
CHAPTER ONE

Government Regulation of Fundraising for Charity: Origins and the Contemporary Climate

<p>§1.1 Charitable Sector and American Political Philosophy 1</p> <p>§1.2 Charitable Fundraising: A Portrait 8</p>	<p>§1.3 Evolution of Government Regulation of Fundraising 9</p> <p>§1.4 Contemporary Regulatory Climate 13</p>
--	--

Charitable organizations are an integral part of U.S. society, and many of them must engage in the solicitation of contributions and grants to continue their work, which benefits that society. Yet both these organizations and their fundraising efforts are under constant criticism and immense regulation. Some of this regulation comes from the many state *charitable solicitation acts*—statutes that are designed to regulate the process of raising funds for charitable purposes. Other aspects of this regulation are found in the federal tax law, with mounting legislation and application of legal principles by the Internal Revenue Service¹ and the courts. Increasingly, other federal laws are contributing to the overall mass of regulation of charitable fundraising.

One of the pressing questions facing philanthropy in the United States is whether this form of regulation is far too extensive and thus whether it is unduly stifling the nation's independent and voluntary sector. Another attitude is that charity, and fundraising for it, has become a major "industry," and warrants regulation to minimize abuse, protect prospective and actual donors from fraud and other forms of misrepresentation, and reduce waste of the charitable dollar.

Before examining the extent of this regulation, and the accompanying contemporary issues and trends, the role of charitable organizations must be placed in its historical and public policy context.

§1.1 CHARITABLE SECTOR AND AMERICAN POLITICAL PHILOSOPHY

Because modern U.S. charity evolved out of the common law of charitable trusts and property, and has been accorded exemption from income taxation since the beginning of federal tax policy and gifts to charity are tax-deductible, the contemporary

1. Throughout this book, the Internal Revenue Service is referred to as the IRS.

GOVERNMENT REGULATION OF FUNDRAISING FOR CHARITY

treatment of charitable organizations is understandably fully reflected in the federal tax laws.

The public policy rationale for exempting organizations from tax is illustrated by the category of organizations that are charitable, educational, religious, scientific, literary and similar entities,² and, to a lesser extent, social welfare organizations.³ The federal tax exemption for charitable and other organizations may be traced to the origins of the income tax,⁴ although most of the committee reports accompanying the 1913 act and subsequent revenue acts are silent on the reasons for initiating and continuing the exemption.

One may nevertheless safely venture that the exemption for charitable organizations in the federal tax statutes is largely an extension of comparable practice throughout the whole of history. Congress believed that these organizations should not be taxed and found the proposition sufficiently obvious as not to warrant extensive explanation. Some clues may be found in the definition of charitable activities in the income tax regulations,⁵ which include purposes such as relief of the poor, advancement of education or science, erection or maintenance of public buildings, and lessening of the burdens of government. The exemption for charitable organizations is clearly a derivative of the concept that they perform functions which, in the organizations' absence, government would have to perform; therefore, government is willing to forgo the tax revenues it would otherwise receive in return for the public services rendered.

Since the founding of the United States, and earlier in the colonial period, tax exemption—particularly with respect to religious organizations—was common.⁶ Churches were openly and uniformly spared taxation.⁷ This practice has been sustained throughout the nation's history—not only at the federal but also at the state and local levels, most significantly with property taxation.⁸ The U.S. Supreme Court, in upholding the constitutionality of the religious tax exemption, observed that the "State has an affirmative policy that considers these groups as beneficial and stabilizing influences in community life and finds this classification [exemption] useful, desirable, and in the public interest."⁹

2. These are the organizations described in section ("§") 501(c)(3) of the Internal Revenue Code of 1986, as amended, Title 26, United States Code ("IRC").

3. These are the organizations described in IRC § 501(c)(4).

4. 38 Stat. 166. The income tax exemption for charitable organizations originated in the 1894 statute (28 Stat. 556, § 32), which was declared unconstitutional in *Pollock v. Farmers' Loan and Trust Co.*, 157 U.S. 429 (1895). In general, see McGovern, "The Exemption Provisions of Subchapter F," 29 *Tax Law.* 523 (1976); Bittker & Rahdert, "The Exemption of Nonprofit Organizations from Federal Income Taxation," 85 *Yale L. J.* 299 (1976).

A companion book by the author describes the federal tax law as it applies to nonprofit organizations. Chapter 1 of *Law of Tax-Exempt Organizations*, contains a fuller analysis of this aspect of public policy and of the independent sector.

5. Income Tax Regulations ("Reg.") § 1.501(c)(3)-1(d)(2).

6. Cobb, *The Rise of Religious Liberty in America*, 482–528 (1902); Lecky, *History of European Morals* (1868).

7. Torpey, *Judicial Doctrines of Religious Rights in America*, 171 (1948).

8. *Trustees of the First Methodist Episcopal Church v. City of Atlanta*, 76 Ga. 181 (1886); *Trinity Church v. City of Boston*, 118 Mass. 164 (1875).

9. *Walz v. Tax Commissioner*, 397 U.S. 664, 673 (1970).

§1.1 CHARITABLE SECTOR AND AMERICAN POLITICAL PHILOSOPHY

The Supreme Court early concluded that the foregoing rationalization was the basis for the federal tax exemption for charitable entities. In one case, the Court noted that “[e]vidently the exemption is made in recognition of the benefit which the public derives from corporate activities of the class named, and is intended to aid them when not conducted for private gain.”¹⁰

The U.S. Court of Appeals for the Eighth Circuit observed, as respects the exemption for charitable organizations, that “[o]ne stated reason for a deduction or exemption of this kind is that the favored entity performs a public service and benefits the public and relieves it of a burden which otherwise belongs to it.”¹¹ One of the rare congressional pronouncements on this subject is further evidence of the public policy rationale. In its committee report accompanying the Revenue Act of 1938, the House Ways and Means Committee stated:

The exemption from taxation of money or property devoted to charitable and other purposes is based upon the theory that the government is compensated for the loss of revenue by its relief from financial burden which would otherwise have to be met by appropriations from public funds, and by the benefits resulting from the promotion of the general welfare.¹²

One federal court observed that the reason for the charitable contribution deduction has “historically been that by doing so, the Government relieves itself of the burden of meeting public needs which in the absence of charitable activity would fall on the shoulders of the Government.”¹³

Other aspects of the public policy rationale are reflected in case law and the literature. Charitable organizations are regarded as fostering voluntarism and pluralism in the American social order.¹⁴ That is, society is regarded as benefiting not only from the application of private wealth to specific purposes in the public interest but also from the variety of choices made by individual philanthropists as to which activities to further.¹⁵ This decentralized choicemaking is arguably more efficient and responsive to public needs than the cumbersome and less flexible allocation process of government administration.¹⁶

The principle of pluralism was stated by John Stuart Mill, in *On Liberty* (1859), as follows:

In many cases, though individuals may not do the particular thing so well, on the average, as the officers of government, it is nevertheless desirable that it should be done by them, rather than by the government, as a means to their own mental education—a mode of strengthening their active faculties, exercising their judgment, and giving them a familiar knowledge of the subjects with which they are thus left to

10. *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578, 581 (1924).

11. *St. Louis Union Trust Company v. United States*, 374 F.2d 427, 432 (8th Cir. 1967). Also *Duffy v. Birmingham*, 190 F.2d 738, 740 (8th Cir. 1951).

12. H. R. Rep. No. 1860, 75th Cong., 3d Sess. 19 (1939).

13. *McGlotten v. Connally*, 338 F. Supp. 448, 456 (D.D.C. 1972).

14. *Green v. Connally*, 330 F. Supp. 1150, 1162 (D.D.C. 1971), *aff'd sub nom. Coit v. Green*, 404 U.S. 997 (1971).

15. Rabin, “Charitable Trusts and Charitable Deductions,” 41 *N.Y.U. L. Rev.* 912, 920–925 (1966).

16. Saks, “The Role of Philanthropy: An Institutional View,” 46 *Va. L. Rev.* 516 (1960).

GOVERNMENT REGULATION OF FUNDRAISING FOR CHARITY

deal. This is a principal, though not the sole, recommendation of jury trial (in cases not political); of free and popular local and municipal institutions; of the conduct of industrial and philanthropic enterprises by voluntary associations. These are not questions of liberty, and are connected with that subject only by remote tendencies; but they are questions of development. . . . The management of purely local businesses by the localities, and of the great enterprises of industry by the union of those who voluntarily supply the pecuniary means, is further recommended by all the advantages which have been set forth in this Essay as belonging to individuality of development, and diversity of modes of action. Government operations tend to be everywhere alike. With individuals and voluntary associations, on the contrary, there are varied experiments, and endless diversity of experience. What the State can usefully do is to make itself a central depository, and active circulator and diffuser, of the experience resulting from many trials. Its business is to enable each experimentalist to benefit by the experiments of others; instead of tolerating no experiments but its own.

This same theme was echoed by then-Secretary of the Treasury George P. Shultz, in testimony before the House Committee on Ways and Means in 1973, when he observed:

These organizations [“voluntary charities, which depend heavily on gifts and bequests”] are an important influence for diversity and a bulwark against over-reliance on big government. The tax privileges extended to these institutions were purged of abuse in 1969 and we believe the existing deductions for charitable gifts and bequests are an appropriate way to encourage those institutions. We believe the public accepts them as fair.¹⁷

The principle of voluntarism in the United States was expressed by another commentator as follows:

Voluntarism has been responsible for the creation and maintenance of churches, schools, colleges, universities, laboratories, hospitals, libraries, museums, and the performing arts; voluntarism has given rise to the private and public health and welfare systems and many other functions and services that are now an integral part of the American civilization. In no other country has private philanthropy become so vital a part of the national culture or so effective an instrument in prodding government to closer attention to social needs.¹⁸

Charitable organizations, maintained by tax exemption and nurtured by the ability to attract deductible contributions, are reflective of the American philosophy that all policymaking should not be reposed in the governmental sector. Philanthropy, wrote one jurist,

is the very possibility of doing something different than government can do, of creating an institution free to make choices government cannot—even seemingly arbitrary ones—without having to provide a justification that will be examined in a court of law, which stimulates much private giving and interest.¹⁹

17. “Proposals for Tax Change,” Department of the Treasury, Apr. 30, 1973, at 72.

18. Fink, “Taxation and Philanthropy—A 1976 Perspective,” 3 *J. C. & U. L.* 1, 6–7 (1975).

19. Friendly, “The *Dartmouth College* Case and the Public–Private Penumbra,” 12 *Tex. Q.* (2d Supp.) 141, 171 (1969).

§1.1 CHARITABLE SECTOR AND AMERICAN POLITICAL PHILOSOPHY

The public policy rationale for tax exemption (particularly for charitable organizations) was reexamined and reaffirmed by the Commission on Private Philanthropy and Public Needs in its findings and recommendations in 1975.²⁰ The Commission observed:

Few aspects of American society are more characteristically, more famously American than the nation's array of voluntary organizations, and the support in both time and money that is given to them by its citizens. Our country has been decisively different in this regard, historian Daniel Boorstin observes, "from the beginning." As the country was settled, "communities existed before governments were there to care for public needs." The result, Boorstin says, was that "voluntary collaborative activities" were set up to provide basic social services. Government followed later.

The practice of attending to community needs outside of government has profoundly shaped American society and its institutional framework. While in most other countries, major social institutions such as universities, hospitals, schools, libraries, museums and social welfare agencies are state-run and state-funded, in the United States many of the same organizations are privately controlled and voluntarily supported. The institutional landscape of America is, in fact, teeming with nongovernmental, noncommercial organizations, all the way from some of the world's leading educational and cultural institutions to local garden clubs, from politically powerful national associations to block associations—literally millions of groups in all. This vast and varied array is, and has long been widely recognized as, part of the very fabric of American life. It reflects a national belief in the philosophy of pluralism and in the profound importance to society of individual initiative.

Underpinning the virtual omnipresence of voluntary organizations, and a form of individual initiative in its own right, is the practice—in the case of many Americans, the deeply ingrained habit—of philanthropy, of private giving, which provides the resource base for voluntary organizations. Between money gifts and the contributions of time and labor in the form of volunteer work, giving is valued at more than \$50 billion a year, according to Commission estimates.

These two interrelated elements, then, are sizable forces in American society, far larger than in any other country. And they have contributed immeasurably to this country's social and scientific progress. On the ledger of recent contributions are such diverse advances as the creation of noncommercial "public" television, the development of environmental, consumerist and demographic consciousness, community-oriented museum programs, the protecting of land and landmarks from the often heedless rush of "progress." The list is endless and still growing; both the number and deeds of voluntary organizations are increasing. "Americans are forever forming associations," wrote de Tocqueville. They still are: tens of thousands of environmental organizations have sprung up in the last few years alone. Private giving is growing, too, at least in current dollar amounts.²¹

Exemption from taxation for certain types of nonprofit organizations is a principle that is larger than the Internal Revenue Code. Citizens combating problems and

20. *Giving in America—Toward a Stronger Voluntary Sector* (1975). All quotations herein from the Commission's report are by permission.

21. *Id.* at 9–10.

GOVERNMENT REGULATION OF FUNDRAISING FOR CHARITY

reaching solutions on a collective basis—in “association”—are inherent in the very nature of American societal structure. Nonprofit associations are traditional in the United States, and their role and responsibility are not diminished in modern society. Rather, some contend that the need for the efforts of nonprofit organizations is greater today than previously, in view of the growing complexity and inefficiency of government. To tax these entities would be to flatly repudiate and contravene this doctrine that is so much a part of the nation’s heritage.

This view of nonprofit associations operating in the United States has been most eloquently stated by Alexis de Tocqueville. He, too, espoused the principle of pluralism, as expressed in his *Democracy in America*:

Feelings and opinions are required, the heart is enlarged, and the human mind is developed only by the reciprocal influence of men upon one another. I have shown that these influences are almost null in democratic countries; they must therefore be artificially created, and this can only be accomplished by associations. . . . A government can no more be competent to keep alive and to renew the circulation of opinions and feelings among a great people than to manage all the speculations of productive industry. No sooner does a government attempt to go beyond its political sphere and to enter upon this new track than it exercises, even unintentionally, an insupportable tyranny; for a government can only dictate strict rules, the opinions which it favors are rigidly enforced, and it is never easy to discriminate between its advice and its commands. Worse still will be the case if the government really believes itself interested in preventing all circulation of ideas: it will then stand motionless and oppressed by the heaviness of voluntary torpor. Governments, therefore, should not be the only active powers; associations ought, in democratic nations, to stand in lieu of those powerful private individuals whom the equality of conditions has swept away.

But de Tocqueville’s classic formulation on this subject came in his portrayal of the use by Americans of “public associations” in civil life:

Americans of all ages, all conditions, and all dispositions constantly form associations. They have not only commercial and manufacturing companies, in which all take part, but associations of a thousand other kinds, religious, moral, serious, futile, general or restricted, enormous or diminutive. The Americans make associations to give entertainments, to found seminaries, to build inns, to construct churches, to diffuse books, to send missionaries to the antipodes; in this manner they found hospitals, prisons, and schools. It is proposed to inculcate some truth or to foster some feeling by the encouragement of a great example, they form a society. Wherever at the head of some new undertaking you see the government in France, or a man of rank in England, in the United States you will be sure to find an association.

One distinguished philanthropist believed that if the leadership of the government and business sectors of U.S. society were to assume the responsibility for support of the private sector, “[w]e would surprise ourselves and the world, because American democracy, which all too many observers believe is on a downward slide, would come alive with unimagined creativity and energy.”²²

22. Rockefeller 3d, “America’s Threatened Third Sector,” *Reader’s Digest*, Apr. 1978, at 105, 108.

§1.1 CHARITABLE SECTOR AND AMERICAN POLITICAL PHILOSOPHY

Contemporary writing is replete with examples of these fundamental principles. Those who have addressed the subject include:

. . . the associative impulse is strong in American life; no other civilization can show as many secret fraternal orders, businessmen's "service clubs," trade and occupational associations, social clubs, garden clubs, women's clubs, church clubs, theater groups, political and reform associations, veterans' groups, ethnic societies, and other clusterings of trivial or substantial importance.—Max Lerner

. . . in America, even in modern times, communities existed before governments were here to care for public needs.—Daniel J. Boorstin

. . . voluntary association with others in common causes has been thought to be strikingly characteristic of American life.—Merle Curti

We have been unique because another sector, clearly distinct from the other two [business and government], has, in the past, borne a heavy load of public responsibility.—Richard C. Cornuelle

The third sector is . . . the seedbed for organized efforts to deal with social problems.—John D. Rockefeller

. . . the ultimate contribution of the Third Sector to our national life—namely, what it does to ensure the continuing responsiveness, creativity and self-renewal of our democratic society. . . . —Waldemar A. Neilsen

. . . an array of its [the independent sector's] virtues that is by now fairly familiar: its contributions to pluralism and diversity, its tendency to enable individuals to participate in civil life in ways that make sense to them and help to combat that corrosive feeling of powerlessness that is among the dread social diseases of our era, its encouragement of innovation and its capacity to act as a check on the inadequacies of government.—Richard W. Lyman

The problems of contemporary society are more complex, the solutions more involved and the satisfactions more obscure, but the basic ingredients are still the caring and the resolve to make things better.—Brian O'Connell²³

Tax exemption for charities and the charitable contribution deduction, therefore, are not anachronisms, nor are they loopholes. Rather, they are a bulwark against overdomination by government and a hallmark of a free society. These elements of tax law help nourish the voluntary sector of this nation, preserve individual initiative, and reflect the pluralistic philosophy that has been the guiding spirit of democratic America. The charitable deduction has been proven to be fair and efficient, and without it the philanthropic sector of U.S. society would be rendered unrecognizable by present standards.

In sum, there needs to be a realization that the charitable deduction and exemption are predicated on principles that are more fundamental than tax doctrines and are larger than technical considerations of the federal tax law. The federal tax provisions that enhance charity exist as a reflection of the affirmative national policy of not inhibiting by taxation the beneficial activities of qualified organizations striving to advance the quality of the American social order.

23. These quotations in fuller form, and others, are collected in O'Connell, *America's Voluntary Spirit* (New York: The Foundation Center, 1983).

A companion book by the author, *Starting and Managing a Nonprofit Organization*, addresses this point in additional detail, and traces the origins and development of a hypothetical charitable organization to illustrate applicability of the various laws, including fundraising regulation requirements.

GOVERNMENT REGULATION OF FUNDRAISING FOR CHARITY

Likewise, in the zeal to regulate charitable solicitations, government must take care not to destroy the very institutions that compose the essence of the American societal fabric.

§ 1.2 CHARITABLE FUNDRAISING: A PORTRAIT

About the time the first edition of this book was being written, which largely was during the course of 1989, total giving to charity in the United States was \$114.7 billion.²⁴ Living individuals provided \$96.43 billion of this giving, with bequests yielding \$6.57 billion; private foundations, \$6.7 billion; and corporations, \$5 billion. This \$114.7 billion was allocated as follows: \$54.32 billion for religion, \$11.39 billion for human services, \$10.69 billion for education, \$10.04 billion for health, \$7.49 billion for the arts and humanities, \$3.62 billion for civic and public causes, and \$17.15 billion for other purposes.

By the time this edition of the book was in preparation, total annual charitable giving in the United States was nearly triple the 1989 amount. Giving escalated in 2007 to an estimated \$306.4 billion. This is growth of about 1 percent compared to 2006. Total giving represented 2.2 percent of the nation's gross domestic product in 2007.

Giving by individuals in 2007 totaled about \$229 billion. Individual giving constituted 74.8 percent of total giving in 2007.

Bequests in 2007 were estimated to be \$23.2 billion. Gifts by means of bequests represented 7.6 percent of all contributions made in 2007.

Grant-making by private foundations (other than corporation-related foundations) was \$38.5 billion in 2007. These foundation grants accounted for 12.6 percent of total giving in 2007.

Gifts from corporations in 2007 totaled 15.7 billion. In that year, corporate charitable contributions constituted 5.1 percent of total giving.

Giving to religious organizations reached \$102.3 billion in 2007. Contributions for religious ends accounted for 33.4 percent of all giving in 2007.

In the realm of education, giving totaled \$43.3 billion in 2007. Giving to education accounted for 14.1 percent of total giving in 2007.

Giving to social services was \$29.6 billion in 2007. Social services received 9.7 percent of all charitable contributions in 2007.

Giving to health entities in 2007 totaled \$23.2 billion. In 2007, gifts for health purposes represented 7.6 percent of all gifts.

Giving to community organizations in 2007 was \$22.7 billion. Giving for these purposes accounted for 7.4 percent of all gifts in 2007.

Giving to the arts, culture, and the humanities reached \$13.7 billion in 2007. Contributions for these purposes were 4.5 percent of all giving in 2007.

Giving to international affairs reached \$13.2 billion in 2007. Giving for international charitable purposes represented 4.3 percent of all giving in 2007.²⁵

Giving to environment and wildlife entities totaled \$6.7 billion in 2007. These organizations received 2.3 percent of all charitable contributions in 2007.

24. *Giving USA* (AAFRC [American Association of Fund Raising Counsel] Trust for Philanthropy, 1990).

25. The foregoing data are from *Giving USA 2008* (Center on Philanthropy, Indiana University).

§1.3 EVOLUTION OF GOVERNMENT REGULATION OF FUNDRAISING

There are more than 30,000 members of the Association of Fundraising Professionals. The preponderance of these individuals are female (67 percent) and Caucasian (59 percent). Although the age of one-half of the AFP membership is not known, the largest known age group is 51–60 (16 percent). Only 8 percent of this membership consists of consultants. Many of those who are employees serve in the fields of education (17 percent), human services (14 percent), health (13 percent), arts (4 percent), and religion (3 percent). Of the members who provided data on the point (about 40 percent), 12 percent of them have operating budgets in excess of \$1 million; 6 percent of the membership reported operating budgets over \$20 million. Those reporting stated that 12 percent of them raised between \$1 million and \$5 million; 3 percent reported raising in excess of \$20 million.²⁶

§1.3 EVOLUTION OF GOVERNMENT REGULATION OF FUNDRAISING

“‘Helping’ Children” was the first line of a front-page *Washington Post* headline, which continued: “Va. Charity Raised Nearly \$1 Million, but 93 Percent Went for Expenses.”²⁷ That headline encapsulates one of the prime issues facing America’s philanthropic community today: the reasonableness of fundraising costs, as perceived by federal and state legislators and regulators and by the general public—as well as those who manage or are generally responsible for the charities involved. Government regulation of fundraising for charity, while encompassing other matters, is fixed on the single issue of fundraising expenses: their measurement, reporting, and “proper” amount.²⁸ In fact, the origin of government regulation of fundraising is traceable to the fundraising cost issue; the history of this field of regulation reflects reaction to a pageant of alleged abuses by charities soliciting gifts, each of which featured an ostensibly “high” percentage of fundraising costs.

The *Washington Post* article detailed the direct mail fundraising activities of Children’s Aid International (CAI), an organization headquartered in Alexandria, Virginia. According to the account, the organization raised nearly \$1 million over a two-year period—“money it promised to spend on packages of high-protein food for malnourished children around the world”—yet expended on “food for children” less than 7 cents out of each dollar raised. The breakdown on CAI’s expenditures: 25 percent for management fees, 17 percent for other administrative costs, 51 percent for fundraising, and the balance—7 percent—for “starving children.”

The clear implication gained from the article is that a 93 percent fundraising cost experienced by a charity is “improper,” may be close to “fraudulent,” and is certainly “wrong.” The closest the article came to expressing criticism was its observations that

26. Data (as of December 31, 2007) provided by the Resource Center of the Association of Fundraising Professionals.

27. *Wash. Post*, Feb. 7, 1980, at A1. Also see “Correction,” *Wash. Post*, May 11, 1980, at 2.

28. One commentator observed that many states “are beginning to reexamine laws regulating charitable solicitations in the wake of recent disclosures revealing the actual expenditure patterns of many organizations” and concluded: “Of primary concern have been the revelations that in many instances only a small percentage of the money given to further a charitable cause is expended on that cause.” Quandt, “The Regulation of Charitable Fundraising and Spending Activities,” 1975 *Wis. L. Rev.* 1158, 1159 (1975).

GOVERNMENT REGULATION OF FUNDRAISING FOR CHARITY

CAI's fundraising costs are "high in comparison with . . . many established charities," and that the fundraising costs of the local United Way agency are less than 7 percent. The organization's defense—unavoidably high startup costs—went unanalyzed and was buried deep in the story. It may be safely assumed that the article helped fuel public suspicion about charitable institutions generally.

Some months before, another *Washington Post* headline had announced: "Pallottines Say Nearly 75% Spent for Fund-Raising."²⁹ This story featured the celebrated case of the Pallottine Fathers, a Catholic order based in Baltimore, Maryland, that conducted a massive direct-mail fundraising effort and allegedly devoted, in one 18-month period, 2½ cents out of every dollar received for missionary work. Apparently, in 1976, the order raised \$7.6 million and spent \$5.6 million to do so. This undertaking eventuated in a grand jury investigation, which developed evidence of extensive real estate dealings by the order and a loan to the then governor of the state to help finance his divorce. Little of the proceeds of the order's solicitations went to support Pallottine missions in underdeveloped countries as claimed. The publicity became so intense that the Vatican rector general of the order commanded that Pallottine fundraising activities cease and formed a special investigating commission; the priest who headed the order's fundraising operations was banished from Maryland by the archbishop of Baltimore.

The public had been exposed to a fundraising abuse that was framed in terms of high expenses in relation to contributions received.

Another well-publicized instance of this nature concerned the Freedom Forum International, Inc., formerly the Gannett Foundation. Although this matter did not involve fundraising costs, it focused on ostensibly high administrative expenses; the organization was under investigation by the office of the state attorney general in New York to determine whether these expenses were "imprudent or excessive." A front-page *Washington Post* headline stated: "Neuharth Foundation Spares No Expense," with an inside-page headline trumpeting that "Freedom Forum's Expenses Far Outstrip Its Contributions, Grants."³⁰ According to this account, in 1991, the foundation incurred expenses of \$34.4 million and made grants in the amount of \$20.2 million. Office expenses were \$17 million and a rooftop conference center accounted for \$5.4 million; trustees' fees were higher than the norm, and the chairman's compensation was said to be "more than 10 times greater than is typical in large private foundations."³¹ The article related trips of the board of trustees to resort areas for meetings, air travel on first class, and payment of travel expenses of board members and some of their spouses. The newspaper concluded that the organization's "spending is unusual compared with similar-sized foundations—or even those twice or more its size—which . . . receive their funding from endowments, not from public donations."³²

29. *Wash. Post*, Nov. 3, 1977, at C1.

30. *Wash. Post*, Mar. 23, 1993, at A1. The reference to the "Neuharth Foundation" (not its formal name) reflects the fact that the chairman of the board of the foundation is Allen H. Neuharth, formerly the chief executive of the Gannett Co.; the foundation was established in 1935 by New York newspaper publisher Frank E. Gannett.

31. *Id.* at A6.

32. *Id.* The three-year investigation of the spending practices of the Forum culminated in an agreement by its trustees to pay to the organization about \$174,000 in settlement of claims as to lavish spending; the specifics of the settlement are detailed in XII *Nonprofit Counsel* (No. 2) 1 (Feb. 1995).

§1.3 EVOLUTION OF GOVERNMENT REGULATION OF FUNDRAISING

Another of these reports focused on the use of candy, gum, and other vending devices by charitable organizations as a fundraising technique. Apparently, the charities often receive small amounts of money in the form of licensing fees, while the vast bulk of the funds flows to those who sell and operate the devices. The arrangement spawned this front-page *Washington Post* headline: "For Charity, Just Drops in the Bucket," followed by "Most of Public's Donations Go to Marketers, Vendors."³³ Although one national charitable organization was said to have received 10 percent of the amount received from dispensers in 1992 (\$1.4 million), many receive little or nothing in this fashion. When the charities own the devices directly or in partnership with a vending company, it seems that they regularly receive as much as 15 percent of the gross receipts.³⁴

Still another of these episodes, this one involving the Marine Toys for Tots Foundation, was splashed across the front page of the *Washington Post*: "Marines' Toys for Tots Spent Millions on Itself," with the subheadline stating: "Donations Used to Run Charity, Not Buy Gifts."³⁵ This organization was said to have "collected nearly \$10 million in the last two years through a direct-mail campaign, but foundation officials acknowledge that none of the money has gone to buy toys for needy children."³⁶ When contributions from other sources are taken into account, however, the report added, the three-year-old foundation expended 10 percent of the money raised in its most recent fiscal year for toys for children; the balance was spent on management, fundraising expenses, and promotional materials. The new head of the foundation was quoted as saying that "[m]y goal, and it is an optimistic one, is to have 75 percent of the money raised in the next mailing go toward program expenses, with most of that going to buy toys."³⁷ Other program activities of the foundation included education of the public on the needs of poor children.

These episodes are, unfortunately, only a few in a series of similar exposés that have haunted legitimate charities for years and helped taint the term *fundraising*.³⁸ These events also fueled the machinery that has been built by and for government to regulate fundraising by charitable organizations. Many an aspiring or practicing politician has parlayed a probe of a charity "scandal" into high office. Thus *Time* magazine, for example, was moved to characterize the Pallottine order scandal as indicative of widespread wrongdoing: "The Pallottine mess provides Americans with one more excuse not to give money to church agencies,

33. *Wash. Post*, Oct. 2, 1993, at A1.

34. *Id.* at A8. According to this account, some states are investigating this practice, either on the basis of fraud, to force the marketers and vendors to register as professional fundraisers (see § 3.6), or to cause the charities to disclose the percentage of their receipts from this source (see § 3.15).

35. *Wash. Post*, Feb. 10, 1994, at A1.

36. *Id.*

37. *Id.* at A16. Far into the article is this statement: "Part of the problem, according to the foundation, is that it is very expensive to initiate a direct-mail campaign" (*id.*).

38. Also, "Charity Fund-Raiser, Client Target of Md. Grand Jury Probe," *Wash. Post*, Dec. 12, 1991, at D1; "Solicitors Cash In on Budget Pinch Felt by Nonprofit Groups," *Wash. Post*, Oct. 18, 1982 (Washington Business), at 19; "Many Charity Shows Benefit Mostly the Fundraiser," *Charlotte Observer*, Mar. 22, 1981, at 1.

GOVERNMENT REGULATION OF FUNDRAISING FOR CHARITY

even those that make full public accountings³⁹ and the "Pallottines were not the only agency that used 80% or more of their [sic] gifts to cover the exorbitant costs of direct mail."⁴⁰

Other episodes—isolated instances having major impact on public and regulatory attitudes—include the solicitation activities of Father Flanagan's Boys Town, the Sister Kenny Foundation, the Police Hall of Fame,⁴¹ the Freedom for All Forever Foundation, the Korean Cultural and Freedom Foundation,⁴² and the Children's Relief Fund.⁴³ Thus, the public media remain alive with one report after another of the alleged misdeeds of charities. Invariably, the scandals involve solicitations of charitable contributions from the general public, by or for organizations that derive their principal support from public giving,⁴⁴ with an ostensibly excessive amount of funds devoted to direct-mail campaigns, questionable investments, or administration.⁴⁵ At the same time, these developments should be kept in perspective, in that the organizations involved represent only a very small segment of the charitable community.

Forty years ago, federal regulation of fundraising for charity did not exist (other than by means of the charitable contribution deduction), and state regulation in the field was just beginning to flower. Before that time, fundraising regulation (such as it was) was a combination of occasional IRS audits and state attorneys general inquiries, the latter predicated on their historical role of enforcing the requirements imposed on the administration of charitable trusts.⁴⁶ These efforts were based on one premise, and today's vast and growing governmental apparatuses overseeing charitable fundraising continue to be guided by that premise: "The greatest possible portion of the wealth donated to private charity must be conserved and used to further the charitable, public purpose; waste must be minimized and diversion of funds for private gain

39. "Radix Malorum Est Cupiditas?" *Time*, Jan. 23, 1978, at 75.

40. "Wrist Tap," *Time*, May 22, 1978, at 64.

41. In this matter, the Circuit Court of Cook County, Illinois, ordered fundraisers to pay \$528,231.52 (including \$150,000 in punitive damages) into a trust fund for widows and children of slain law enforcement officers, as the result of a fundraising effort that generated \$785,731, of which the fundraisers received \$622,000 for costs and compensation. One contract allowed up to 75 percent of total contributions to be consumed in fundraising expenses; the court characterized this and other contracts as authorizing "illegitimate commissions and expenses and were outrageous, unconscionable and an assault upon the public conscience in violation of public policy and Illinois law relating to charitable solicitations." *People of the State of Illinois v. Police Hall of Fame, Inc.*, No. 74 CH 5015 (order dated Oct. 19, 1976).

42. In one instance, the Attorney General of the State of New York charged the Foundation with raising \$1,508,256 and expending only \$95,674 (6.3 percent) for charitable purposes, and characterized the Foundation as "perpetrating a fraud upon the contributing public." News release dated Feb. 16, 1977.

43. For a litany of fundraising "abuses," see Hearing on Children's Charities Before the Subcommittee on Children and Youth of the Senate Committee on Labor and Public Welfare, 93d Cong., 2d Sess. (1974), chaired by then-Senator Walter F. Mondale. Also Hearings on Fund Raising By or In Behalf of Veterans Before the House Committee on Veterans' Affairs, 85th Cong., 2d Sess. (1958); Hearings on Federal Agencies and Philanthropies Before a Subcommittee of the House Committee on Government Operations, 85th Cong., 2d Sess. (1958).

44. E.g., Baldwin, "Ideology by Mail," *New Republic*, July 7 and 14, 1979, at 19.

45. These developments have spawned articles in the popular media, such as Smith, "New Guidelines for Giving" (subtitled "Our 10 commandments help you separate top charities from wastrels"), *Money*, Dec. 1989, at 141.

46. Bogert, "Proposed Legislation Regarding State Supervision of Charities," 52 *Mich. L. Rev.* 633 (1954).

§1.4 CONTEMPORARY REGULATORY CLIMATE

is intolerable."⁴⁷ Out of the inadequacies of common law principles and tax enforcement efforts has grown—and is still growing—a comprehensive supervisory and regulatory program governing the fundraising efforts by charitable organizations at the federal, state, and local levels.

Statutory regulation of fundraising for charity began with codification of the supervisory and investigatory authority of state attorneys general. Thereafter, there came into being provisions seeking to prevent fraud in charitable solicitations or to promote disclosure of information about these solicitations, or both. Municipal ordinances earlier introduced the concepts of licensing and periodic reporting of charities' fund collection activities, and this approach was adopted by the states as their charitable solicitation acts were written. As the years passed, the statutes became more extensive and stringent, the staffs of the regulatory agencies increased, and regulations, rules, and forms unfolded. In general, the call of one observer, who declaimed that the "evils of inefficient or unscrupulous charitable organizations must be attacked head on by strong government regulation,"⁴⁸ was heard.

The process is by no means wholly an instance of government regulation increasing merely for the sake of increase. The nature of organized philanthropy and the perception of it by the public, lawmakers, and regulators, have altered dramatically over the past three decades.

§1.4 CONTEMPORARY REGULATORY CLIMATE

The number of nonprofit organizations remains steadily on the rise. Most of these are exempt from federal and state income and property taxation, many are eligible to attract tax-deductible contributions, and many utilize preferred postal rates. The involvement of these groups in the day-to-day management and change of American life has never been greater.

Concurrent with the rise in state regulation of fundraising for charity has been a significant upsurge in regulatory activity at the federal level by means of administration of the nation's tax and other laws. The process got under way in 1950, when Congress enacted laws taxing the unrelated business income of otherwise tax-exempt organizations. In 1963, the Internal Revenue Code was sizably thickened by a battery of rules defining, regulating, and taxing private foundations, seeking to prevent self-dealing and large stockholdings and to increase grant-making and public involvement in the affairs of foundations. In 1974, Congress authorized the formation, within the IRS, of a formal administrative and regulatory structure, which has stepped up federal oversight and audit of the nation's nonprofit, including charitable, organizations. In 1987, Congress enacted disclosure laws for noncharitable tax-exempt organizations engaged in fundraising; in 1989, the IRS launched a renewed effort to require disclosures in the course of fundraising for charitable organizations; in 1993, Congress enacted substantiation and disclosure laws applicable to tax-exempt charitable organizations engaged in fundraising; in 2004, Congress provided rules concerning the charitable deduction for contributions of vehicles and intellectual property, and increased reporting for noncash contributions; and, in 2006, Congress enacted new

47. Karst, "The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility," 73 *Harv. L. Rev.* 433-434 (1960).

48. Quandt, *supra* note 28, at 1187.

GOVERNMENT REGULATION OF FUNDRAISING FOR CHARITY

substantiation rules, stiffer penalties for inflated valuations, and rules concerning charitable gifts of fractional interests in art (and other tangible personal property), clothing and household items, and taxidermy.

Still, notwithstanding this rise in government regulation, all is not well. The malady was evidenced several years ago by a blast from a normally rather staid publication, hurling the following charges against some nonprofit organizations—they:

- Pay their executives fat salaries and allow them generous fringe benefits.
- Award contracts to their trustees and board members.
- Serve as fronts for commercial enterprises with which they have “sweetheart” deals.
- Enjoy special mailing privileges and property tax breaks that give them a competitive edge against tax-paying establishments.
- Engage in wasteful and sometimes fraudulent fundraising with little accountability to the public.⁴⁹

The last allegation is the most immediate concern in relation to this book, but this inventory of wrongdoings is indicative of the state of the nonprofit sector as perceived by some. Public regard is essential to the successful functioning of charitable groups; this regard—which has remained high throughout the country’s existence—may be eroding in the face of well-publicized abuses and other pressures.

This, then, is the dilemma of the charities: abuses appear to be on the increase, triggering greater governmental regulation, which makes operations more difficult for authentic charitable undertakings and creates a public climate that is more critical of these undertakings. The inroads being made by a few unscrupulous and fraudulent operators in tapping the resources of philanthropy are threatening to undermine the seriously needed solicitation programs conducted by legitimate charitable organizations.

Coincidentally, the public is demanding greater accountability from nonprofit, principally charitable, organizations. The consumerism movement is causing individual and corporate donors to be more concerned and sophisticated about the uses of their gift dollars. The emphasis now is on disclosure; donors—prospective and actual—are demonstrating greater proclivity to inquire of federal, state, and local agencies, lawmakers, independent “watchdog” agencies, and the philanthropic community itself about the fundraising and fund-expenditure practices of charitable organizations.

In this age when the tax bills being levied are rising annually, taxpayers often lack sympathy for and even resent organizations that do not pay tax. Greater understanding of the principle that taxes forgone by one entity must be made up by others may be fostering a public attitude toward nonprofits that is somewhat less lofty than that captured by concepts of voluntarism and pluralism. Likewise, the lure of the standard deduction (now used by a substantial majority of taxpayers) is pulling people away from deductible charitable giving, thereby severing still another traditional nexus between Americans and their charities. The ongoing interest in a flat (or flatter) tax, a national sales or other consumption tax, or a value-added tax is reflective of

49. “For Many, There Are Big Profits in ‘Nonprofits,’” *U.S. News & World Rep.*, Nov. 6, 1978, at 45.

§1.4 CONTEMPORARY REGULATORY CLIMATE

public interest in a simpler tax system, even though it may lack incentives for charitable giving.

Therefore, in the face of seemingly inadequate disclosure of meaningful information to the public, excessive administrative and fundraising costs, and insufficient portions of the proceeds of charitable gifts passing for charitable purposes, government regulation of fundraising for charity is thriving. Some of the few states that currently lack a comprehensive charitable solicitation act are engaged in the process of trying to enact one. Many states with such a law are contemplating toughening it, either by amending the act or by increasing reporting and similar regulatory burdens. Although the drive for a federal charitable solicitations law has temporarily slowed, the IRS, expanding its administrative capabilities, is quietly but assuredly embarking on a program of substantial regulation in this field, augmented from time to time by Congress. Other federal agencies are creeping into the realm of fundraising regulation.

Despite all this activity, the pressure for still more regulation continues, perhaps ultimately to be manifested in some form of a federal charitable solicitations statute. The drive for such a law, now dormant, may be awaiting only the spark of a well-publicized charity scandal to trigger action by Congress. Part of the interest in a federal law in this field derives from dissatisfaction with the present state-by-state regulatory scheme. Critics voice a variety of complaints about the present reach of federal and state regulation:

- There is no requirement (as there is for private foundations) that public charities annually distribute a portion of their funds for charitable purposes.
- There is no requirement that charities disclose to potential contributors the portion of their funds actually devoted to charitable purposes.
- There are no common requirements regarding state registration, licensing, periodic reporting, disclosure of financial information, and limitations on compensation of fundraisers.
- There are no uniform accounting standards for public charities imposed by law.
- Some charitable and other nonprofit organizations are escaping taxation of unrelated activities, in part by portraying those activities as *fundraising*.

Certain legislative and nonlegislative developments (all discussed in subsequent chapters), however, may mute some of this criticism—for example, development of a new federal annual information return and the mandatory document distribution rules. Also, efforts going forward under the auspices of the National Association of State Charity Officials may result in significant progress toward uniformity of administration and enforcement in this area.

Some parallel developments may also introduce federal law governing charitable solicitations. These concern the fact that, in the wake of more than three decades of experience in strenuously regulating the operations and activities of private foundations, many in the IRS and the Department of the Treasury, and some in Congress, are seriously contemplating comparable regulation of the affairs of one or more categories of public charities.

Unlike the torrents of alleged scandals that preceded the revolution in the federal tax laws pertaining to private foundations, which culminated in a major portion of

GOVERNMENT REGULATION OF FUNDRAISING FOR CHARITY

the Tax Reform Act of 1969, there has been no parade of ostensible abuses warranting strict supervision of public charities. Rather, it appears that this is a last frontier for reformers in the field of charitable organizations and that most of the reforms are being advocated because the statutory basis for the rules is already in place;⁵⁰ furthermore, the imposition of these rules on public charities strikes many as the thing to do as a logical extension of existing regulation. Hence, the not-too-far-distant future may well see extension of some of the private foundation restrictions to some or all public charities. (This process got under way in 1996 when Congress enacted the intermediate sanctions rules, which are, in many ways, patterned after the private foundation self-dealing rules.) In this context, the recent attention to the matter of government supervision or regulation of solicitations for charitable contributions may bring some new federally enforced rules to govern the fundraising activities of public charities, that is, as part of a comprehensive effort to regulate public charities to the same degree as is at present the case for private foundations.⁵¹

Whatever happens, one aspect of the matter is clear: both state and federal regulation are on the rise. The former is not likely to be preempted by the latter, at least not any time soon. Students of this regulatory scene have astutely observed that, "[a]s legislators continue efforts to devise schemes which comply with the [Supreme Court] decision [finding a state charitable solicitation act unconstitutional as violating free speech rights], they will certainly not renounce long-standing views on the important role of state regulation of charitable solicitation."⁵²

Probably the most difficult issue to cope with is what all of this regulation is and will be doing to the philanthropic sector. Will fundraising regulation improve the solicitation picture for legitimate charitable groups or will it unduly burden legitimate charitable fundraising efforts? Is there actually sufficient abuse taking place in this area to warrant the massive costs of compliance? Is the overall panoply of nonprofit organizations, tax exemption, and charitable giving becoming an anachronism, in the process of evolutionary departure in the face of the growth of the state? Is fundraising for charity the wave of the past, because charity itself is becoming obsolete?⁵³

Although no one knows the answers to these questions, the march of government regulation of fundraising for charity continues inexorably. This new form of regulation, arising from humble origins only a few years ago, is now one of philanthropy's major concerns. How and whether these new governmental policies and philanthropy can coexist will say much about the nature of the charitable sector in the coming years.⁵⁴

50. IRC ch. 42.

51. In early 1989, a task force at the IRS recommended that many of the federal tax rules that are presently applicable only to private foundations be extended to apply to some or all public charities (Report of the IRS Commissioner's Executive Task Force on Civil Penalties). A summary of and commentary on these recommendations appears in *VI Nonprofit Counsel* (No. 5) 1 (1989).

52. Harris, Holley, & McCaffrey, *Fundraising into the 1990's: State Regulation of Charitable Solicitation after Riley 90* (New York: NYU School of Law, 1989).

53. See Cook, "Is Charity Obsolete?" *Forbes*, Feb. 5, 1979, at 45. Also Mayer, "End of an Era," *Progressive*, Oct. 1979, at 32; Morganthau, "The Charity Battle," *Newsweek*, May 7, 1979, at 33; Delloff, "Private Philanthropy and the Public Interest," *Christian Century*, Feb. 21, 1979, at 188.

54. See § 7.15; Hopkins, "Coming: New Law, More Regulation," 20 *Fund Raising Mgmt.* (No. 11) 28 (1990); Hopkins, "Fund-Raisers and the Tax Law: 20 Years' Experience," 20 *Fund Raising Mgmt.* (No. 2) 32 (1989).