

2003

Intermediate Sanctions: Protection for Charitable Organizations and the Donations They Receive

Allison M. Sawyer

Follow this and additional works at: <http://lawcommons.luc.edu/lclr>



Part of the [Consumer Protection Law Commons](#)

Recommended Citation

Allison M. Sawyer *Intermediate Sanctions: Protection for Charitable Organizations and the Donations They Receive*, 15 Loy. Consumer L. Rev. 125 (2003).

Available at: <http://lawcommons.luc.edu/lclr/vol15/iss2/4>

This Student Article is brought to you for free and open access by LAW eCommons. It has been accepted for inclusion in Loyola Consumer Law Review by an authorized administrator of LAW eCommons. For more information, please contact law-library@luc.edu.

Intermediate Sanctions: Protection for Charitable Organizations and the Donations They Receive

Allison M. Sawyer*

I. Introduction

In 2001, American individuals, foundations, and corporations donated \$212 billion to charitable organizations.¹ Of that amount, \$160.7 billion represented donations from individual American citizens.² This figure demonstrates that despite frozen wages, lost jobs, and plunges in stock market value, Americans continue to give. Nevertheless, as a result of the declining economy, donations have decreased across the country.³ Charitable donations dropped 2.3% from 2000 to 2001, a larger decline than has been seen in average recession years.⁴

The decrease in donations has forced charitable organizations to be more creative. Facing the possibility of closing their doors, charities regularly employ professional solicitors who have the marketing expertise to increase donations. Unfortunately, that expertise imposes a significant cost on charities and donors, because a bulk of the donations is used to pay solicitors rather than applied towards the charitable purpose. When faced with the choice between earning very little with a professional solicitor or nothing at all, charities understandably opt for the former.

* J.D. candidate, May 2003, Loyola University Chicago School of Law; B.A. Business Administration, 2000, *cum laude*, Wayne State University. The author wishes to thank her family and friends for all of their support.

¹ Nicole Lewis, *Charitable Giving Slides*, CHRON. OF PHILANTHROPY, June 27, 2002, at 27.

² *Id.*

³ *Id.*

⁴ *Id.* (noting that charitable contributions decrease by an average of 1.1% in recession years).

Interested in protecting consumers from fraud, various governmental agencies have attempted to regulate how charitable organizations solicit donations. In the past, regulation of charitable organizations has been within the domain of the Attorney General.⁵ After Attorneys General nationwide attempted to regulate the method by which charities solicited donations, but were defeated on First Amendment grounds, the Internal Revenue Service (“IRS”) stepped in with regulation of its own.⁶ In 1996, Congress enacted I.R.C. § 4958,⁷ also known as “intermediate sanctions.”⁸ Originally directed at regulating the growing non-profit health care field, this provision imposes an excise tax on individuals who engage in excess benefit transactions with charitable organizations.⁹ When the temporary regulations were released in 1998, however, it was clear that § 4958 would extend far beyond the realm of health care as a result of the continuous growth of the not-for-profit sector.¹⁰ In 2002, the IRS and the Treasury Department issued the final regulations, which iterate the broad regulatory and enforcement power granted to the IRS.¹¹ This article will (1) examine how First Amendment protection precluded the states from effectively regulating charitable solicitations, (2) describe how intermediate sanctions are imposed in the context of charitable organizations, and (3) explain why this provision will be an effective tool in protecting charitable organizations and donors from fraud.

⁵ See Lisa Loftin, *Protecting the Charitable Investor: A Rationale for Donor Enforcement of Restricted Gifts*, 8 B.U. PUB. INT. L.J. 361, 382 (1999).

⁶ James J. Fishman, *Improving Charitable Accountability*, 62 MD. L. REV. 218, 265 (2003).

⁷ Taxpayer Bill of Rights 2, Pub. L. No. 104-168, 110 Stat. 1452 (codified as I.R.C. § 4958 (2000)).

⁸ See generally Pamela S. Kaufman, *A Selective Review of the Intermediate Sanctions Temp. Regs. – Generally Improved All Around*, 94 J. TAX’N 301 (2001) (discussing the taxes on excess benefit transactions as “intermediate sanctions,” as they are commonly known).

⁹ See Intermediate Sanctions, 26 C.F.R. § 53.4958 (2002).

¹⁰ See *id.*

¹¹ See *id.*

II. Charitable Solicitations Escape Regulation by Way of First Amendment Protection

By the middle of the twentieth century, many charities were soliciting nationally, having adopted advanced methods of contacting the public.¹² In order to communicate with new audiences, they hired “professional solicitors” who were experienced with mass communication.¹³ With the surge of non-local organizations requesting donations, states became increasingly concerned with protecting their consumers from fraud.¹⁴

The first charitable solicitation regulation case decided on First Amendment grounds was *Village of Schaumburg v. Citizens for a Better Environment*.¹⁵ In that case, the Village of Schaumburg, Illinois, enacted an ordinance mandating that at least 75% of the gross funds raised go to the charitable purposes of an organization.¹⁶ The Schaumburg ordinance regulated whether an organization could disseminate its message based upon the percentage of gross revenues it retained from the solicitations.¹⁷ One group, Citizens for a Better Environment, hired professional solicitors to canvass neighborhoods to promote its charitable purpose and solicit financial support.¹⁸ More than 75% of the funds raised, however, were paid directly to the solicitors, thereby violating the ordinance.¹⁹

When the case eventually reached the United States Supreme Court in 1980, the Court concluded that the ordinance was a “direct and substantial limitation on protected activity,” and thus, could not be sustained unless it served a governmental interest.²⁰ The Court

¹² See Errol Copilevitz, *Nonprofit Symposium: The Historical Role of the First Amendment in Charitable Appeals*, 27 STETSON L. REV. 457, 463 (1997).

¹³ *Id.*

¹⁴ *See id.*

¹⁵ 444 U.S. 620 (1980).

¹⁶ *Id.* at 624.

¹⁷ *Id.* at 624. Solicitors were required to have a permit in order to canvass the neighborhoods. The ordinance required that the charity prove that 75% of the funds were going directly to the charity before the permit application was approved. *Id.*

¹⁸ *Id.* at 625.

¹⁹ *Id.* at 626.

²⁰ *Id.* at 636.

considered the inflexibility of the ordinance significant.²¹ The rule arbitrarily classified all charities into one group, with no allowance for nontraditional, advocacy-oriented organizations that incur substantial administrative expenses.²²

The Court concluded that an appeal for support by a charitable organization was fully protected free speech and not a form of commercial speech,²³ despite the solicitation for charitable donations.²⁴ Because advocacy and the dissemination of ideas and information were so closely tied to the solicitations, the Court reasoned, the entire activity was entitled to First Amendment protection.²⁵ Therefore, the Court ruled that because the statute was insufficiently related to a compelling governmental interest, it was an unconstitutional restraint on protected speech.²⁶ Justice Rehnquist, the lone dissenter, argued that the Court should have applied a less stringent standard: the solicitations should only be afforded the protection that is given to commercial speech.²⁷

Four years later, the regulation of charitable solicitations was again considered by the Supreme Court in *Secretary of State of Maryland v. Joseph H. Munson Co.*²⁸ The primary issue in *Munson* was whether a variable percentage limitation on the amount professional solicitors receive could survive the standard set forth in *Schaumburg*.²⁹ Maryland enacted a statute restricting solicitors'

²¹ *Village of Schaumburg*, 444 U.S. at 636.

²² *Id.*

²³ *See* Va. State Bd. of Pharmacy v. Va. Citizens Consumer Council, Inc., 425 U.S. 748, 762 (1976) (describing the First Amendment protection afforded to commercial speech). “[T]he speech whose content deprives it of protection cannot simply be speech on a commercial subject. . . . Our question is whether speech which does ‘no more than propose a commercial transaction,’ is so removed from any ‘exposition of ideas,’ and from ‘truth, science, morality, and arts in general, in its diffusion of liberal sentiments on the administration of Government,’ that it lacks all protection. Our answer is that it is not.” *Id.* (quoting *Pittsburgh Press Co. v. Human Relations Comm’n*, 413 U.S. 376, 385 (1973); *Chaplinsky v. New Hampshire*, 315 U.S. 568, 572 (1942); *Roth v. United States*, 354 U.S. 476, 484 (1957)).

²⁴ *See Schaumburg*, 444 U.S. at 636.

²⁵ *See id.* at 634.

²⁶ *Id.* at 639.

²⁷ *See id.* at 640 (Rehnquist, J., dissenting).

²⁸ 467 U.S. 947 (1984).

²⁹ *Id.* at 949-50.

portion to a maximum of 25% of the fundraising revenues.³⁰ The statute, however, also allowed a charitable organization to file a waiver if the restriction interfered with fundraising efforts.³¹ In a 5-4 decision, the Court held that the flexibility included within the Maryland statute could not withstand the standard delineated in *Schaumburg*.³² A common theme within the majority's opinion was that charities should not be afforded less protection because professional solicitors are communicating on their behalf.³³ Charities' right to free speech was the fundamental issue, regardless of who was delivering the message.³⁴ Additionally, as in *Schaumburg*, the Court ruled that the Maryland statute was based on "a fundamentally mistaken premise that high solicitation costs are an accurate measure of fraud."³⁵

The third case in the trilogy of Supreme Court cases involving the regulation of charitable solicitations was *Riley v. National Federation of the Blind of North Carolina*, decided in 1988.³⁶ In that case, the National Federation of the Blind of North Carolina challenged a North Carolina statute prohibiting professional fundraisers from retaining an "unreasonable" or "excessive" fee.³⁷ Fees were defined by a three-tier system.³⁸ A fee of up to 20% of the gross receipts was considered reasonable.³⁹ A fee of 20% to 35% was deemed unreasonable unless the organization could show that it was an advocacy-oriented charity.⁴⁰ Finally, a fee exceeding 35% was presumed unreasonable, but the solicitor could rebut the presumption by showing that the fee was necessary because of the nature of the charitable organization.⁴¹

³⁰ *Riley*, 487 U.S. at 950.

³¹ *Id.* at 952.

³² *Id.* at 964-65.

³³ *See id.* at 956 n.6.

³⁴ *Id.*

³⁵ *Id.* at 966.

³⁶ 487 U.S. 781 (1988).

³⁷ *Id.* at 784, 786.

³⁸ *Id.* at 786.

³⁹ *Id.* at 785-86.

⁴⁰ *See id.* at 786.

⁴¹ *Id.*

The Court was not persuaded that the three-tiered system was sufficiently narrowly tailored to pass constitutional muster.⁴² One of the justifications put forth by North Carolina was that charities' speech must be regulated for their own benefit.⁴³ In rejecting that argument, the Court stated, "we presume that speakers, not the government, know best both what they want to say and how to say it."⁴⁴ Despite North Carolina's attempt to adhere to the flexibility requirements set forth in *Schaumburg* and *Munson*, the Court held that "the First Amendment does not permit the State to sacrifice speech for efficiency."⁴⁵ Thus, the Court ruled that the statute's percentage-based system of regulating charities did not serve a compelling government interest, and struck it down as a violation of the First Amendment.⁴⁶

III. *United Cancer Council: The IRS Takes Action*

In the wake of the states' seemingly endless losing streak with regard to the regulation of charitable solicitations, in 1997, the IRS finally took action. Historically, the IRS played a significant role in the regulation of charitable organizations because federal tax exemption is extremely important to their day-to-day operations. The IRS's strategy was to revoke the tax-exempt status of charities that overpaid solicitors.⁴⁷ The IRS has a legitimate interest in ensuring that a majority of tax-deductible donations actually go to the charity and not to fundraisers.

The IRS's strategy was challenged in *United Cancer Council, Inc. v. Commissioner* ("*United Cancer I*").⁴⁸ Facing a financial crisis, United Cancer hired Watson & Hughey Co. ("W&H"), a fundraising firm willing to advance the costs of the solicitation program.⁴⁹ In return, W&H was entitled to receive fees for services rendered and the exclusive right to unrestricted use of the mailing list created under

⁴² *Riley*, 487 U.S. at 789.

⁴³ *See id.* at 790.

⁴⁴ *Id.* at 791.

⁴⁵ *Id.* at 795.

⁴⁶ *Id.* at 789.

⁴⁷ *See, e.g., United Cancer Council, Inc. v. Commissioner*, 109 T.C. 326, 327, 329, 334 (1997) [hereinafter *United Cancer I*].

⁴⁸ 109 T.C. 326.

⁴⁹ *Id.* at 330.

the contract.⁵⁰ Over a five-year period, United Cancer accumulated \$28.8 million dollars in gross receipts stemming from W&H's direct mail solicitations.⁵¹ According to the terms of the contract, W&H received \$26.5 million and United Cancer received the remaining \$2.3 million.⁵² The IRS revoked United Cancer's § 501(c)(3) tax-exempt status⁵³ on the grounds that the contract was so favorable that it resulted in a private benefit to W&H.⁵⁴ In an amended filing, the IRS added an inurement⁵⁵ claim that would become the focus of both the IRS and the Tax Court.⁵⁶

Concentrating on the inurement claim, the Tax Court held that the IRS properly revoked United Cancer's tax-exempt status because its net earnings inured to W&H.⁵⁷ The ruling was contingent upon the Tax Court's finding that W&H was an "insider" with respect to United Cancer, and that the compensation it received was unreasonable.⁵⁸ The issue on appeal was whether W&H was, in fact, an "insider."⁵⁹

On appeal, the Seventh Circuit employed a "functional" test to determine that W&H was not an insider.⁶⁰ The court looked to the "reality of control rather than to the insider's place in [the] organization."⁶¹ The contract was more favorable to W&H, the court held, because United Cancer was desperate to stay afloat, not because it exercised control over the organization.⁶² As the government

⁵⁰ *Id.* at 331.

⁵¹ *Id.*

⁵² *Id.* at 332.

⁵³ See I.R.C. § 501(c)(3) (2002).

⁵⁴ *United Cancer I*, 109 T.C. at 334.

⁵⁵ The concept of inurement has been described as follows: "A charity is not to siphon its earnings to its founder, or the members of its board, or their families, or anyone else fairly to be described as an insider . . ." *United Cancer Council v. Commissioner*, 165 F.3d 1173, 1176 (1999) [hereinafter *United Cancer II*].

⁵⁶ *United Cancer I*, 109 T.C. at 328.

⁵⁷ *Id.* at 398-99.

⁵⁸ *Id.* at 397.

⁵⁹ See *United Cancer II*, 165 F.3d at 1175.

⁶⁰ *Id.* at 1176.

⁶¹ *Id.*

⁶² *Id.* at 1178.

conceded, the contract was negotiated at arm's length.⁶³ In the court's view, the ability to "drive a hard bargain" with a charitable organization did not make W&H an insider.⁶⁴ The court also noted that United Cancer would not have been able to discontinue its contract if W&H had been in control of the organization.⁶⁵

Although the court did not find liability on inurement grounds, it did recognize that United Cancer's board may have imprudently negotiated its contract with W&H.⁶⁶ Arguably, United Cancer was not operating for solely charitable purposes, but rather for the private benefit of W&H.⁶⁷ The board of a charitable organization owes a duty of care to the mission of the charity, just as the board of a for-profit corporation owes a duty of care to its shareholders.⁶⁸ The court held that distributing over 90% of gross revenues to the fundraiser may constitute a breach of that duty, which supports a finding that United Cancer was conferring a private benefit to W&H.⁶⁹ This may be true even if W&H is not deemed to have controlled or exercised undue influence over the charity.⁷⁰ Because the Tax Court did not consider the private benefit claim, the Seventh Circuit remanded the issue.⁷¹

IV. Intermediate Sanctions: A New Weapon in the IRS Arsenal

In *Munson*, Justice Rehnquist argued in his dissent that limiting the amount professional fundraisers receive fulfills donors' expectations that the bulk of their donation will go directly to the charitable purpose they selected.⁷² In an effort to meet those expectations, in January 2002, the Treasury Department released the final regulations for I.R.C. § 4958, a groundbreaking law designed to

⁶³ *United Cancer II*, 165 F.3d at 1175.

⁶⁴ *Id.*

⁶⁵ *Id.*

⁶⁶ *Id.* at 1179.

⁶⁷ *Id.*

⁶⁸ *Id.* at 1180.

⁶⁹ *Id.*

⁷⁰ *Id.*

⁷¹ *Id.* at 1180.

⁷² *See Munson*, 467 U.S. at 980 (Rehnquist, J., dissenting).

impose excise taxes on individuals who reap excess benefits from tax-exempt organizations.⁷³ Before § 4958 was enacted, when assets of a charitable organization inured to the benefit of an individual, the only options the IRS had was to revoke the organization's tax-exempt status or ignore the inurement.⁷⁴ The sanctions imposed by § 4958 seek to find a middle ground by penalizing those individuals who are enriched by the transaction and the officers and directors who allow the enrichment.⁷⁵

Referred to as "intermediate sanctions" by the non-profit community,⁷⁶ under § 4958, an excise tax of 25% is imposed on every excess benefit transaction.⁷⁷ The excise tax is increased to 200% of the excess benefit if the transaction is not corrected in a timely manner.⁷⁸ Additionally, a secondary tax equal to 10% of the excess benefit is imposed individually on an "organization manager" who approves or condones an excess benefit transaction.⁷⁹

What makes this law unique is on whom the primary tax is imposed. For intermediate sanctions to be imposed, the transaction must confer an economic benefit of greater value to a "disqualified person" than the consideration received by the charitable organization.⁸⁰ Under § 4958(f), the definition of a "disqualified person" is extremely broad. Anyone who, within five years prior to the transaction in question, was in a position to "exercise substantial influence over the affairs of the organization" or a family member of that individual is deemed "disqualified."⁸¹ The definition also includes any person who owns 35% or more of a corporation's voting

⁷³ See generally I.R.C. § 4958 (2002) (imposing an excise tax on "disqualified individuals" who privately benefit from their association with a charitable organization).

⁷⁴ J. Eric Taylor, *Intermediate Sanctions Under § 4958: An Overview of the Proposed Regulations*, 73 FLA. BAR J. 73, 73 (1999).

⁷⁵ *Id.*

⁷⁶ *Id.*

⁷⁷ I.R.C. § 4958(a)(1) (2002).

⁷⁸ *Id.* § 4958(b).

⁷⁹ *Id.* § 4958(a)(2) ("The tax imposed by this paragraph shall be paid by any organization manager who participated in the excess benefit transaction.")

⁸⁰ *Id.* § 4958(c)(1)(A).

⁸¹ *Id.* §§ 4958(f)(1)(A), (B).

power, a partnership's profit interest, or trust's beneficial interest.⁸²

Individuals are also described as "disqualified persons" if they engage in revenue-sharing transactions with a charitable organization.⁸³ The IRS defines such transactions as those wherein employees or independent contractors receive some or all of their compensation based on the revenue of the organization.⁸⁴ These transactions are most common in the health care field and in compensation arrangements with fundraisers.⁸⁵ In the IRS's proposed regulations, if an individual's compensation is based primarily on revenues derived from activities within his control, he is automatically deemed to have "substantial influence" over the organization.⁸⁶ In the final regulations, however, rather than a per se rule, revenue-based compensation is merely one of the factors considered in determining "substantial influence."⁸⁷ Nevertheless, the final regulations indicate that if the benefits received by the disqualified person are not proportional to the services provided, the transaction might constitute an excess benefit transaction even if the compensation paid to him was reasonable.⁸⁸

V. Liberal Relief Provisions Balance Stringent Restrictions

Although the requirements for transactions between charitable organizations and third parties seem strict, there are three provisions in the final regulations that offer substantial relief: the initial contract

⁸² I.R.C. §§ 4958(f)(1), (3) (2002).

⁸³ *Id.* § 4958(c)(2).

⁸⁴ *Id.*

⁸⁵ See 26 C.F.R. § 53.4958-3(g) (2002) (providing two examples of revenue-sharing, in example 10 and 11, both within a health care setting); Eugenia Stark, Note, *The Tangled Web of Disqualified Persons: A Temporary Treasury Regulation Analysis*, 21 VA. TAX REV. 277, 290-91 (2001) (discussing the status of revenue-sharing arrangements, which are commonly found in the health care industry).

⁸⁶ See Failure by Certain Charitable Organizations to Meet Certain Qualification Requirements; Taxes on Excess Benefit Transactions, 63 Fed. Reg. 41,486-01, 41,488, 41,490 (proposed Aug. 4, 1998) (codified, in relevant part, at 26 C.F.R. § 53.4958-3 (2002)).

⁸⁷ Intermediate Sanctions, 26 C.F.R. § 53.4958-3(c) (2002).

⁸⁸ *Id.*

rule,⁸⁹ the rebuttable presumption of reasonableness,⁹⁰ and the written opinion safe harbor.⁹¹ The effect of these provisions is two-fold: charitable organizations are empowered to control their day-to-day operations and, if they follow the regulations, charities are immunized from revocation of their tax-exempt status.

A. Initial Contract Rule

The initial contract rule, also known as the “one free bite rule,” excludes transactions from intermediate sanctions if the individual with whom the charitable organization contracts is not deemed a “disqualified person” at the time the contract is made.⁹² This exception applies regardless of whether the individual receives an excess benefit.⁹³ An “initial contract” is defined as a binding, written contract with a fixed payment amount between the charitable organization and a third party, who, at the time the contract became binding, is not a “disqualified person.”⁹⁴ A “fixed payment” consists of a specific amount of cash or property, or a fixed formula based upon “preestablished, objective criteria.”⁹⁵ Thus, bonuses and other discretionary disbursements are not protected by the initial contract rule.⁹⁶ Additionally, the rule does not apply if the contract is materially modified or if the individual fails to substantially perform his obligations under the contract.⁹⁷

There is an important reason why this provision protects charitable organizations. In order to be protected by this provision, charities must negotiate a specific, rather than a percentage-based, fee. By using specific dollar amounts, charities will be able to research and compare the costs of similar services more easily. Also, specific fees may be structured in a way that maximizes the charities’ total revenue. For example, a charity may negotiate a fee that

⁸⁹ *Id.* § 53.4958-1(f)(2).

⁹⁰ *Id.* § 53.4958-6.

⁹¹ *Id.* § 53.4958-1(d)(4)(iii).

⁹² Intermediate Sanctions, 26 C.F.R. § 53.4958-4(a)(3)(iii) (2002).

⁹³ *Id.*

⁹⁴ *See id.* § 53.4958-4(a)(3)(iii).

⁹⁵ *Id.* § 53.4958-4(a)(3)(ii).

⁹⁶ *See id.*

⁹⁷ *See id.* §§ 53.4958-4(a)(3)(iii), (iv).

represents 20% of projected donations and an additional specific fee if the professional solicitor raises more. So long as the additional fees are not discretionary, this fee schedule offers charities, and the professional solicitors, protection under the initial contract rule, in addition to encouraging the solicitation company to raise as much in total revenue as possible.

However, there is a situation where the “one free bite” rule fails to protect charitable organizations in most situations. In order for the charity to be protected, a binding, written agreement must be in place before an individual becomes a “disqualified person.”⁹⁸ The stringency of this requirement ignores the fact that a third party will likely begin working with the organization before a final agreement is reached. As a result, most charities will not be able to take advantage of the “one free bite” exception.

B. The Rebuttable Presumption of Reasonableness

The final regulations also allow charitable organizations to insulate themselves from intermediate sanctions by establishing a rebuttable presumption that a transaction with a third party does not result in an excess benefit transaction.⁹⁹ The presumption arises if three conditions are satisfied: (1) the governing body of the organization, consisting solely of disinterested parties, approves the transaction; (2) the body obtains and relies upon “appropriate data as to comparability” of the transaction to similar transactions involving similarly situated organizations; and (3) the governing body adequately documents the basis for its decision to approve the transaction.¹⁰⁰

Regarding the second requirement, the governing body of an organization with receipts of less than \$1 million is considered to have “appropriate data” if it obtains information on compensation paid by three comparable organizations in comparable geographic areas for comparable services.¹⁰¹ For organizations with receipts greater than \$1 million, the governing board must make a determination about the facts and circumstances of every transaction.¹⁰² For example, the governing board may rely on a

⁹⁸ See Intermediate Sanctions, 26 C.F.R. § 53.4958-4(a)(3)(iii) (2002).

⁹⁹ See *id.* § 53.4958-6(b).

¹⁰⁰ See *id.* §§ 53.4958-6(a), (c)(1)(A).

¹⁰¹ See *id.* § 53.4958-6(c)(2)(ii).

¹⁰² See *id.* § 53.4958-6(c)(2)(i) (providing specific examples of relevant

fundraiser compensation survey compiled by an independent firm, so long as the data is sufficiently similar, such that it is meaningful to the organization.¹⁰³

Although the rules governing the rebuttable presumption of reasonableness are liberal, there is a significant restriction to its applicability. The use of “reciprocal approval” arrangements to evade the disinterested body requirement is strictly prohibited.¹⁰⁴ For example, two board members, each financially interested in a separate transaction awaiting approval from the board, are deemed to have a conflict of interest in approving the transaction of the other.¹⁰⁵ This prohibition offers significant protection to most charitable organizations because entrepreneurs and local business-persons are likely candidates for board positions in charitable organizations. This rule protects charitable organizations from individuals who become board members to satisfy their own business interests.

C. Written Opinion Safe Harbor

The written opinion safe harbor provision also lessens the burden on charitable organizations, particularly organizational managers. An organizational manager can avoid the 10% secondary tax¹⁰⁶ by securing a written opinion from a qualified professional that he or she is acting appropriately and in the best interest of the organization.¹⁰⁷ In order to be protected, the organizational manager must fully disclose all the relevant information.¹⁰⁸ In the proposed regulations, only attorneys were allowed to craft these opinions.¹⁰⁹ Despite immense resistance after the discovery of Arthur Andersen’s involvement with Enron, however, the definition of “appropriate professionals” in the final regulations was expanded to include certified public accountants, expert accounting firms, and certain

information that the board should review in making its determination; referring, in part, to the “facts and circumstances” test set forth in 26 C.F.R. § 53.4958-4(b)(2)(i).

¹⁰³ See *id.* § 53.4958-6(c)(2)(i).

¹⁰⁴ *Id.* § 53.4958-6(c)(1)(iii)(E).

¹⁰⁵ See *id.*

¹⁰⁶ I.R.C. § 4958(a)(2) (2002).

¹⁰⁷ See 26 C.F.R. § 53.4958-1(d)(4)(iii) (2002).

¹⁰⁸ See *id.* § 53.4958-1(d)(4)(iii).

¹⁰⁹ See *id.*

“independent valuation experts.”¹¹⁰

The requirements for the written opinion safe harbor are analogous to the “reliance on counsel” defense, often employed in securities cases when the timing and character of trades or financial documents are at issue.¹¹¹ The manager of a charitable organization cannot hide behind the written opinion if he did not fully and accurately disclose all the relevant information to the professional.¹¹² The opinion itself is not what gives rise to the protection, rather, it is the analysis contained within the opinion based upon all of the relevant information.¹¹³

VI. Intermediate Sanctions: A Reasonable Method of Regulating Charitable Solicitations

As Justice Stevens noted in his dissent in *Riley*, the government has a legitimate interest in “preventing fraud on potential donors and protecting against overcharging of charities by professional fundraisers.”¹¹⁴ Preserving donor confidence is paramount to maintaining the over \$200 billion Americans donated in 2001. For example, consumers would have been far less likely to donate to United Cancer Council if they knew that over 90% of their donations were going directly to the solicitation company. However, an equally difficult problem exists at the opposite end of the spectrum: the government cannot afford to over-regulate the industry. The government’s reliance on charitable organizations continues to grow, especially in this recession, when there are fewer and fewer governmental dollars budgeted to social-welfare programs.

Today’s charities do far more than feed the hungry: they support the arts, encourage small business growth, provide educational resources, and promote cultural and community growth, to name only a few. The government cannot afford to lose the services that charities provide. Therefore, a careful balance must be

¹¹⁰ See 26 C.F.R. § 53.4958-1(d)(4)(iii).

¹¹¹ To invoke the defense of reliance on counsel the defendant has to show that he (1) made complete disclosure to counsel, (2) sought advice as to the legality of his conduct, (3) received advice that his conduct was legal, and (4) relied on that advice in good faith. *Markowski v. SEC*, 34 F.3d 99, 105 (2d Cir. 1994) (citing *SEC v. Savoy Indus., Inc.*, 665 F.2d 1310, 1314 (D.C. Cir. 1981)).

¹¹² See *Intermediate Sanctions*, 26 C.F.R. § 53.4958-1(d)(4)(iii) (2002).

¹¹³ See *id.*

¹¹⁴ *Riley*, 487 U.S. at 808.

found between preserving donative intent and allowing charities to keep their doors open by using professional solicitors. If properly administered, intermediate sanctions will achieve this balance. These excise taxes will protect charities from abuse by professional solicitation companies and from their own corrupt self-interest, while maintaining the public's perception of the integrity within charitable organizations and promoting integrity within such entities. They will also allow charities to operate independently, without fear that their tax-exempt status will be revoked.

A. Charities Need Protection from Aggressive Solicitation Companies

Both the IRS and the states have a reasonable interest in prohibiting professional solicitors from reaping excessive benefits from charitable donations. When a charitable organization seeks § 501(c)(3) tax-exempt status, the application does not require that an attorney or someone with transactional business experience is a member of the board.¹¹⁵ For that reason, it would not be unusual for a small charitable organization to be run by directors who have little to no experience with typical business matters, particularly contracts. Aggressive solicitation companies could easily take advantage of the situation by seeking out small, vulnerable charities. As a result, it is not difficult to imagine how charitable organizations, such as United Cancer Council, become contractually liable to transfer a majority of their receipts to a solicitor.

Charitable organizations can protect themselves by taking advantage of the rebuttable presumption of reasonableness provision within the final regulations to I.R.C. § 4958. The presumption forces small organizations with less than one million dollars in annual receipts to become familiar with the rate similar organizations are paying for similar services. After surveying the industry, charitable organizations are far less likely to engage in disadvantageous transactions with professional fundraisers and solicitors. Furthermore, if organizational managers take advantage of the written opinion safe harbor, a qualified professional could point out disadvantageous terms before the contract is finalized. An attorney representing a charity would not craft a written opinion that insulates a manager from liability if the terms of the contract are grossly unfavorable to the organization, unless it has no other means of attaining the

¹¹⁵ See generally IRS, Form 1023 (1998), available at <http://www.irs.gov/pub/irs-pdf/k1023.pdf>.

services.

B. Protecting Charities from Their Own Corrupt Self-Interest

The government also has a legitimate interest in protecting donors from charitable organizations that do not see the down side to only receiving ten cents for every dollar donated. It is difficult for a financially struggling organization to pass up income, even when it represents only a fraction of the total donations contributed to the charity's purpose. If professional solicitors are willing to take over fundraising efforts, any revenue that the charity receives may be viewed as "free money" since they are not expending any direct resources. Although these types of transactions should be sanctioned, revocation of the organization's tax-exempt status is a drastic, and possibly fatal, measure. Rather, the IRS may impose intermediate sanctions on the excess benefit.

Some charitable organizations may argue that they should be able to use every resource available, including unfavorable fundraising contracts. But, as the Seventh Circuit stated in *United Cancer II*, if an organization is consistently having severe financial problems, perhaps it makes sense to close, rather than enter into disadvantageous contracts.¹¹⁶ The public at large does not benefit from a public charity¹¹⁷ that transfers a majority of its receipts to a for-profit solicitor. The IRS rationalizes granting tax-exempt status to charitable organizations because they perform services for the community at large, rather than for the private gain of the organizations' owners. Furthermore, the IRS has a significant interest in prohibiting tax-exempt donations from being transferred to a for-profit enterprise. Viewed from the opposite perspective, the IRS does not want to deny taxpayers' charitable gift deductions because, despite taxpayers' intentions, a majority of the funds donated were not used for charitable purposes. Therefore, although charitable organizations operate to do "good work," entering into unfavorable contracts according to the "free money" theory is against public

¹¹⁶ *United Cancer II*, 165 F.3d at 1178.

¹¹⁷ See generally IRS, Instructions for Form 1023, at 5 (1998), available at <http://www.irs.gov/pub/irs-pdf/k1023.pdf>. There are two types of I.R.C. § 501(c)(3) tax-exempt organizations: public charities and private foundations. Generally, in order to be a public charity, the organization must derive at least 35% of its receipts from public donations. An organization would usually prefer to be a public charity because the yearly filing and maintenance requirements are far less stringent. See *id.* at 5.

policy and should be sanctioned.

VII. Conclusion

American consumers consistently make generous donations to charitable organizations. Historically, philanthropic giving has been a necessary compliment to our capitalistic marketplace and laissez-faire approach to public and government benefits. As a result, maintaining the integrity of charitable organizations and protecting donative intent are paramount to the success of the not-for-profit community. Disadvantageous contracts with professional fundraisers threaten that success.

The trilogy of Supreme Court cases demonstrates the states' inability to regulate charitable regulations by punishing charities directly.¹¹⁸ Constitutional issues aside, this approach fails to sanction the parties deriving the benefit from the transactions: professional solicitors and fundraisers. Intermediate sanctions, imposed by the IRS through I.R.C. § 4958, protects charities and donors from abuse by professional solicitors. Additionally, this provision protects charities from their own corrupt self-interest by reducing the incentive for charities to adopt the "free money" theory because organizational managers may be sanctioned for acquiescing to the transaction. Intermediate sanctions enable charities to operate independently, including raising funds for their charitable purposes, while ensuring that charitable donations reach the intended donee.

¹¹⁸ *See supra* Part II.
