

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 July 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 non-

profits 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.

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