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All About UBIT: What Nonprofit Leaders Need to Know

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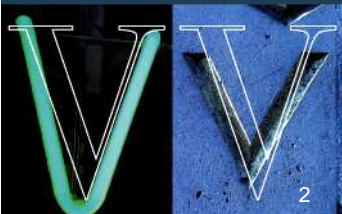
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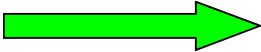



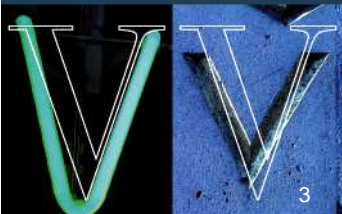
What is Unrelated Business Income?

- What is unrelated business income?
- What is excluded from unrelated business income?
- Explanation of specific UBI exceptions
 - Sponsorship income
 - Licensing income
 - Royalty income
- Cause-related marketing



UBIT Basics

- General Rule  Organization recognized as exempt does not pay income tax on income received by organization
- Exception  If the income received is unrelated business income (UBI or UBTI), subject to taxation; organization must report and pay tax at corporate rate



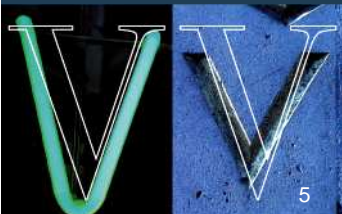
“The term ‘unrelated trade or business’ means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 ...”

Internal Revenue Code Section 513



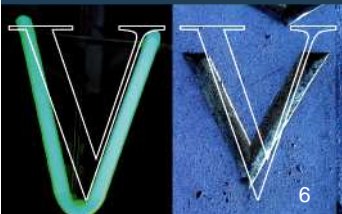
1. Trade or Business

- Profit motive – but actual profit doesn't matter
- Does the activity resemble those done by taxable commercial entities?
 - *C.F. Mueller Co.* case – law school-owned pasta manufacturer
- Does exemption provide an unfair competitive advantage in light of activity?



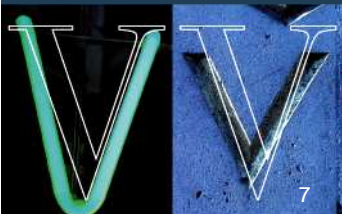
2. Regularly Carried On

- Compared to frequency with which commercial activity is carried on by taxable entities
- *National Collegiate Athletic Association v. CIR* – advertising for program booklets for tournament over three weekends not frequent enough although advertising sales took place over several months
- Compare to *Veterans of Foreign Wars, Michigan v. CIR* – selling Christmas cards was unrelated because it was an intermittent business/seasonal business and the seasonal participation was regularly carried on



3. Not Substantially Related to Exempt Purpose

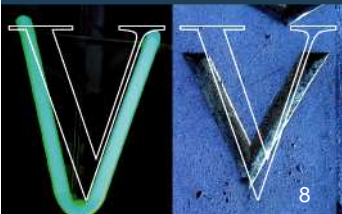
- Need for income is not enough
- Association context – exempt purpose directed toward the improvement of members' business conditions; activities to benefit members as a whole instead of individual businesses
- Rev. Rul. 81-138 - Chamber of Commerce's lease of building below market rent to industrial tenant to spur economic development found to be substantially related to exempt purpose



Is the Income Taxable?

- Unrelated Business Income Tax (UBIT)
 - It is a trade or business,
 - It is regularly carried on, and
 - It is not substantially related to furthering the exempt purpose of the organization

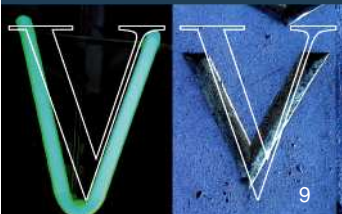
- Income that is usually UBIT
 - Advertising income
 - Rents received from debt financed property
 - Flow through profits from certain controlled entities
 - Income received for the performance of services in exchange for tangible goods



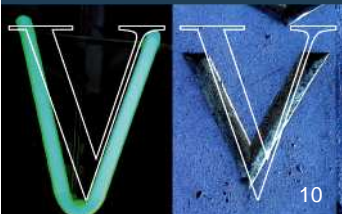
Is the Income Taxable?

- Income that is generally excluded from UBIT
 - Passive income
 - Passive investment income
 - Donations

- Income that is specifically excluded from UBIT
 - Interest income
 - Royalty income
 - Certain research income
 - Conference and trade show revenue
 - Qualified sponsorship income
 - Certain bingo games
 - Debt management plan services
 - Renting mailing list to another charitable organization



UBIT Exceptions: Qualified Sponsorship Income



Corporate Partnerships Maximizing Income

Qualified Sponsorship Payments

IRC Section 513(i)

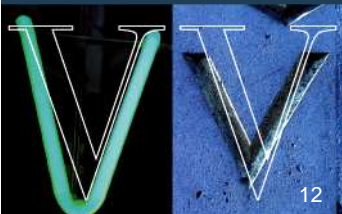
- Safe Harbor - no arrangement or expectation that the payor will receive a substantial return benefit (valued at 2% or less of sponsorship payment)
 - Other than the use or acknowledgment of the name or logo (or product lines) of the payor's trade or business in connection with the tax-exempt organization's activities
 - Applicable to broad range of activities, excluding:
 - » Tradeshow and convention
 - » Advertisement or acknowledgment in regular periodicals (journals, e-newsletters, etc.)
 - » Contingent payments



Illustration

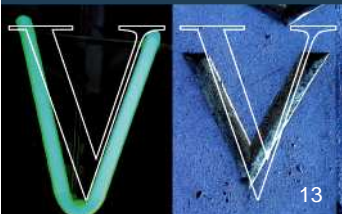
Hix Corporation makes \$5,000 gift to the Good Deeds Foundation (2% = \$100)

- Ex. 1 - \$ 60 Return Benefit – Safe Harbor
 - \$20 educational event tickets
 - \$30 advertising in event program
 - \$10 board dinner
- Ex. 2 - \$150 Return Benefit – No Safe Harbor
 - \$50 licensing rights (not taxed, passive royalty)
 - \$50 educational event tickets (not taxed, related)
 - \$50 advertising in event program (taxed at market rate)



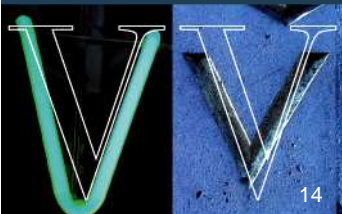
Analyzing Benefits

1. Acknowledgment or Advertising?
2. Eligible for Safe Harbor?
3. Determine Value of “Eligible” Benefits



1. Acknowledgment or Advertising?

- Acknowledgement
 1. Name or logo
 2. Description of Services/Product Lines, as long as use is not qualitative or comparative
 - But slogans which are an established part of identity are permissible
 3. Contact Information, including list of sponsor's location, telephone number, and/or Internet address, including a hyperlink from the exempt organization's website to the sponsor's website
 4. Product displays, visual depictions, product samples (whether products are sold or are free)
- Advertisement
 - Qualitative or comparative, price information, indications of savings or value, endorsements, inducement to purchase



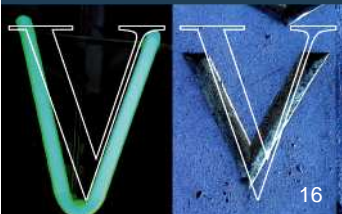
Illustrations - Acknowledgement

- Name and Logo on Functional Items: Use of sponsor's name and logo on advertisements for events (Reg. § 1.513-4(f), Ex 1); event programs, cups used at event, helmets and jerseys on players (Ex 4)
- Naming of Events: "Coca-Cola Young Scholar's Program" (TAM 9805001)
- Website Listing: List of sponsor names on website, including hyperlink to sponsor's site (PLR 200303062)



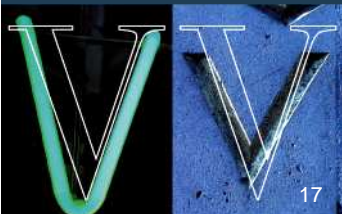
Illustrations - Acknowledgement

- Product Display: Displays of automaker sponsor's cars at event (Reg. § 1.513-4(f), Ex 11)
- Established Part of Company's Identity: "Better Research, Better Health" (Reg. § 1.513-4(f), Ex 9)
- Exclusive Sponsors – Right to be sole sponsor of an event, or exclusive sponsor among competitors (Reg. § 1.513-4(f), Ex 4)



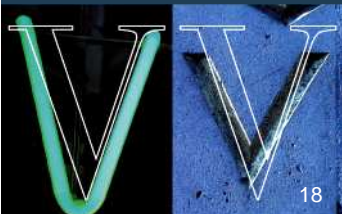
Illustrations - Advertising

- Name and Logo on Unrelated Items: Sponsor name on souvenir flags (purchased by the tax-exempt entity) bearing sponsor's name, for use by sponsor's employees (Reg. § 1.513-4(f), Ex 5)
- Call to Action:
 - “For your music needs, give our sponsor a call today” (Reg. § 1.513-4(f), Ex 7)
 - “Visit our sponsor today for the finest selection of music CDs and cassette tapes” (Reg. § 1.513-4(f), Ex 8)



Illustrations - Advertising

- Comparative Language: “language is used comparing R's product with the products of other manufacturers, or claiming that it is rated best by veterinarians” (TAM 9805001)
- Endorsement: “We endorse sponsor’s drug and suggest you contact your physician for a prescription” (Reg. § 1.513-4(f), Ex 12)
- Weblink to Sales Page: Link from tax-exempt’s sponsor acknowledgment page to sponsor’s sales ad
 - 2000 EO CPE, the IRS stated that “a moving banner is probably more likely to be classified as an advertisement”



2. Eligible for Safe Harbor?

Safe harbor does not apply to (apply regular analysis):

- Over 2% – Sponsorship payments where return value is over 2%
- Contingent Payments – Where level of payment depends on attendance, web hits, etc. (not if contingent on event occurring)
- Exclusive Provider Arrangements – Right to be exclusive provider of soft drinks (Reg. § 1.513-4(f), Ex 6)



2. Eligible for Safe Harbor?

Convention and trade show (exhibit booths, tickets to trade show, acknowledgment at trade show, etc.)

Advertising or acknowledgement in regular periodical

- Illustration: A textbook publisher makes a large payment to have its name displayed on the inside cover of a monthly magazine (Reg. § 1.513-4(f), Ex 10)
 - Includes online periodicals
 - Safe Harbor DOES apply to periodical primarily distributed in conjunction with a specific event
- Public Interest Advertising – “You will not realize (UBIT) when you acknowledge the donations with public interest advertising (where the) advertisements acknowledge the contributing organizations' sponsorship of the N project” consistent with corporate sponsorship rules (PLR 8749085)



3. Determine Value of Eligible Benefits

Valuation Period

- Valuation is applied to each tax year of a multi-year agreement – impacts pay up-front agreements

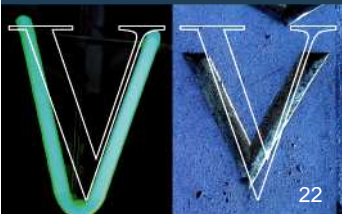
Valuation Date

- If a contract specifies the (good faith and reasonable) “market value,” then the valuation date is the date of the contract
 - Resets if there is a material change, including renewal or extension
- If no contract, then the date that a benefit is provided

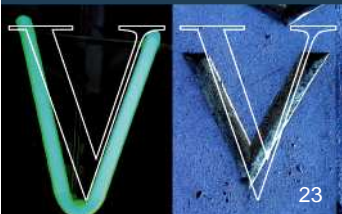


Essentials for Sponsorship Contracts

- Specify exact form of acknowledgment
- Specify all return benefits
- Specify value of taxable benefits
- Have right to approve any copy relating to sponsorship, or using tax-exempt's name/logo
- Specify site to which hyperlinks will link

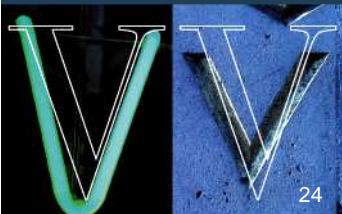


UBIT Exceptions: Royalty Income



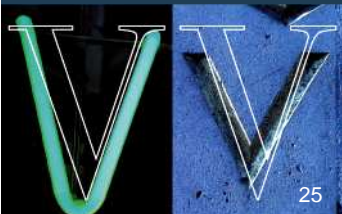
Specific Exclusions - Royalties

- Passive royalty income is excluded from UBI
- What is a Royalty?
 - “Payments received for the right to use intangible property rights and that such definition does not include payments for services” *Sierra Club v. Commissioner*
- Components
 - Name, mark and mailing list
 - Third-Party Product
 - e.g. affinity card, not medical journal
 - No active promotion (or quantify value and pay tax)
 - Announcement letter okay
 - Quality control measures okay



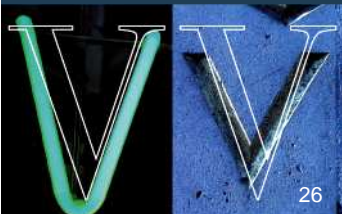
Royalties – License of Name or Logo

- General rule: The less an organization does the more likely income is to be characterized as royalty income
- Evidence of royalty relationship:
 - Payment relates to use of a valuable right
 - Organization's activities are generally limited to those necessary to protect its reputation
 - Review use of logo for quality and style
 - Limit the use of logo to approved circumstances
- Evidence of other (usually service) relationship:
 - Personal service component to relationship (*i.e.*, appearance or endorsement requirement)
 - Significant activities or rights such as approval of editorial content and preparing articles in a publication
 - Existence of a quid pro quo transaction



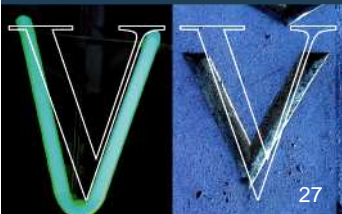
Royalties – License of Name or Logo

- IRS has taken a strict position with royalty income
- Dual purpose relationships:
 - If service component minimum – likely not an issue
 - If service component significant
 - IRS will likely determine that none of the income is royalty income
 - Courts have looked to the entire relationship



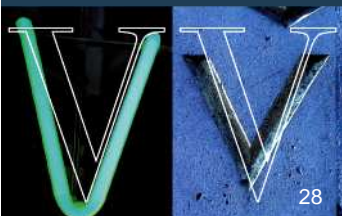
Royalties – License of Name or Logo

- Dual purpose relationships best practices:
 - IRS would prefer two separate agreements, usually not necessary
 - Clearly identify and bifurcate the royalty and service payments in the agreement
 - Be reasonable
 - Do not title the agreement “Service Agreement”



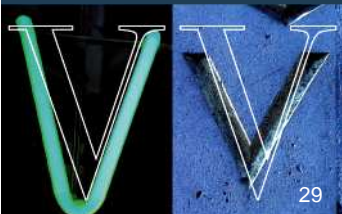
Royalties – Mailing List Rental

- Income from rental of mailing list to exempt organization is excluded for UBIT under Code
- Rental of mailing list to taxable entities is excluded from UBIT as royalties
- Courts have looked to whether the agreement requires “significant” activities – usually problems are the result of promotional or endorsement activities
- Are your organization’s mailing lists marketed to specific organizations or entities or sorted to meet the particular needs of a taxable entity? This could be problematic



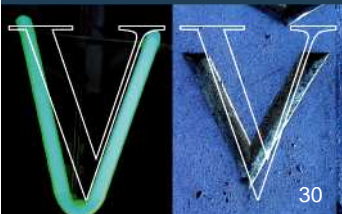
Royalties – Mailing List Rental

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Royalties – Affinity Card

- Courts have ruled that payments received by organizations through affinity card relationships are for valuable intangible property – the organization’s name, logo, and mailing lists
- The issue is whether an organization is receiving a payment for the goodwill associated with the organization’s name and logos or a payment for promotional and mailing list management services
- Courts have held that the amount of services does matter

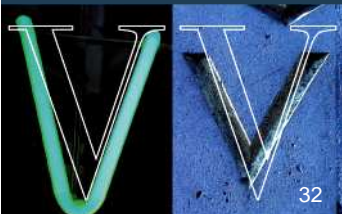


Cause-Related Marketing



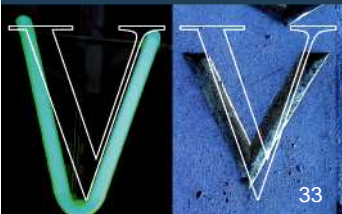
Cause Marketing

- Attributes
 - Commercial entity uses your name or logo in its advertisements with promise to pay a portion of purchase price to you
 - Passive
 - Lack of control
- Rewards
 - Increased donations
 - Increased awareness of your organization
- Risks
 - No control over where advertisements are displayed
 - Possible state reporting requirements
 - Problems with having underlying product associated with your organization



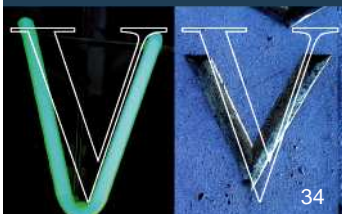
Commercial Co-Ventures

- Commercial Co-Venture (“CCV”) – An arrangement between a charity and a commercial entity under which the commercial entity advertises in a sales or marketing campaign that the purchase or use of its goods or services will benefit a charity or charitable purpose
- *“When you buy our new iPhone app, 50% of the purchase price will go to the Lincoln Center!”*
- Frequently referred to as “charitable sales promotions” or “cause-related marketing”
- Excellent fundraising and marketing mechanism for both the charity and commercial co-venturer



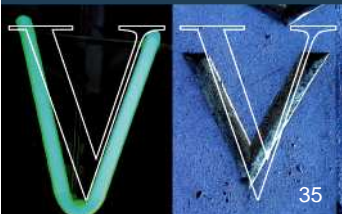
Regulation of Commercial Co-Ventures: State Law

- More than 40 states have laws that regulate various methods of fundraising, including charitable solicitations and CCVs
- About 20 states have laws that specifically regulate CCVs
- Purpose of laws – consumer protection
- Ex: General Mills/Yoplait “*Save Lids to Save Lives*” campaign in late 1990s to Benefit Breast Cancer Research Foundation
 - GA Secretary of State concluded that the disclosures regarding the donation amount were misleading to consumers (GA Secretary of State press release: <http://sos.georgia.gov/pressrel/pr991221.htm>)



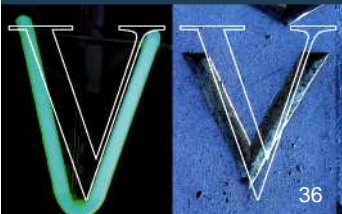
Regulation of Commercial Co-Ventures: State Law

- Statutory language and requirements vary by state → always check language of the statute
- NY definition of “commercial co-venturer” is fairly standard:
 - “Any person who for profit is regularly and primarily engaged in trade or commerce other than in connection with the raising of funds or any other thing of value for a charitable organization and who advertises that the purchase of goods, services, entertainment, or any other thing of value will benefit a charitable organization.” [N.Y. Exec. Laws § 171-a]
- Compare with broader MA statute:
 - “[A]ny person who for profit or other commercial consideration conducts, produces, promotes, underwrites, arranges or sponsors a performance, event, or sale to the public of any good or service which is advertised in conjunction with the name of any charitable organization or as benefitting to any extent any charitable purpose.” [Mass. Gen. Laws ch. 68, § 18, 22-28]



Regulation of Commercial Co-Ventures: State Law

- State Law Requirements, Generally:
 - Registration
 - Bonding
 - Written Contract
 - Advertising Disclosures
 - Accounting & Recordkeeping
- Registration – Several states require advance registration by co-venturer, including AL, HI, IL, MA, ME and SC
- Bonding – A few states, including AL, MA and ME require the co-venturer to obtain a surety bond



Regulation of Commercial Co-Ventures: State Law

■ Written Contract

- Many states (including NY and NJ) require a written contract, which must be filed with the state by co-venturer
- Handful of states (including AR, CT, NH and UT) require the charity to file a copy of the contract. Some states require specific terms to be included in contract, including:
 - Identification of charity or charitable purposes benefited
 - Description of sales promotion, including goods/services and estimated number to be sold
 - Description of offer to be made to the public regarding amount to be given to charity [N.Y. Exec. Law § 170-b(2)]
 - Terms relating to charity's right to cancel [N.Y. Exec. Law § 174-a]
 - Charity authorization, e.g., MA requires the signatures of 2 officers [Mass. Laws Ch. 68 § 22(a)]
 - Location, start, and end dates of sales promotion
- Both parties must keep a copy of the contract



Regulation of Commercial Co-Ventures: State Law

■ Advertising Disclosures

- Ads must disclose anticipated portion of the sales price, % of the gross proceeds, dollar amount per purchase, or other consideration or benefit received by charity [N.Y. Exec. Law § 174-c]
- Some states require disclosure on a per-unit basis

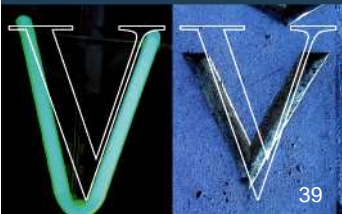
■ Accounting & Recordkeeping

- Most states require commercial co-venturers to keep records, provide the charity (and sometimes the state) with a final accounting of the campaign, and keep that accounting for a specified number of years
- CA: Funds raised must be given to charity every 90 days during campaign [Cal. Gov't Code § 12599.2]



Regulation of Commercial Co-Ventures: State Law

- **Co-venturer obligations** – States generally impose requirements on the commercial co-venturer only
- **Charity obligations**
 - A few states impose certain CCV requirements (filing of notice, contract, and accounting) on the charity
 - Charities should be registered to solicit funds under charitable solicitation laws in states where sales promotion will run
- Requirements vary by state. Check the statute!
- Most state laws and forms can be found via the National Association of State Charity Officials website: www.nasconet.org/agencies



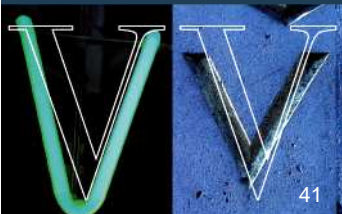
Regulation of Commercial Co-Ventures: BBB Standards

- BBB Wise Giving Alliance Standards for Charity Accountability – www.bbb.org/us/charity-standards
- BBB Standard 19
 - Should clearly disclose how charity benefits from sales promotion
 - Ensure that sales promotions disclose the following at the point of solicitation:
 - the actual or anticipated portion of the purchase price that will benefit the charity (e.g., 5 cents will be contributed to ABC charity for every XYZ company product sold)
 - the duration of the campaign (e.g., the month of October) and
 - any maximum or guaranteed minimum contribution amount (e.g., up to a maximum of \$200,000)



Federal Tax Law and Maximizing CCV Income

- If charity plays a wholly passive role, the funds it receives from the CCV should count as public support
- If charity has a more active role and/or provides any “return benefit” to co-venturer (e.g., including the co-venturer’s name and logo on charity website in connection with the promotion), then UBIT may be triggered
- In that case, structure as a qualified corporate sponsorship payment



How to Approach Commercial Co-Ventures

- **Identify CCVs.** Ensure staff is able to recognize a charitable sales promotion and informed about CCV regulations. Consider developing a checklist of issues to address in selecting and working with commercial entities
- **Advance Planning.** Pick co-venturer wisely—you want them to be established, organized, and serious about compliance. Give yourself and co-venturer plenty of time to meet state requirements—particularly disclosures on ad copy—well in advance of start date
- **Written Contract.** Required by most regulating states, the written contract should contain any required terms and standard legal protections, and should be signed by charity officer (or two, in MA)
- **Monitor Co-Venturer for Compliance.** Nobody wants a state investigation. It is in the charity's best interests to encourage the co-venturer to meet state requirements and to enforce terms of the CCV contract, both before and after to the start of the promotion



Questions?

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