations are creating online storefronts complete with virtual shopping carts. Although specific regulations governing online storefronts have not been published, the IRS has stated that it would treat them as it traditionally addresses sales activities of exempt organizations. The IRS applies the "primary purpose test," which states that an organization will be regarded as operated exclusively for exempt purposes only if it engages primarily in activities which accomplish one or more exempt purposes.

For example, in the case of museum shops, the IRS determines the relatedness of sales based on the organization's primary purpose for selling the item. If the purpose is in furtherance of an exempt purpose, the sale will be considered related, and therefore exempt. The IRS applies the primary purpose test on merchandise item by item, rather than taking them altogether. Thus, the sale of a poster exhibiting a piece of art in the museum's collection will not be subject to UBIT while the sale of a poster of an art piece not in its collection may incur UBIT.

The IRS's primary tax concern regarding online auctions relates to the manner in which they are conducted. While some organizations conduct their own auctions, many charities rely on outside vendors that specialize in online auction services which provide the additional benefits of a larger auction audience, as well as avoiding problems with credit card fraud.

The IRS is concerned about the degree of control that the charity will exercise over the marketing and conduct of such auctions. To avoid having the income be treated as advertising, the IRS suggests that the event be "sufficiently segregated from other, particularly non-charitable auction activities," and that the charity retain "primary responsibility" for the marketing and publicity. If the vendor is primarily responsible for marketing and publicity of the auction rather than the charity, the IRS might consider the auction activities as income from classified advertising rather than income derived from the conduct of a fundraising event, although the IRS has yet to take a definitive position.

An "online charity mall" is typically a Web site that provides links to affiliated merchants' Web sites. The merchant or the charity mall agrees to remit a portion of the sales proceeds to the charity. The mall operator credits the charity with the contribution when it receives the rebate from the vendor. There are generally no tax consequences to the charity from participating in an online charity mall because no action is usually required to be taken other than granting the mall rights to use the charity's name and logo on their Web site.

With regard to tax deductions for purchasers, if the consumer does not retain control over whether to direct the rebate to the charity or receive a refund, which is generally the case, the person would not be entitled to a tax deduction. One of the IRS's concerns is that the beneficiary organizations might not have any agreement with the virtual mall operators and therefore may not be entitled to any record of member designations or transactions to ensure that they are receiving all promised proceeds.

Merchant affiliate programs and other co-venture programs are another increasingly popular mechanism with which charities can generate revenue. Organizations partner with vendors (such as online booksellers), and make product recommendations that are displayed on the organization's Web site as links to the for-profit partner's Web site. The exempt organization earns a percentage from sales of recommended materials and a lesser commission on other purchases sold as a result of the referring link.

An off-line example of this is an affinity

credit card program, where a designated charity allows a credit card issuer to use its logo on the credit card, and in return receives as a donation a percentage of the amount spent using the card and a fee for each card subscriber. In the late 1990s, the IRS sought to impose UBIT on affinity credit card programs affiliated with University alumni associations, arguing that the marketing of a credit card by an exempt organization involves services typically provided by a commercial entity.

The Tax Court, however, determined that the income received by the exempt organization was a royalty, which is not subject to UBIT. Royalties are payments for the right to use valuable intangible property rights; they are not payments for services rendered by the property owner. The key question is whether significant services are rendered by the nonprofit in carrying out the affiliation. For example, if one or more employees of the nonprofit spend a significant amount of time promoting the affiliate program, the payments may lose their royalty status. The Tax Court's decisions with respect to affinity credit card programs should shed light on the IRS's future treatment of income generated by online merchant affiliate programs.

The FTC and CAN-SPAM

The role of the Federal Trade Commission (FTC) is to police unfair and deceptive business practices. Its jurisdiction is circumscribed as it relates to nonprofits that do not generally conduct trade or commerce. However, nonprofits' activities are not completely out of the FTC's reach.

According to the FTC's Final Rules relating to solicitation emails, effective as of March 28, 2005, certain nonprofits must comply with the FTC's rules, known as the CAN-SPAM regulations. The CAN-SPAM regulations specify information that is either prohibited or required to be included in any commercial email solicitation.

Nonprofit advocates sought to obtain a blanket exemption from the CAN-SPAM regulations because charities, by nature, are not in the business of commercial solicitation. The FTC refused to grant a blanket exemption, arguing that there are certain limited circumstances under which a charity might have to comply with CAN-SPAM for email messages containing commercial solicitations, such as an email message sent by a nonprofit hospital offering medical screening in exchange for a fee. Furthermore, the applicability of the Final Rules to email messages is not based upon the sender's intent, but rather upon the email recipient's reasonable interpretation of the message as a commercial email message.

Future regulation

If history is any guide, there will be limited explicit guidance from federal and state agencies as to how Internet fundraising and revenue generation should be regulated. The philanthropic community would benefit from greater coordination of state regulation, as well as the addition of definite guideposts, such as the establishment of a threshold amount of online contributions from a state that would trigger registration requirements.

Regulators will continue to apply existing laws to the Internet activities of nonprofits. As Internet technology continues to evolve, regulators must learn how to incorporate this evolution into their existing frameworks.

The application of existing fundraising regulation is based heavily on the specific facts and circumstances of the activity in question. The Internet is rapidly multiplying the facts and circumstances that must be considered when applying statutes that were, for the most part, originally implemented to deal with direct mail, telemarketing and face to face solicitations. Changes in regulatory framework will inevitably follow. *DRFE*

Seth Perlman is a senior partner at Perlman and Perlman. He is author of Fund-Raising Regulation. His email is seth@perlmanandperlman.com. Karen I. Chang is an associate with the firm. Her email is karen@perlmanandperlman.com

Reprinted with permission of *THE NONPROFIT TIMES* July 15, 2006, Vol. 20, No. 12
For subscription information, please visit www.nptimes.com For subscription information, please visit www.nptimes.com