

**IN THE UNITED STATES COURT OF APPEALS  
FOR THE SEVENTH CIRCUIT**

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**Nos. 98-2181 and 98-2190**

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**UNITED CANCER COUNCIL, INC.,**

**Petitioner-Appellant,**

**v.**

**COMMISSIONER OF INTERNAL REVENUE,**

**Respondent-Appellee.**

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**ON APPEAL FROM THE UNITED STATES TAX COURT  
HONORABLE HERBERT L. CHABOT, JUDGE**

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**BRIEF FOR APPELLANT**

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## PRELIMINARY STATEMENT

This case raises issues of fundamental importance to charities across the nation, in particular new, small, or unpopular charities that in their early years must spend large amounts of money — often well in excess of their initial yield — to develop the donor base essential to future stability and growth.<sup>1/</sup> In this unprecedented case, however, the Tax Court has upheld the IRS’s revocation of the tax-exempt status of a small, financially struggling charity because of the high cost of its fundraising campaign — a campaign that actually saved its existence.

The pertinent provisions of the Internal Revenue Code are familiar and straightforward. Income of organizations qualifying under Section 501(c)(3) is exempt from federal income tax, and their contributions are tax-deductible. Such organizations may lose their tax-exempt status if (1) they operate for a substantial non-exempt purpose; (2) their operations result in a substantial private benefit; or (3) their net earnings inure to the benefit of an “insider.” This case concerns only the last of these, prohibiting “private inurement.”

Appellant United Cancer Council (“UCC”) was an umbrella organization formed in the early 1960s by member groups that split from the American Cancer Society (“ACS”) in disagreement over cancer-fighting policies. By 1984, UCC encountered serious financial problems, caused at least in part by

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<sup>1</sup> Fundraising is premised on, and constrained by, the old adage that “[m]oney begets money.” Old English proverb attributed to John Ray in BARTLETT, FAMILIAR QUOTATIONS 301 (15th ed. 1980).

interference by ACS. To avert imminent financial demise, UCC searched for professional fundraising help, ultimately retaining The Watson & Hughey Company (“W&H”).

W&H was wholly unrelated to UCC. There was no common ownership, management, or control, nor any interlocking financial interests, direct or indirect, involving officers, directors, or employees. In fact, until UCC began looking for a professional fundraiser, no one affiliated with UCC had ever heard of W&H. UCC negotiated a contract with W&H at arm’s length, just as it would with any other potential vendor.

Over the five-year term of the contract, UCC raised \$27.8 million in contributions. But, like any charity commencing large-scale direct-mail fundraising and attempting to build a donor base, UCC’s fundraising costs were high in relation to contributions. The purpose of the mailings, however, was not solely pecuniary. The solicitations were always accompanied by educational materials regarding prevention and early detection of cancer, thus directly advancing UCC’s public education function; nearly half of the expenses were allocated, under generally accepted accounting procedures, to this function. In addition, UCC realized net cash income of \$2.2 million from the campaign, which it also spent on its cancer-fighting efforts.

Deeming UCC’s fundraising costs unacceptably high, the IRS revoked UCC’s tax-exempt status retroactively to 1984, when UCC had entered into the W&H contract. The IRS has contended at various times that, solely because of the contract, (1) UCC was not operated exclusively for exempt purposes, (2)

the fundraising campaign resulted in an impermissible private benefit to W&H, and (3) a portion of UCC's net earnings impermissibly inured to the benefit of an insider, which it claimed W&H to be.

The Tax Court sustained the revocation, relying solely on the "private inurement" rationale. It found that (1) W&H, although a third-party vendor wholly unrelated to UCC, nevertheless became an "insider" for purposes of inurement analysis because the contract allegedly gave W&H control over certain aspects of UCC's operations; and (2) the compensation paid to W&H under the contract was "excessive" in light of the high ratio of fundraising costs to contributions raised. The court also sustained the decision to make the revocation retroactive to 1984. This led to the imposition of substantial retroactive taxes and interest.

This decision is flawed at every turn. *First*, its wholly unprecedented ruling that a third-party vendor of services under a contract negotiated at arm's length can be an "insider" for purposes of inurement analysis is contrary to the Internal Revenue Code and places an untenable burden on nonprofit organizations dealing at arm's length with unrelated parties. *Second*, it was clear error to find that W&H exercised control over UCC's operations or that W&H's contractually determined compensation was excessive. *Third*, the court's reliance on the high ratio of fundraising costs raises grave First Amendment problems, for the Supreme Court has held that charitable solicitations are speech protected by the First Amendment, has recognized that high expenses are an expected feature of fundraising efforts of new, small, or unpopular charities, and has prohibited governmental regulation based on high expense ratios. *Finally*, the Tax Court clearly abused its discretion in allowing the revocation to be retroactive to 1984.

## **JURISDICTION**

The Tax Court had jurisdiction under 26 U.S.C. § 7428(a)(1)(A). Its decisions (App. A1-A3) were entered on January 30, 1998, and UCC's notices of appeal (App. A76-A77) were timely filed on April 30, 1998. See Fed. R. App. P. 13. The jurisdiction of this Court is based on 26 U.S.C. § 7482.

## **ISSUES PRESENTED FOR REVIEW**

1. Whether the doctrine of private inurement is applicable to payments made to a third-party fundraiser pursuant to a contract negotiated at arm's length, and, if so, whether the Tax Court correctly determined (a) that W&H exercised such control over UCC as to make it an "insider" and (b) that W&H's compensation under the contract with UCC was excessive.

2. Whether it was permissible to revoke UCC's tax-exempt status retroactively.

## **STATEMENT OF THE CASE**

By letter ruling dated March 31, 1969, the IRS declared that UCC was exempt from federal income tax and was an eligible charitable donee. On November 2, 1990, the prior ruling was revoked, retroactive to June 11, 1984. App. A441-A442. On January 30, 1991, UCC challenged the revocation in the Tax Court, pursuant to 26 U.S.C. § 7428. The court denied UCC's motion for summary judgment on First and Fifth Amendments grounds (App. A78-A97). Trial was held over several weeks, at various intervals, during 1992 and 1993.

On December 2, 1997, the Tax Court issued an opinion sustaining the revocation of UCC's tax-exempt status on the sole ground that UCC's net earnings had improperly inured to W&H (App. A4-A54). The court's decision was entered on January 30, 1998. App. A1. Also on that date, the Tax Court entered judgment against UCC for \$174,290 in retroactively imposed taxes. App. A2-A3.

### **STATEMENT OF FACTS**

The historical facts underlying this case are essentially undisputed and are largely set out in the Tax Court's opinion. App. A5-A40.

#### **A. The United Cancer Council**

UCC was organized in 1963 as a Delaware not-for-profit corporation. App. A406 ¶ 11. UCC was a national umbrella organization of local independent cancer agencies. App. A408 ¶ 28. Its member agencies ranged in number from 21 in the 1970s to 47 in 1988. App. A414 ¶ 57; A160, A182, A245. UCC's founding member affiliates formerly were local chapters of the American Cancer Society; they separated from ACS because they (i) wanted to participate in United Way fundraising campaigns (which ACS prohibited); and (ii) sought to concentrate on cancer prevention and the alleviation of the suffering of cancer victims and only secondarily on seeking cancer cures. App. A414 ¶ 56; A98.

UCC's mission was to promote, encourage, and assist in programs serving cancer patients, to provide cancer-related education to the public, and to support research in preventing and alleviating cancer.

App. A109. In a 1969 letter ruling, the IRS recognized UCC's tax-exempt status under 26 U.S.C. ("I.R.C.") § 501(c)(3) and charitable donee eligibility under I.R.C. § 170(c).<sup>2/</sup> App. A406 ¶ 10.

UCC's 30-member board of directors was comprised of highly qualified volunteers representing a cross-section of the community. App. A99-A100. Chosen from the boards of UCC's member agencies (App. A111), the directors included medical professionals, such as physicians, dentists, nurses, and a hospital administrator (App. A107-108, A120, A261); several attorneys (App. A295, A297-298); a federal and a state judge (App. A102, A252); and banking and financial professionals (App. A104).

#### **B. UCC's Financial Crisis and the Negotiation of the W&H Contract**

Prior to 1984, UCC's operating funds consisted primarily of membership dues from affiliates; UCC received about 1% of each member agency's United Way allocations. App. A101. This sum was supplemented by small amounts generated by sporadic contributions, bequests, special fundraising events, and a small annual fundraising drive. App. A117, A161-A162, A239. As an umbrella organization, UCC was not itself eligible to receive United Way funds. App. A103-A104, A238. UCC's annual operating budget in 1983 was approximately \$35,000. App. A114, A164, A239.

In 1984, some of UCC's largest member agencies dropped out, precipitating a financial crisis. App. A103-A104. UCC board members felt that ACS was "pick[ing] away" at UCC's affiliates. App. A102-A103. For example, the Michigan Cancer Foundation left UCC after accepting a research grant

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<sup>2</sup> "I.R.C." citations are to the Internal Revenue Code of 1986, and identical provisions of the Internal Revenue Code of 1954.

from ACS that was contingent upon exclusive ACS affiliation. App. A102-A103, A112, A163. These departures, and the resultant loss of dues, caused a budget crisis. The board projected a deficit of \$13,000 for 1984. App. A111-A114. The board considered letting UCC perish but was loath to do so, principally because UCC, with its commitment to cancer patient services, occupied a special niche among cancer charities. App. A118, A164-A165, A240-A241.

UCC's board had created a Long Range Planning Committee in 1983 to study fundraising issues. App. A236. This committee recommended diversification of income sources. App. A237-A238. After several unsuccessful fundraising efforts, the committee decided to seek a direct-mail fundraiser. App. A113-A114, A248. Adopting this suggestion, UCC's board instructed its Executive Director to seek fundraising avenues that would not require initial capital outlay by UCC. App. A114-A115, A167-A168, A241-A242.

Prior to conducting her search, the Executive Director personally visited each of UCC's member agencies to develop a budget for the services they required. App. A115. She then investigated different fundraising approaches, reviewing various fundraising publications and contacting firms that advertised therein. App. A115-116, A154-A155, A166, A240. Her extensive investigation led her to identify W&H as the most promising. She accordingly recommended that UCC's board initiate negotiations with W&H. App. A116, A166, A241-A242.

As noted, W&H was wholly independent of and unrelated to UCC. There was no overlap in the ownership or control of the two entities, nor were there any interlocking financial interests on the parts of officers, directors, or employees. App. A123, A148, A181, A279-A280, A341.

UCC's board appointed a four-person Negotiating Committee consisting of the board President, two other board members (a lawyer and a judge), and UCC's Executive Director. App. A152, A169, A244. Under W&H's initial proposal, UCC would bear the risks of the fundraising campaign; it would exclusively own all donor names, and W&H would charge 3.5 cents per prospect mailing and 7 cents per housefile mailing (these terms are explained at p. 9, *infra*). App. A518-A522.

UCC lacked the financial resources to enable it to advance printing and mailing expenses and to bear the risks of the fundraising campaign. From its perspective, therefore, an essential feature of any fundraising contract was a "no risk" arrangement, *i.e.*, one under which the fundraiser alone would be responsible for all expenses and would bear the risk of loss if the campaign were unsuccessful. App. A149-A150, A167-A168. Therefore, at UCC's request, W&H submitted a "no risk" contract proposal. App. A523-A527. Because it would assume a significant risk of loss under such a contract, W&H insisted on co-ownership of the list of names generated by the campaign. App. A55-A60, A523-A533.

UCC asked several present and former board members to review drafts of the W&H contract proposal and to identify any issues or concerns. App. A151. Lengthy discussions ensued between the Negotiating Committee and W&H representatives, during which the contract was negotiated paragraph-by-paragraph. App. A153, A175-A175, A243, A247, A321-A325. At least four different drafts of the contract were considered over the six-month course of the negotiations (App. A170-A173), and the final contract reflected numerous changes from the initial W&H proposal. App. A152, A171-A172, A245-A246, A320.

Prior to executing the contract, UCC’s board investigated W&H, checking its list of references and contacting former clients. App. A177. Finally, UCC’s approximately 30-person board unanimously ratified the contract. App. A119-A120. On June 11, 1984, UCC entered into a “Full Service Direct Response Fundraising Agreement” with W&H, pursuant to which W&H would undertake a direct-mail fundraising campaign for the benefit — and under the direction and control — of UCC. App. A408 ¶ 26.

### **C. The Benefits of Direct-mail Fundraising**

A direct-mail campaign enables a charity simultaneously to communicate its mission, disseminate educational material, and solicit broader-based financial support from the general public. App. A307-A309, A368-A369. Direct-mail fundraising is, however, both expensive and risky. App. A370-A371, A389.

Direct-mail campaigns typically consist of two types of mailings: “prospect” mailings and “housefile” mailings. The former are made to individuals who have not previously contributed. App. A183. If a recipient of a prospect package makes a contribution, that person’s name and address are added to a list of contributors to the organization, known as the housefile. App. A183. Mailings addressed to prior contributors are known as “housefile mailings.” App. A417 ¶ 72.

Prospect mailings generally lose money (*i.e.*, the amount received in contributions does not cover the expenses of conducting the mailing) or, at best, break even. App. A559-A560; A557. A charity undertakes prospect mailings to generate names for its housefile, hoping that, because housefile mailings typically generate higher response levels, the results of subsequent mailings to prior contributors will justify the investment in prospect mailings. *Ibid.* But even housefile mailings are likely to produce relatively small

profits during the first few years of a direct-mail campaign; only well established charities with mature housefiles of repeat donors are able to generate revenues that substantially exceed expenses. App. A310-A311.

**D. The Terms of UCC's Contract with W&H**

Under the terms of the contract, UCC retained W&H for five years as its exclusive direct mail fundraising advisor and consultant. App. A55 § 1; App. A59 § 17. Every component of the fundraising campaign — including content and form of solicitations, lists of recipients, number of solicitations to be sent, and frequency and dates of mailings — was subject to UCC's approval. App. A56 § 3.

Of central importance to UCC was the provision covering allocation of risk. UCC would neither be required to advance funds nor risk incurring losses if contributions failed to cover expenses. W&H accepted liability for payment of all vendors and suppliers, and UCC agreed to “reimburse W&H only to the extent that W&H has raised such funds.” App. A57 § 9. During the contract's first two years, W&H could apply up to 50% of housefile mailing receipts towards the cost of prospect mailings; after two years, such recoupment was limited to 30% of housefile receipts. *Ibid.* W&H was not permitted to recoup expenses from donations that UCC board members, or other prior donors, might give unrelated to the campaign. *Ibid.*

As compensation, W&H would receive a fee of 5 cents per prospect letter mailed and 10 cents per housefile letter (compared to 3.5 cents and 7 cents, respectively, under W&H's initial proposal, which had UCC taking financial responsibility). For housefile mailings, W&H was to be paid a design fee of \$2,500-\$5,000, depending on the size of the mailing. App. A56-A57 § 8. Because W&H bore the risk of loss, UCC ceded it a partial ownership interest in contributor lists developed through its efforts, which were to be jointly owned by the parties. App. A58 § 14. UCC could use its housefile for its own account at any time and in any manner it chose, but it could not, during or after the contract, rent, exchange, or lease the names developed by W&H. W&H had free use of the lists. *Ibid.*

Because W&H remained liable for all expenses generated by the campaign, the parties agreed to select a bank, or "caging" company, to act as cashier and escrow agent for the collection and disbursement of funds.<sup>3/</sup> App. A56 § 4. W&H agreed to use reasonable efforts to obtain competitive bids for any work subcontracted to suppliers but was permitted to hire its own affiliates, subject to the competitive bid requirement. W&H was not permitted to "mark up" any supplier or subcontractor invoice. *Id.* § 6. The contract had a five-year term, renewable for another five years unless either party canceled it. App. A59 § 17.

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<sup>3</sup> Caging services include opening the mail generated by the direct-mail campaign and processing any receipts. App. A293.

### **E. UCC's Experience Under the W&H Contract**

Over the term of the contract, UCC mailed approximately 79.6 million letters. App. A6, A22. The funds raised enabled UCC for the first time to provide grants to its member agencies. These grants supported services by UCC's member agencies in their local communities (App. A121-A122), including patient care, cancer research, and education activities. App. A412 ¶ 42. In 1986, for example, UCC gave \$100,000 in grants to 18 member agencies for such purposes as outdoor camping for children with cancer, chemotherapy for needy patients, provision of wigs and turbans to patients undergoing chemotherapy or radiation treatment, transportation to treatment facilities, speech instruction for patients with throat cancer, home care training, and educational programs and literature. App. A499; App. A501-A502; App. A503-A506. In total, UCC was able to help over 114,000 cancer victims. App. A361. In addition, the mailings themselves advanced UCC's educational goal; every solicitation included educational material regarding cancer and its warning signs. App. A110, A126.

W&H created and developed direct-mail fundraising packages with UCC's assistance and input. Before any package was mailed, UCC received from W&H all materials to be included therein, together with a list of suggested recipients. Through its staff and a committee of the board, UCC would review and revise the proposed package and mailing list, giving instructions to W&H as to the volume of the mailing, text of the copy, and dates of mailing. App. A23.

To obtain lists of prospects to whom solicitations would be sent, UCC occasionally rented names, paying about \$60 per thousand names. App. A194-A195. This included rentals from Washington Lists, a list broker that was a division of W&H. App. A277-A278. Goods and services for the campaign were obtained from a number of different vendors. W&H did not own or have any interest in the vendors who furnished printing, mailing, telemarketing, data processing, or “caging” services to UCC. App. A25.

### *1. UCC's Draws*

Throughout the campaign, W&H advanced funds to UCC against anticipated receipts. During the early period of the contract, UCC's draws exceeded the amounts realized by the solicitations. These draws were, in effect, no-interest loans; they benefitted UCC greatly by enabling it to continue uninterrupted operations. App. A176, AA225, A274-A275, A367, A383.

UCC's initial draw was \$5,000 in October of 1984. App. A156, A273-A274. Thereafter, UCC drew from the escrow account almost every month over the term of the contract. App. A20-A21. UCC had a budget process to determine how much money could be drawn each year. App. A190-A191. As the fundraising campaign achieved increasingly favorable results, UCC's monthly draw increased; by January 1988, it was \$60,000. App. A20-A21; A290; App. A484.

## ***2. The Modification of the W&H Contract***

Independent CPAs prepared and audited UCC's financial statements annually. App. A409-A410 ¶ 32. For the 1985 audit, the accountants were willing to provide only a qualified opinion, fearing that lack of fundraising success might make UCC unable to repay its monthly draws. App. A189-A190. UCC and W&H therefore negotiated a contract modification, embodied in an Addendum executed on April 9, 1987, and made retroactive to January 1, 1986. App. A408 ¶ 26; A60. The Addendum had two major provisions. W&H agreed that UCC's monthly draws would be treated in the same manner as its "prospecting" expenses, *i.e.*, not subject to recoupment if the direct-mail campaign failed to generate sufficient revenue. In return, UCC agreed to maintain the share of its housefile receipts available for repayment of debt at 50%, rather than having it decline to 30% after two years. *Ibid.*; App. A189-A190, A268. In addition, UCC extracted two further concessions from W&H: a \$500,000 cap on the fee for housefile mailings; and a reduction of the creative fee from \$5,000 to \$2,500 per package. These concessions were contained not in the Addendum but in a separate agreement. App. A266-A272. After these changes were made, UCC received only unqualified opinion letters from its independent auditors. App. A187-A188.

## ***3. The Escrow Account***

Concurrently with the June 1984 W&H contract, UCC entered into an escrow and caging contract with Washington Intelligence Bureau ("WIB"). App. A419 ¶ 86. Under such an agreement, contribution

checks generated by a direct-mail campaign are sent to a post office box, where the caging service collects the envelopes, endorses the checks, categorizes them, and deposits the funds in the client's account. App. A420 ¶ 89; A230. Thus, checks from UCC's direct-mail campaign went to WIB, which deposited them in an escrow account and sent deposit slips to UCC and W&H. App. A183-A184. All revenues generated by the direct-mail campaign went into the escrow account, not just net profits. App. A299-A300.

Although UCC technically owned the funds in the escrow account (App. A348) and could terminate it at any time by revoking WIB's signature authority (App. A319), such action would not have given UCC immediate possession of the funds because the account usually contained funds to which W&H was entitled under the contract. App. A32.

Fundraising expenses were approved by UCC and then paid by WIB. App. A184. UCC carefully monitored escrow account disbursements and refused to approve invoices that differed materially from the purchase order. App. A188.1-A188.2. Once approved by UCC, the invoices and corresponding check requests would be sent to WIB, which would reconcile invoices with check requests and write checks to the appropriate vendors. WIB provided copies of the invoice and check to UCC and W&H. App. A184, A346, A347-A351, A352. On one occasion, W&H mistakenly directed payment of an invoice without UCC's approval; UCC complained, and W&H agreed it would pay the bill from its own funds. App. A33. The only disbursement from the escrow account that did not require UCC's approval was for postage expenses charged to UCC's business reply accounts. App. A206, A301.

#### ***4. Sweepstakes Mailings and Straight Mailings***

Charitable solicitations take various forms. So-called “straight” packages consist of straightforward requests for contributions. “Sweepstakes” packages, on the other hand, combine the solicitation with a game of some sort, usually offering the recipient a chance to win a prize. App. A196, A229, A233, A263-A264. Many well-known non-profit and commercial organizations use sweepstakes mailings. App. A543-A546; App. A555. Unlike a lottery, no payment is required to take part in a sweepstakes.

After determining that many large, established charities were achieving fundraising success with sweepstakes packages, W&H suggested that approach to UCC. App. A328-A331. It tested a UCC “sweeps” package patterned after an Easter Seals package. When the results proved positive, UCC approved and W&H began sending sweepstakes packages regularly. App. A325-A334, A375-A376.

Sweepstakes packages have many advantages for a charity attempting to develop a housefile. They are one of the most cost-effective ways to add new donors because they typically produce comparatively high response levels. App. A545; App. A54, A556; A344, A354, A390. Indeed, contrary to the usual experience with prospect mailings, several of UCC’s sweeps packages produced substantial profits. App. A29. Also, by targeting sweepstakes donors and not traditional donors, UCC avoided competition with established cancer groups and at the same time disseminated its educational message to segments of the population typically ignored by cancer charities. App. A545; App. A555; A227-A228, A335.

Sweepstakes packages also have certain drawbacks. While they generate high response rates, the respondents may be more interested in playing the game than in UCC's cause. App. A29. Sweeps respondents are likely to respond to further sweeps packages, but UCC had difficulty converting sweeps donors to straight donors. App. A336-A337, A345, A380-A381. Furthermore, as discussed next, UCC received some negative publicity from the use of sweeps packages.

Of UCC's 90 prospect mailings, 71 were sweepstakes packages. App. A436 ¶ 30. Of the 75 housefile mailings, 47 were sweepstakes packages. *Id.* ¶ 31. In 1989, during the final months of the contract, UCC discontinued prospect mailings and sent monthly straight housefile packages in an effort to strengthen its housefile. App. A356-A360, A377, A378.

### ***5. Negative Publicity***

UCC experienced some negative publicity from its direct-mail fundraising campaign. App. A157-A158. This fell into four categories: (1) local affiliates expressed concern that UCC was cannibalizing their contributions, leading UCC to agree not to solicit in the local affiliates' zip codes (App. A249-A250); (2) some considered a few of the sweepstakes packages potentially misleading (App. A251-A253; App. A30-A31); (3) others objected to UCC's association with W&H, which had experienced negative publicity from its relationship with another cancer charity (*ibid.*); and (4) concerns were expressed that UCC's fundraising expenses were too high during the early years of the contract (*ibid.*).

National nonprofit organizations in the health field (like ACS) disliked direct-mail solicitations by smaller charities competing for donor dollars and had been known actively to foment negative publicity

directed at their competitors. App. A302-A304, A305-A306. They would also interfere with small health charities in other ways, such as attempting to influence state regulatory authorities. App. A368. UCC was a recipient of such unwanted attention from ACS. App. A294-A295, A296. For example, ACS distributed a “look-alike manual” denigrating non-profits that competed with ACS for cancer donation dollars. See App. A561-A609. The manual defines ACS “look-alikes” as cancer charities that use words like National, American, Institute, Foundation, or Society in their names. App. A563. The manual advises ACS volunteers “to avoid a direct confrontation [with look-alikes], which could appear self-serving.” App. A566. Rather, the manual exhorts volunteers to contact “[p]otential allies” such as postal officials and representatives of the state attorney general in “building [the] story with the media.” *Ibid.* The manual lists UCC as an offending “look-alike.” App. A607.

#### ***6. UCC’s Oversight of W&H’s Fundraising Efforts***

The contract made all aspects of W&H’s work “subject to the approval of the client.” App. A56 § 2. UCC had approval power over “copy, list selection and proposed quantity.” *Id.* § 3. Each year, UCC told W&H its fundraising goal for the direct-mail campaign, and W&H developed a mailing schedule to meet that goal. UCC reviewed each year’s proposed program in advance and could accept or reject any part of it. App. A190-A191. It could also stop the campaign at any time simply by refusing to approve further packages or lists. App. A136, A258, A325, A342-A343, A372-A373.

Initially, the task of monitoring the content of the direct-mail solicitations was assigned to UCC's Chairman and its Executive Director. App. A128. In January 1985, about six months after the contract was signed, concerns were expressed about the content of solicitations. At the suggestion of board member Charles Schwartz, Jr., a United States District Judge from New Orleans, the board decided to create a committee to exert increased vigilance over solicitations. App. A128, A137-A138, A178-A179, A253. In November 1985, the Creative Fundraising Committee was established to review proposed solicitations and help to create new packages and educational pamphlets. App. A128-A131, A192, A254, A260.

The Creative Fundraising Committee performed its assigned task energetically; indeed, W&H personnel believed that UCC was too involved with the details of the copy and list approval. App. A314-A315, A338. Nevertheless, UCC exercised its contractual right to modify or reject W&H proposals with respect to 65% of all packages, rejecting 15% outright. App. A312-A313. The rejected packages were never mailed. App. A374. On one occasion, UCC revoked its prior approval on the eve of a scheduled mailing; as a result, W&H had to absorb the substantial costs of the aborted mailing. App. A259, A314-A316. All changes requested by the Creative Fundraising Committee were made by W&H. App. A132, A382.

One concern expressed by UCC's auditors when issuing the qualified opinion letter for 1985 related to documentation and accounting under the contract. Thus, when it organized the Creative

Fundraising Committee, UCC's board also created an Administrative Fundraising Committee. That committee meticulously monitored the frequency and timing of mailings, package costs, accounting procedures, invoices, purchase orders, and all expenditures of the direct-mail campaign. App. A133-A135, A193, A254-A257, A276, A355. The committee worked closely with W&H and exercised UCC's rights under the contract even more actively. The documentation problems were quickly alleviated, and although UCC harbored some lingering concerns, it thereafter received only unqualified opinions from its auditors (App. A187-A188), who observed substantial improvement in UCC's oversight of the W&H contract (App. A208-A210).

The Administrative Fundraising Committee also discovered that W&H was not always meeting its contractual obligation to seek three bids for every supplier or vendor contract. The committee complained to W&H, and that issue too was substantially resolved. App. A139-140. Eventually, the Administrative Fundraising Committee transferred its review function to UCC's Chief Financial Officer. App. A133-A134.

### ***7. Public Education***

The W&H contract enabled UCC to develop valuable cancer information and distribute it to millions of people, many of them lower-income people not usually contacted by the established cancer charities. App. A545; App. A555; A110, A227-A228, A264-A265, A335. UCC included cancer prevention information in every mailing under the contract. App. A110, A126. The heart of education effort was distribution of UCC's pamphlet identifying the "Nine Warning Signals of Cancer." App. A126,

A180, A262. UCC thought the public ill-informed on this subject and believed that repetition, in a manner similar to commercial advertising, was important to “get the point across.” App. A124-A127, A262. Although UCC and W&H occasionally were at odds over issues such as the amount of educational material to include in a mailing, W&H consistently acceded to UCC. App. A197.

Generally accepted accounting principles (“GAAP”) govern accounting for businesses and nonprofit organizations. GAAP requires special accounting treatment for direct-mail solicitations. App. A211. There are GAAP rules governing allocation of the costs of a direct-mail campaign between the functions of fundraising and public education when both functions are represented in a mailing. For the first three years of the contract, the GAAP rule was Statement of Position (“SOP”) 78-10. App. A536. UCC employed the most common method of implementing SOP 78-10, the “physical units” method, which relied on a basis of line-by-line evaluation of each mailing. App. A199-A200, A214-A218, A234-A235. UCC’s allocations of expenses between education and fundraising were reviewed by its accountants, whose suggested changes UCC invariably accepted. App. A198-A199, A213, A218, A220.

In 1987, SOP 87-2 was promulgated, imposing a new approach to cost allocation. App. A536. SOP 87-2 required UCC to analyze the audience to which it was appealing and to produce additional documentation regarding list rentals. App. A537. UCC adapted its allocation approach to conform to the new rule. App. A538-539; App. A549-552. According to the testimony of its auditors, UCC’s allocation percentages were reasonable and accorded with GAAP. App. A220-A221, A226, A231-A232.

## ***8. Total Financial Results Under the Contract***

The direct-mail campaign conducted under the contract generated \$28,763,387 in contributions during 1984-1989. App. A7; A222; A456; A485-495. The campaign's expenses amounted to \$26,523,917. *Ibid.* In accordance with GAAP, \$12,211,404 of these expenses were allocated to UCC's educational mission. App. A219, A224; A456; A485-A495. The U.S. Postal Service was paid \$7,498,227. App. A24. W&H received fees of \$4,118,560 for its services. App. A223; A456, A485-A495; App. A443-A455; A462-A483. Washington Lists, the list broker division of W&H, received \$3,901,204. App. A8-A9.

In sum, nearly \$14.5 million of the contributions generated by the fundraising campaign was spent in fulfillment of UCC's exempt purposes — the \$12.2 million allocated to cancer education (App. A219, A224; A456; A485-A495) and over \$2.2 million in cash to be spent for patient services and research. App. A20-A21.

### **F. The Termination of the Contract**

Prior to the expiration of the contract in 1989, UCC evaluated its options. The board's Executive Committee directed UCC's staff to solicit proposals from fundraisers other than W&H. Eventually, UCC considered contract proposals from W&H and two other fundraisers. App. A282-A283, A284, A287; A507-A511; A458-A461; A512-A517.

UCC was considerably stronger in 1989 than in 1984, when it had been on the verge of bankruptcy. By the end of the W&H contract, UCC had a \$490,000 reserve and a steady monthly income

stream. App. A144, A360, A361. In 1984, UCC had no housefile of contributors; by the end of the contract, its housefile contained over 1.1 million active names (App. A353) and had been operating profitably during the last few months of the W&H contract. App. A339-A340. Having an existing housefile and a track record of success is very important leverage in negotiating with potential fundraisers. App. A388. And UCC's board was much better informed about day-to-day operations of direct-mail fundraising/education campaigns. App. A285-A286, A360. As a result, UCC was in a much stronger negotiating position.

Notwithstanding the great financial success achieved under the W&H contract, few members of UCC's board or staff thought it should be renewed. App. A365-A366. The board was troubled by the adverse publicity resulting from UCC's association with W&H and by the criticism from UCC member agencies. Moreover, UCC's financial independence in 1989 enabled it to assume fundraising risks. App. A285, A291-A292, A384-A385. Furthermore, UCC's relations with W&H had been strained at times. In addition to disputes over accounting procedures for the campaign and the quantity of educational material to include in mailings, UCC had experienced difficulty obtaining a copy of its housefile at the end of the contract. App. A37. In fact, in 1989 UCC contemplated suing W&H to get a complete, current copy of its housefile. App. A159. Consequently, UCC's board decided to terminate the W&H contract. App. A141, A288.

#### **G. The L.W. Robbins Contract and UCC's Bankruptcy**

UCC then signed a fundraising contract with the L.W. Robbins Company, which had a good reputation and proposed less reliance on sweepstakes. App. A142, A201-A204. The new contract

required payment of all fundraising expenses in advance, thus placing UCC at risk for all costs, including the fee due L.W. Robbins. App. A142, A202, A362, A393.

L.W. Robbins projected over \$1,000,000 in net income for UCC in 1989, but the results fell far short. App. A142-147, A399. For example, the first mailing with L.W. Robbins lost \$119,000, which UCC had to pay. App. A143-A146, A203, A363, A391. L.W. Robbins' second mailing for UCC was similarly disastrous. App. A386, A393-A394. Left with mounting debts and no source of income, UCC filed for bankruptcy on June 1, 1990. App. A204-A205, A363-A364, A396-A397; App. 413 ¶ 50.

#### **H. The Retroactive Revocation of UCC's Tax-Exempt Status**

On November 2, 1990, the IRS issued a final notice revoking UCC's tax-exempt status retroactively to June 11, 1984, the date UCC entered the W&H contract. App. A441-A442. Two grounds were asserted for the decision: (1) that UCC was not operated exclusively for exempt purposes because its "activities served private commercial purposes"; and (2) that UCC "operated in large part for the private benefit of W&H." App. A41. On January 30, 1991, after the bankruptcy stay was lifted, UCC sued in the Tax Court seeking a declaration, pursuant to I.R.C. § 7428, that it qualified under I.R.C. § 501(c)(3) and was an eligible charitable donee under I.R.C. § 170(c). App. A9. At trial, the IRS added a third ground to justify the revocation: that UCC's net earnings had impermissibly inured to the benefit of private shareholders or individuals. App. A41, A44-A45.

On December 2, 1997, the Tax Court issued an opinion sustaining the revocation of UCC's tax-exempt status solely on the ground that UCC's net earnings had inured to W&H. App. A4-A54. After a lengthy recitation of the facts (App. A5-A40), the court applied an inurement analysis to the W&H

contract. App. A42. It first concluded (App. A42-A44) that W&H was an “insider” of UCC because it exercised substantial control over UCC’s finances and direct-mail fundraising campaigns (App. A44), then set about determining whether W&H’s contractual compensation was reasonable (App. A44-A49).

The court found that no-risk arrangements like the UCC/W&H contract were sometimes utilized in nonprofit fundraising (App. A46), that co-ownership of mailing lists was a typical feature of such agreements (App. A46), and that the mailing fees charged by W&H under the contract were within the range of fees charged by other direct-mail fundraisers (App. A46). Nevertheless, it concluded that W&H’s compensation under the contract was “excessive.” In so ruling, the court pointed to the absence of a termination clause under the contract and the fact that the mailing fee schedule under the pre-Addendum contract was not graduated. App. A48. The court also conducted a *post hoc* analysis of the actual results obtained under the contract. App. A47, A49. Specifically, the court rejected the argument that the large absolute number of dollars realized by UCC for use to further its purposes justified the compensation to W&H by characterizing the \$2.25 million dollars cash UCC received as “incidental” to the fundraising endeavor under the contract in light of the costs incurred. App. A49. The court also characterized W&H’s efforts to build a successful housefile for UCC “a practical failure.” *Ibid.*

The court also ruled that the IRS had not abused its discretion in making its revocation of UCC’s tax-exempt status retroactive to the date of the contract. App. A49-A50. Finally, the court expressly

declined to consider either the IRS's non-inurement theories for revocation or what portion of UCC's fundraising costs was properly allocable to its public education function. App. A50.

On January 30, 1998, the Tax Court entered decision against UCC for \$174,290 in retroactively applied taxes. App. A1-A3.

## **SUMMARY OF ARGUMENT**

### **I**

The Tax Court's holding that the payments made to W&H under the contract for the direct-mail campaign constituted prohibited private inurement justifying revocation of UCC's tax-exempt status is erroneous for several reasons.

A. The inurement doctrine is designed to prevent the insiders of a tax-exempt organization from using their position of influence or control to enrich themselves. It is analogous to the restraints against self-dealing by fiduciaries. Accordingly, while the organization is allowed to purchase goods or services from insiders, any arrangement that involves payments to an insider is carefully scrutinized, and payments that exceed a reasonable amount constitute prohibited inurement. The Tax Court gave this kind of scrutiny to UCC's contract with W&H, which would have been proper only if W&H or its principals been organizers, shareholders, or officers of UCC.

Here, however, it is undisputed that W&H was entirely independent of UCC at the time it was contacted to make a proposal to provide direct-mail fundraising services to UCC. Furthermore, the Tax

Court found that the contract that emerged from the extended negotiations between the parties resulted from arm's length bargaining. Nor is there the slightest suggestion of improper collusion to divert UCC assets or opportunities to W&H. In short, the terms of W&H's compensation were set at a time when it was in no position to subvert UCC to its own purposes, which is the concern underlying the inurement prohibition. It is for this reason that the courts have uniformly held that inurement inapplicable to outside providers of goods or services.

Even if an outside provider of goods or services could by virtue of its business arrangement with the exempt organization become an insider subject to the restriction on inurement, insider status depends on the existence of control. The Tax Court erred in concluding that W&H exercised the necessary degree of control over UCC. First, it is legally erroneous to find control simply from the exercise of rights conferred by the arm's length contract itself. Second, UCC operated entirely independently of W&H at all times. UCC retained ultimate control over the direct-mail solicitations and the funds generated thereby. Even those funds owed to W&H as reimbursement of sums advanced under the contract were not controlled by W&H but rather were deposited with an independent escrow agent, which handled them in accordance with the contract terms. Finally, the timing, scope, and content of the solicitations were at all times subject to UCC's full control, which it frequently and actively exercised. Thus, the performance of the contract afforded no basis for dubbing W&H an insider of UCC.

**B.** In addition, the Tax Court committed numerous errors in determining that W&H's compensation was unreasonable. To begin with, it neglected the well-settled principle that the terms of a contract negotiated at arm's length are presumptively reasonable. Furthermore, it ignored both the

substantial risks being assumed by W&H under the no-risk arrangement bargained for by UCC and the substantial benefits realized by UCC from dissemination of cancer education materials in the mailings, which its accounting experts, using generally accepted accounting procedures, valued at over \$12 million. Finally, the Tax Court's use of the ratio of expenses to total contributions as the touchstone of the reasonableness inquiry trenches seriously on UCC's First Amendment right to be free from regulation of its fundraising expenses.

## II

It was clear error for the Tax Court to sustain the retroactive feature of the revocation. This decision breaks entirely new ground in ruling that a service-provider operating under a contract negotiated in good faith at arm's length could by virtue of the contract itself become an insider subject to the inurement prohibition. In such circumstances, it is manifestly unfair to take adverse action retroactively against a party that could not have known that it was jeopardizing its exempt status.

### STANDARD OF REVIEW

Review of the legal standard selected by the Tax Court is plenary. *Living Faith, Inc. v. Commissioner*, 950 F.2d 365, 370-371 (7th Cir. 1991). Factual findings are reviewed for clear error. *Id.* at 371. The decision to make the revocation of tax-exempt status retroactive is reviewed for abuse of discretion. *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180, 184 (1957).

## ARGUMENT

### I. NONE OF UCC'S NET EARNINGS INURED TO THE BENEFIT OF A PRIVATE SHAREHOLDER OR INDIVIDUAL

At issue in this case is the interpretation and application of Section 501(c)(3) of the Internal Revenue Code, which defines tax-exempt organizations to include

[c]orporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, \* \* \* no part of the net earnings of which inures to the benefit of any private shareholder or individual \* \* \*.<sup>4</sup>

To qualify for an exemption under Section 501(c)(3), an organization must satisfy five criteria: (1) it must be organized and operated exclusively for one or more of the specified purposes; (2) no part of its net earnings may inure to the benefit of a private shareholder or individual; (3) no part of its activities may constitute intervention or participation in any political campaign on behalf of any candidate for public office; (4) no substantial part of its activities may consist of political lobbying; and (5) its purpose must not be contrary to public policy. *American Campaign Academy v. Commissioner*, 92 T.C. 1053, 1062-1063 (1989).

As noted, the IRS relied on three theories in seeking to justify revocation: (1) UCC did not operate exclusively for exempt purposes; (2) UCC operated for the private benefit of W&H; and (3) UCC's net

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<sup>4</sup> Eligibility as a charitable donee is governed by the identical standard. I.R.C. § 170(a)(1) allows deductions for charitable contributions, which are defined as “a contribution or gift to or for the use of \* \* \* [a] corporation, trust, or community chest, fund, or foundation \* \* \* organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes \* \* \* no part of the net earnings of which inures to the benefit of any private shareholder or individual \* \* \*.” I.R.C. § 170(c)(2)(B)&(C). The standard for inurement is the same under Sections 170 and 501. *Bob Jones University v. United States*, 461 U.S. 574, 586-587 (1983).

earnings inured to the benefit of W&H. The Tax Court sustained the IRS's action solely on the "inurement" theory. App. A49. It expressly declined to rule on the other two theories. App. A50.

The distinction between the private benefit and inurement theories is central to this appeal.<sup>5/</sup> The inurement doctrine regulates transactions between an exempt organization and an "insider" of the organization. See, e.g., HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS § 13.2, at 266 (6th ed. 1992) ("It appears relatively clear that the statutory concept of private inurement \* \* \* contemplates a type of transaction between a tax-exempt organization and an individual in the nature of an 'insider' \* \* \*."); see also App. A42. Because inurement applies only to insiders, which category is narrowly defined (see pages 33-38, *infra*), the test is inflexible and unforgiving. Even the slightest degree of inurement can forfeit tax-exempt status. See, e.g., *Orange County Agricultural Soc'y, Inc. v. Commissioner*, 893 F.2d 529, 534 (2d Cir. 1990); *Church of Scientology v. Commissioner*, 823 F.2d 1310, 1316 (9th Cir. 1987) ("The term 'no part' is absolute. The organization loses tax exempt status if even a small percentage of income inures to a private individual.").

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<sup>5</sup> Because the Tax Court refused to base its holding on the ground that UCC was not operated exclusively for exempt purposes, little ink need be spilt addressing it. We note, however, that the court was well justified in eschewing that theory. The record conclusively demonstrates that UCC acted solely to further its mission of sponsoring service to cancer victims, public education, and cancer research. The contract with W&H was intended to fund these activities. It is well settled that good-faith fundraising to further exempt purposes is itself an exempt purpose. See, e.g., *World Family Corp. v. Commissioner*, 81 T.C. 958, 963 (1983); Rev. Rul. 73-285, 1973-2 C.B. 174.

In contrast, the IRS has stated that the “private benefit prohibition applies to all kinds of persons and groups, not just to those ‘insiders’ subject to the more strict inurement proscription.” GCM 39862 (Nov. 21, 1991). Accordingly, “private benefit” analysis differs substantially from inurement analysis. See HILL & KIRSCHTEN, FEDERAL AND STATE TAXATION OF EXEMPT ORGANIZATIONS, ¶ 2.03[2], at 2-80 (1994) (“The private benefit prohibition, in contrast to the prohibition on inurement, is not absolute.”). Because the operations of any organization necessarily will result in various private benefits, tax-exempt status is safe so long as the private benefit is ancillary to the organization’s exempt activity. See, e.g., GCM 39598 (Dec. 8, 1986).

Thus, the IRS has indicated that if a “private benefit is only incidental to the exempt purposes served, and not substantial, it will not result in a loss of exempt status.” *Ibid.* For example, a charity could be found to have paid a contractor an above-market price to construct a building if the building were necessary for exempt purposes and the payment was not substantially excessive “in light of the overall public benefit” conferred by the charity. *Ibid.* In applying the private benefit test, courts have looked to whether the organization intended to confer a private benefit. See, e.g., *American Campaign Academy*, 92 T.C. at 1070 (sustaining revocation of the exempt status of a school for political campaign personnel because the school “conducted its educational activities with the partisan objective of benefitting Republican candidates and entities). Thus, a payment that would constitute forbidden inurement if accepted by an

insider of an organization may well be legitimate if paid to an outside contractor. See, e.g., *World Family Corp.*, 81 T.C. at 969; *People of God Community v. Commissioner*, 75 T.C. 127, 133 (1980).

Private benefit analysis must of necessity be more lenient than inurement analysis. Exempt organizations have neither the time nor the money to obtain expert advice and reports regarding the reasonableness of every contract with outside service providers. Application of “private benefit” analysis here would almost surely have produced a different outcome.<sup>6/</sup>

In a nutshell, the Tax Court’s fundamental error was in treating W&H as an insider even though it was solely an independent service provider compensated in accordance with the terms of a contract negotiated at arm’s length. It was therefore irrelevant whether W&H’s compensation — when examined with 20/20 hindsight — could be deemed “excessive.” In any event, the Tax Court’s conclusions that W&H exercised an insider’s control over UCC and that it derived excessive compensation under the contract are clearly erroneous when viewed from the proper perspective. Moreover, the Commissioner’s action — which subjected UCC to the ultimate penalty of retroactive revocation because its fundraising

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<sup>6</sup> The Tax Court was unwilling, despite knowing that an appeal was certain to be taken (App. A402), to invoke private benefit as an alternative ground for its holding. This strongly suggests that it understood the contract *not* to afford W&H an impermissible private benefit. And in fact no other conclusion is possible, given that the compensation provided to W&H under the fundraising contract was a necessary by-product of UCC’s ability to continue its exempt activity for the benefit of the public. See GCM 39498 (Jan. 28, 1986) (“a [permissible] private benefit must be a necessary concomitant of the activity which benefits the public at large”). Certainly the record contains no evidence that UCC entered into the contract for the purpose of benefitting W&H. The IRS’s private benefit theory also suffers from the constitutional infirmity discussed at pages 48-50, *infra*.

costs were deemed too high relative to contributions received — infringes established First Amendment principles.

**A. W&H Was Not An Insider Of UCC**

As noted above, inurement analysis is unforgiving but applicable solely to benefits derived by an organization’s insiders. The rationale for this rule is readily apparent. By virtue of their control or influence, insiders may be able to subvert an organization to their personal benefit in a way that outsiders dealing at arm’s length cannot. The decision below is contrary to uniform prior case law, which holds inurement analysis inapplicable to independent vendors of services like W&H. In addition, the Tax Court’s finding that W&H controlled UCC is clearly erroneous.

***1. An independent vendor of goods or services does not become an insider of a charitable organization by entering into a contract negotiated at arm’s length.***

Section 501 of the Internal Revenue Code limits tax-exempt status to charitable organizations “no part of the net earnings of which inures to the benefit of any private shareholder or individual.” The Tax Court sustained the revocation of UCC’s tax-exempt status on the theory that some portion of UCC’s net earnings inured to W&H. But it is undisputed that W&H was not a shareholder of UCC; moreover, as a business organization it is not an “individual.” The Tax Court’s reluctance to come to grips with the statutory language launched it on its error-strewn path.<sup>7/</sup>

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<sup>7</sup> The Tax Court’s only nod in the direction of the statutory text was to speculate (App. A42 n.25) (continued...)

The IRS has explicated the statutory language by regulation: “The words *private shareholder or individual* in section 501 refer to persons having a personal and private interest in the activities of the organization.” 26 C.F.R. § 1.501(a)-1(c) (emphasis in original). Case law refining the meaning of the inurement clause has consistently held that the “private shareholder or individual” language refers to those “insiders” of a charitable organization who are able to control its activities, such as a founder or member of the board of directors. HOPKINS, *supra*, at § 13.2; see also App. A42.

The statute’s use of the term “net earnings” in describing prohibited inurement is also highly revealing of Congressional intent. Although courts have not limited the term to its narrow, literal accounting sense, see, *e.g.*, *Church of Scientology*, 823 F.2d at 1316; *People of God Community*, 75 T.C. at 133 (“paying over a portion of *gross* earnings to those vested with the control of a charitable organization constitutes private inurement as well”), the linking of inurement to “net earnings” clearly demonstrates that the payment of good-faith expenses to outside vendors was not intended to be subjected to inurement analysis.

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<sup>7</sup> (...continued)

that “it may well be” that one or both of W&H’s owners — who are individuals — were recipients of inurement. The IRS bore the burden of proof on the inurement issue (see App. A41), and the Tax Court did not find that any compensation to W&H’s owners was excessive, nor indeed was there evidence as to what that compensation was. Moreover, even putting that aside, there is simply no evidence or finding that Messrs. Watson or Hughey, *as individuals*, possessed such control over UCC as to render them insiders.

In agreeing with the IRS that an outside contractor like W&H could receive inurement, the Tax Court ignored the uniform body of precedent holding that inurement analysis does not apply when an organization contracts at arm's length with an unrelated third party. See, e.g., *American Campaign Academy*, 92 T.C. at 1068 (“this Court has explicitly excluded unrelated third parties from the ambit of the term ‘private shareholder or individual’ in the earnings inurement context”); *Goldsboro Art League, Inc. v. Commissioner*, 75 T.C. 337, 345 (1980) (“the proscription against private inurement to the benefit of any shareholder or individual does not apply to unrelated third parties”); *People of God Community*, 75 T.C. at 133 (“[t]he term ‘private shareholder or individual’ refers to persons who have a personal and private interest in the payor organization. \* \* \* The term does not refer to unrelated third parties.”). Indeed, courts have explicitly noted that the IRS’s attempt to stretch the inurement provision of Section 501 to include outside providers of goods or services would result in a distortion of the statutory scheme: “To equate an ‘insider’ with potentially the whole community would so gut the insider test as to transmogrify it from a test of some precision in distinguishing private benefit to a test of such general application as to be useless.” *Sound Health Assoc. v. Commissioner*, 71 T.C. 158, 186-187 (1978).

The point is illustrated by *Broadway Theatre League v. United States*, 293 F. Supp. 346 (W.D. Va. 1968), a case strikingly similar in many respects to this one. The Broadway Theatre League was a nonprofit corporation organized to cultivate and promote interest in good theater in Lynchburg, Virginia. *Id.* at 347-348. In pursuit of its mission, the League contracted with a booking agent to bring quality

theater productions to Lynchburg. *Id.* at 348. The agent agreed to advance sums that would ultimately be reimbursed by the League, which reserved the power to approve the agent's expenditures; as compensation, the booking agent was entitled to 15% of the League's membership dues. *Ibid.* The League undertook to deal exclusively with the booking agent for the term of the contract. *Ibid.* The contract also provided that the booking agent had such a major interest in the League that it had the right to attempt to reorganize the League if its officers resigned or if its continued existence were in some way threatened. *Ibid.* The IRS refused to grant the League tax-exempt status unless it substantially modified its contract with the booking agent. *Id.* at 349-350. Although the League eventually acceded to this demand, it sued to recover the taxes and penalties it had paid for the period it operated under the original contract, claiming it had been entitled to tax-exempt status. *Id.* at 350-351.

In opposing the suit, the IRS argued "that the provisions of the [booking agent] contract envision such a control that it may be concluded that the League was organized and was operated for the benefit of [the booking agent]" (293 F. Supp. at 353), relying on the claim that the booking agent controlled "advertising, promotion, determination of subscription fees and campaigns for subscriptions." *Id.* at 353-354. The court found this argument "misdirected." 293 F. Supp. at 354. "The terms of the contract neither detract nor add to the exempt purposes for which the League was created. Nor, as we view the provisions of the contract, do the terms impose a controlling superstructure over the League's operation."

*Ibid.* Critical in this regard was the fact that, under the contract, the booking agent “could incur no expense on behalf of the League without prior written approval.” *Ibid.*

The court summed up its conclusion by stating:

The prohibition in Section 501(c)(3) against any benefit inuring to private shareholders or individuals clearly and without question refers to the organization contemplated in the first sentence of the statute and not to any disassociated organization such as the legal services, secretarial services, or from what we have decided, an organization like [the booking agent] who has a bona fide contractual relationship with an exempt organization.

*Id.* at 355. See also *Science & Research Found., Inc. v. United States*, 181 F. Supp. 526, 529 (S.D. Ill. 1960).

The Tax Court did not even acknowledge the existence of this uniform body of contrary rulings, much less attempt to distinguish it. Rather, it merely commented that it was “not aware of any such ‘one-free-bite’ principle in this part of the law.” App. A44. Because the court cannot have been unaware of the uniform state of the law on this point (much of which was cited in UCC’s post-trial briefs), its comment appears to reflect a concern that failure to subject UCC’s contract with W&H to inurement analysis would allow tax-exempt organizations like UCC “one free bite” with every unrelated contractor to funnel away their net earnings.

But any such concern misapprehends the nature of the overlapping organizational tests under Section 501(c)(3). Recognition that the UCC/W&H contract was not properly subject to inurement analysis would not license abuses of tax-exempt status, for such contracts would remain subject to private-

benefit analysis.<sup>8</sup> Thus, although it is difficult to imagine any great danger that an exempt organization would attempt to disperse its net earnings to unrelated vendors pursuant to contracts negotiated at arm's length, any contract resulting in a private benefit to a third-party contractor that is not properly incidental to the exempt organization's overall charitable mission can result in loss of exempt status.

Because the Tax Court assessed the UCC/W&H contract under the wrong legal standard, its judgment must be reversed.

***2. Even if a third-party vendor could become an insider through an arm's length contract, the Tax Court clearly erred in finding that W&H had the requisite degree of control over UCC's affairs.***

The Tax Court summarized its conclusion that the IRS had carried its burden of proving that W&H was a UCC insider as follows (App. A44):

From a practical standpoint, W&H exercised substantial control over petitioner's finances and direct-mail fundraising campaigns during the period from 1984 through 1989. In light of W&H's extensive control over petitioner and petitioner's near-insolvent financial condition when the fundraising arrangement was entered into in June 1984, we conclude that W&H was an insider with respect to petitioner.

Even were the Tax Court right to look at the question of control as the touchstone for applying inurement analysis, its conclusion that the contract gave W&H control over UCC's affairs was clearly erroneous.

This was an issue, as the Tax Court recognized (App. A41), on which the IRS bore the burden of proof.

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<sup>8</sup> As previously noted (page 32 n.6, *supra*), the W&H contract would easily survive a private benefit analysis. "The terms of the contract neither detract nor add to the exempt purposes for which [UCC] was created." *Broadway Theatre League*, 293 F. Supp. at 354.

See Tax Court Rule 217(c)(2)(B). The IRS failed to carry that burden for at least three reasons: first, control must be evaluated as of the time the contract was negotiated; second, because any “control” W&H had was limited in scope and confined to the task assigned to it, *i.e.*, direct-mail fundraising, it could not suffice to render W&H an insider; and third, UCC in fact retained (and exercised) comprehensive oversight with respect to the fundraising campaign as well.

a. As the quote indicates, the Tax Court assessed control on the basis of the powers conferred upon W&H by the contract itself. But this put the cart before the horse. The purpose of the ban on inurement is to prevent insiders from utilizing their position with the organization to divert economic benefits to themselves — for example, to pay themselves excessive amounts for providing fundraising services. This W&H could not have done, for the terms of its compensation were set by a contract negotiated at arm’s length (App. A44) at a time when, all agree, W&H was not an insider. By definition, one cannot negotiate at arm’s length with an insider. Because the Tax Court examined insider status at the wrong point in time, it committed clear error.<sup>9/</sup>

b. Second, the record refutes the Tax Court’s conclusion (App. A44) that W&H had “extensive control over” UCC. To begin with, it is unambiguously clear that W&H had no say, formal or informal,

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<sup>9</sup> Although the parties later executed an Addendum to the contract, at a time when application of the Tax Court’s analysis (whatever its other flaws) would not constitute illogical bootstrapping, the Tax Court correctly eschewed it as a source of inurement to W&H, since the Addendum was indisputably reasonable and was executed principally for UCC’s benefit. See App. A43.

in how UCC pursued its public health objectives or how it used its net earnings under the contract.<sup>10</sup> Only in the relatively narrow area of direct-mail fundraising did W&H have any input at all, and even there control ultimately rested with UCC.

The Tax Court relied (App. A43) upon UCC's supposed lack of control over the funds raised in the direct-mail campaigns. But, of course, because W&H advanced campaign expenses and draws for UCC's operations, substantial portions of those funds *belonged to W&H*. The fact that UCC did not enjoy unfettered access to them no more gave W&H control over UCC than the fact that a bank places construction loan funds in an escrow account to ensure their disbursement only for the purposes of the loan gives the bank control over or makes it an insider in the borrower's business. In any event, it was the independent escrow agent (WIB), not W&H, that controlled disbursement of the funds, which it did in accordance with the contract and subject to the approval of UCC. Finally, the record reflects that UCC in fact exercised increasing and effective oversight of the disbursement of the funds. See pages 18-20, *supra*.

The Tax Court also relied (App. A43) on the fact that UCC had difficulty obtaining a copy of its housefile from W&H during the waning months of the contract. That is true, but UCC refused to acquiesce in this breach of contract; instead, it insisted upon, and eventually vindicated, its contractual rights. App.

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<sup>10</sup> According to the Tax Court (App. A47), UCC "netted" about \$2.25 million cash from fundraising efforts under the contract. No one suggests that even one penny of those net earnings inured to the benefit of W&H.

A44. W&H's improper refusal for a period of time to comply with its contractual obligation no more shows control than would the unwillingness of a burglar to return stolen funds show the burglar's "control." See *Variety Club Tent No. 6 Charities, Inc. v. Commissioner*, T.C. Memo 1997-575, 1997 Tax Ct. Memo LEXIS 660, \*35 (Chabot, J.) ("we do not believe that the Congress intended that a charity must lose its exempt status merely because a president or a treasurer or an executive director of a charity has skimmed or embezzled or otherwise stolen from the charity, at least where the charity has a real-world existence apart from the thieving official"). Indeed, the insistence by UCC on receiving what it was due under the contract — to the point of threatening legal action against W&H — underscores the independence of UCC. Thus, the housefile incident negates rather than confirms any suggestion that W&H was a controlling insider.

c. Finally, the record does not even support the Tax Court's conclusion that W&H exercised substantial control over the fundraising campaign itself. The contract expressly provided that every aspect of the fundraising campaign was subject to the ultimate approval and control of UCC. App. A56 § 3. As the court in *Broadway Theatre League* noted (293 F. Supp. at 354), a contractor cannot be said to have control over an organization that has approval power regarding every action taken on its behalf. That logic certainly applies in this case, in which the record amply reflects (and the Tax Court did not find otherwise) that UCC exercised active — indeed, pervasive — supervision of W&H's fundraising activities. See *supra* pages 18-20.

The Tax Court never defined the nature of its control test, and it applied the test in an arbitrary manner. The degree of control necessary to render an outside vendor an insider of an exempt organization must be broad and pervasive, not the delegated control over a narrow area that a principal grants to an agent. In sum, the Tax Court's conclusion that W&H impermissibly controlled UCC is unsupported by the record and therefore clearly erroneous.

**B. The Compensation Provided W&H Under The Contract Was Reasonable**

Even if W&H were an insider to which inurement principles could properly be applied, the Tax Court's judgment still must be reversed. That is because tax-exempt organizations are permitted to enter into contracts even with their own insiders, so long as unreasonable compensation is not paid. "It is well established that an exempt organization is entitled to pay reasonable compensation for services without endangering its exemption. Such payments are permissible even though they are made to the organization's trustees, officers or founders; the issue is whether the payments are reasonable." *World Family Corp.*, 81 T.C. at 968.

The compensation paid to W&H under the contract was reasonable. First, a contract negotiated at arm's length with an unrelated vendor provides reasonable compensation as a matter of law. Second, the Tax Court's finding of unreasonable compensation is clearly erroneous because it ignored the nature of the risks assumed by W&H and the benefits enjoyed by UCC under the contract. Finally, the Supreme Court has held that the First Amendment prohibits the standard less approach employed by the Tax Court in this case. The finding of inurement by the Tax Court must therefore be reversed.

***1. A contract negotiated at arm's length with an unrelated vendor provides reasonable compensation as a matter of law.***

In determining whether a contract entered into between an exempt organization and an insider is reasonable, courts will evaluate reasonableness by using as the standard of comparison contracts negotiated at arm's length with unrelated vendors. See, e.g., *Church By Mail v. Commissioner*, 765 F.2d 1387, 1392 (9th Cir. 1985); *B.H.W. Anesthesia Found., Inc. v. Commissioner*, 72 T.C. 681, 686 (1979); HOPKINS, *supra*, at 50 (1997 Supp.). Accordingly, where, as here, the contract at issue *is* negotiated at arm's length with an unrelated vendor, it is presumptively reasonable, at least in the absence of extraordinary circumstances compelling a contrary conclusion.

The IRS has recognized this presumption. Rev. Rul. 76-91, 1976-1 C.B. 149 states:

Generally, where an organization purchases assets from an independent third party, a presumption exists that the purchase price (arrived at through negotiations) represents fair market value. However, where the purchaser is controlled by the seller (or there is a close relationship between the two) at the time of the sale,<sup>[11]</sup> this presumption cannot be made because the elements of an arm's length transaction are not present.

IRS regulations confirm the point. In assessing reasonableness under the inurement provision, “[f]actors similar to those considered in determining reasonableness under section 162(a)(1) are examined.” App. A45. The regulations concerning reasonableness of contingent compensation for services under that section state:

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<sup>11</sup> As previously noted (page 39, *supra*), W&H did not control UCC when the contract was negotiated and executed.

Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

26 C.F.R. § 1.162-7(b)(2).

The reason for this strong presumption is obvious. Any other rule would have an absurdly broad reach, permitting the IRS to subject every transaction by a tax-exempt organization to a searching retrospective review and to revoke on grounds as trivial as that the organization could have purchased its paper clips more cheaply at a discount supply store. While the IRS doubtless would insist that it would not abuse its discretion in such a fashion, still this sweeping standard would vest it with such broad powers as to make possible revocations nominally on account of inurement but actually infected by discriminatory animus against disfavored viewpoints and causes.

The Tax Court purported (App. A48) to recognize the presumption of reasonableness in this case but opined that the presumption was not conclusive and that it was required to consider “all the circumstances.” But it then identified no circumstances to counteract the presumption other than its general impression of the record. App. A49. Nor are there any. Accordingly, the presumption of reasonableness accorded arm’s length contracts governs here and requires reversal of the judgment as a matter of law because the reasonableness of W&H’s compensation also dictates the result of a “private benefit” analysis.

**2. *The Tax Court clearly erred in finding W&H's compensation under the contract "excessive."***

Although finding (1) that no-risk contracts were a form of agreement utilized in nonprofit fundraising, (2) that co-ownership of mailing lists was a typical feature of such arrangements, and (3) that the mailing fees charged by W&H were within the range of fees charged by other direct-mail fundraisers (App. A46), the Tax Court nonetheless concluded, primarily on the basis of a summary of the financial results achieved (App. A47), that W&H's compensation under the contract was "excessive" (App. A48).

The Tax Court's analysis of the reasonableness of W&H's compensation under the contract is clearly erroneous, whether viewed (as it should have been) from the outset or even when assessed in retrospect. The court gave no consideration to the magnitude of the risks borne by W&H under the contract or the extent to which those risks warranted higher compensation. The court also gave no weight to the educational benefits of the mailings under the contract. These clear errors fatally infected its conclusion.

The Tax Court's primary objections to the contract appear to be that it failed to provide for an early termination and that the pre-Addendum mailing fee schedule was not graduated. App. A48. But the court failed to compare the contract to any other in which a fundraiser assumed a risk of equal magnitude. The contract committed W&H (1) to protect UCC from suffering a financial loss from the fundraising effort, (2) to advance postage expenses, and (3) to allow UCC to draw operating funds (provided by W&H) in advance of receipt of contributions. No other contract in the record subjected a fundraiser to that degree

of risk.<sup>12/</sup> Given that, it was entirely reasonable for W&H to insist upon a contract term lengthy enough to enable UCC's direct-mail campaign to reach a level of maturity at which W&H might expect to receive payment for its services. Moreover, although UCC could not terminate the contract prior to the end of the five-year period, it retained a highly effective method of limiting W&H's total compensation — it could refuse to authorize further mailings.

In finding the contract unreasonable, the Tax Court relied primarily on a retrospective analysis of total compensation paid and results achieved. Undertaking that analysis at all was legal error, see 26 C.F.R. § 1.162-7(b)(3), but the court also made at least two other specific mistakes in conducting its flawed analysis.

First, the Tax Court appears to have valued the benefit to UCC at only \$2.25 million, the amount of money it received “for its own uses unrelated to the Contract.” App. A47. The court inexplicably ignored the \$12.2 million allocated by UCC's accounting expert to the distribution of cancer-related information to the public, which directly served UCC's charitable and educational purposes. While the appropriateness of this allocation was challenged, the Tax Court simply chose to disregard the allocation issue (see App. A50); instead, it indefensibly ascribed *no benefit whatever* to the educational component

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<sup>12</sup> The Tax Court's observation (App. A47) that W&H could at some point have limited its risk by reducing or eliminating draws and advances of operating funds and postage misses the point. By the time such action, potentially fatal to UCC, would have become necessary, W&H would already have placed a sizeable investment at risk. It was certainly entitled to be compensated for this risk.

of the 79.6 million letters distributed throughout the country during the direct-mail campaign. That approach to measuring contract benefits to UCC was utterly unreasonable.

The Tax Court also peremptorily dismissed the point that the net proceeds to UCC of \$2.25 million (many times its pre-contract income) enabled it to aid cancer victims on a far larger scale than had previously been possible, thus rendering the fundraising operation a substantial success from its perspective that justified the compensation paid to W&H. The court responded with the following comment (App. A49):

The \$2 1/4 million is so small in comparison to the amounts of contributions, of W&H compensation, of postage and shipping costs, of printing and publications costs, as to be almost an incidental product of the fundraising campaign[.]<sup>13/</sup>

Thus, the basis for the Tax Court's finding that W&H's fee was unreasonable was its disapproval of UCC's ratio of expenses to contributions — in effect penalizing UCC for being a small charity struggling to convey its message against the powerful and established charities in the cancer area. Not only does that analysis fail to justify the conclusion of excessive compensation on its own terms, its use violates UCC's First Amendment rights.

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<sup>13</sup> The Tax Court also commented (App. A49) that W&H's services were a "practical failure" in not providing a productive housefile for UCC. This too was manifestly in error, given the financial successes of mailings made to UCC's housefile during the final months of the W&H contract. The fact that a successor fundraiser failed to utilize the housefile as effectively as UCC did under W&H's guidance hardly establishes that W&H was overcompensated.

### 3. *The First Amendment prohibits the Tax Court's arbitrary approach.*

In three landmark cases, the Supreme Court has established that charitable solicitations constitute speech subject to the full protection of the First Amendment. See *Riley v. National Federation of the Blind*, 487 U.S. 781 (1988); *Maryland v. Joseph H. Munson Co.*, 467 U.S. 947 (1984); *Village of Schaumburg v. Citizens for a Better Environment*, 444 U.S. 620 (1980). Those cases also hold that government cannot regulate protected speech on the basis of what it may deem to be unreasonable fundraising expenses in relation to donations. See *Riley*, 487 U.S. at 784. In short, those cases condemn precisely the approach adopted by the Tax Court here.

In *Schaumburg*, the Court confronted a municipal law that prevented charities from soliciting contributions unless at least 75% of gross donations were used directly for charitable purposes. 444 U.S. at 624. Concluding that the law placed a direct and substantial limitation on protected speech, the Court subjected it to strict scrutiny. *Id.* at 636. Rejecting the municipality's justification that charities with high fundraising costs are inherently fraudulent, the Court struck down the statute. *Id.* at 639.

In *Munson*, a professional fundraiser challenged a Maryland law that prohibited charities with fundraising expenditures exceeding 25% of gross contributions from soliciting funds unless the charity could show that the restriction would effectively prevent it from raising contributions. 467 U.S. at 950-951. Observing that there was a "tenuous connection between low fundraising costs and a valid charitable endeavor" (*id.* at 967 n.15), the Court struck down the Maryland statute as unconstitutionally overbroad. *Id.* at 970.

Perhaps most directly on point is *Riley*, which dealt with a North Carolina statute prohibiting professional fundraisers from retaining an “unreasonable” or “excessive” fee. 487 U.S. at 784. The Supreme Court recognized as legitimate and constitutionally protected the very feature relied on by the Tax Court to condemn UCC:

[T]here are several legitimate reasons why a charity might reject the State’s overarching measure of a fundraising drive’s legitimacy -- the percentage of gross receipts remitted to the charity. For example, a charity might choose a particular type of fundraising drive, or a particular solicitor, expecting to receive a large sum as measured by total dollars rather than percentage of dollars remitted. \* \* \* [A] charity may choose to engage in the advocacy or dissemination of information during a solicitation \* \* \*.

*Id.* at 791-792. In striking down the statute, which presumed that fundraising costs higher than 35% of contributions were unreasonable, the Court also observed that “the Act is impermissibly insensitive to the realities faced by small or unpopular charities, which must often pay more than 35% of the gross receipts collected to the fundraiser due to the difficulty of attracting donors.” *Id.* at 793.

In this case, as in *Riley*, government regulation is subjecting a charity to discriminatory treatment based on its fundraising costs. It is of no moment that the present case involves the denial of a tax exemption rather than direct regulation. Although it is certainly true that tax exemptions are a matter of legislative grace and are not a constitutional right, *Regan v. Taxation with Representation*, 461 U.S. 540 (1983), it is equally true that legislatures may not allocate their grace in a manner that discriminates on the basis of activity protected by the First Amendment. *Speiser v. Randall*, 357 U.S. 513, 518 (1958); *Nationalist Movement v. Commissioner*, 102 T.C. 558, 589, *aff’d*, 37 F.3d 216 (5th Cir. 1994).

The Tax Court disapproved of UCC's high fundraising costs, and it found the compensation paid to UCC's fundraiser "excessive" based on those costs. But the use of expense ratios as a proxy for reasonableness is precisely what *Riley* forbids. Of course, the fact that the Tax Court relied not on any objective criteria but on its visceral reaction in concluding that UCC's fundraising costs were too high makes its ruling all the more problematic under the First Amendment. See *Living Faith v. Commissioner*, 950 F.2d 365, 376 (7th Cir. 1991); *Big Mama Rag v. United States*, 631 F.2d 1030, 1035 (D.C. Cir. 1980).

The Tax Court interpreted I.R.C. § 501(c)(3) in such a manner as to make UCC's entitlement to retain its exempt status turn on the perceived reasonableness of its fundraising costs. At a minimum, that interpretation calls into serious question the constitutionality of Section 501(c)(3), as applied in this case. "A statute, of course, is to be construed, if such a construction is fairly possible, to avoid raising doubts of its constitutionality." *St. Martin's Evangelical Lutheran Church v. South Dakota*, 451 U.S. 772, 780 (1981). This Court should reject the Tax Court's interpretation of Section 501(c)(3) and reverse its attempt to deprive UCC of its tax-exempt status discriminatorily on the basis of its fundraising costs.

## **II. THE IRS ABUSED ITS DISCRETION IN REVOKING UCC'S TAX-EXEMPT STATUS RETROACTIVELY TO THE DATE OF THE W&H CONTRACT**

Even if the revocation of UCC's tax-exempt status were sustainable, the decision to make the revocation retroactive to the beginning of the contract is untenable. The IRS has discretion to revoke tax-exempt status retroactively, but it must "limit retroactive application to the extent necessary to avoid inequitable results." *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180, 184 (1957). This

Court has articulated two factors in reviewing retroactive action by the IRS: the extent to which the taxpayer justifiably relied on prior settled law; and whether retroactive application would create an inordinately harsh result. *Gehl Co. v. Commissioner*, 795 F.2d 1324, 1332 (7th Cir. 1986). Both factors indicate an abuse of discretion in this case.

Fourteen years ago, when UCC entered its contract with W&H, the law appeared clear that a contract negotiated at arm's length with an unrelated third-party vendor could not result in private inurement. The inurement argument certainly did not occur to the IRS at the time it retroactively revoked UCC's tax-exempt status. Indeed, the law of inurement remained clear and unchanged until the day the Tax Court decided this case. UCC's board can hardly be faulted for having relied on this established and uniform state of the law.

In addition, many of the facts on which the Tax Court relied to find inurement — including its emphasis on the actual financial results under the contract — arose only during or after the course of performance of the contract. Only if the mere entry into such a contract violated the inurement prohibition can it possibly be rational to make the revocation retroactive to the contract date.

This case has been viewed as a “test case” in which the IRS is seeking to make dramatic changes in the law. See App. A391.1. Such test cases are poor vehicles for imposing massive liabilities in the form of retroactively applied taxes and interest. Doing so here would certainly create an inordinately harsh result, and the IRS abused its discretion in concluding otherwise.

### **III. THE IRS'S ASSESSMENT OF RETROACTIVE TAXES MUST ALSO BE REVERSED**

This case is a consolidated appeal. Case number 98-2190 is an appeal from the Tax Court's decision sustaining the IRS's retroactive revocation of UCC's tax-exempt status. Case number 98-2181 is an appeal from the decision of the Tax Court in the related case imposing liability on UCC for income taxes in the taxable years 1986 and 1987. If the Court reverses or vacates the decision in the case determining UCC's tax-exempt status, it should similarly reverse or vacate the decision in the related deficiency case, which was expressly predicated on the conclusion in the status case. See App. A2-A3.

### **CONCLUSION**

The Court should reverse the Tax Court's decisions and direct entry of an order that UCC is an organization described in I.R.C. § 501(c)(3) and is an eligible charitable donee under I.R.C. § 170(c)(2).

Respectfully submitted,

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