

A large, abstract graphic on the left side of the page, consisting of overlapping, layered shapes in shades of blue, teal, and grey, resembling a stylized arrow or a modern architectural element.

# UBIT: What Your Nonprofit Needs to Know about Sponsorships, Advertising, Royalties, and Cause Marketing

Tuesday, April 5, 2016, 12:30 – 2:00 pm ET

Venable LLP, Washington, DC

## Moderator

**Jeffrey S. Tenenbaum, Esq.**, Partner  
Chair of the Nonprofit Organizations Practice, Venable LLP

## Speakers

**Lisa M. Hix, Esq.**, Partner  
Nonprofit Organizations Practice, Venable LLP

**Lakshmi Sarma Ramani, Esq.**, General Counsel  
National Association for the Education of Young Children



# Presentation

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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



*"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



## 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?



## 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



## 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 at 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

VENABLE <sup>9</sup>



## Is the Income Taxable?

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

VENABLE <sup>10</sup>



## UBIT Exceptions: Qualified Sponsorship Income

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VENABLE 11



## 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:
      - Trade show and convention
      - Advertisement or acknowledgment in regular periodicals (journals, e-newsletters, etc.)
      - Contingent payments

VENABLE 12





## 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)

VENABLE <sup>13</sup>



## Analyzing Benefits

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

VENABLE <sup>14</sup>



## 1. Acknowledgment or Advertising?

- Acknowledgment
  - Name or logo
  - 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
  - Contact Information, including list of sponsor's location, telephone number, and/or internet address, including a hyperlink from the exempt organization's web site to the sponsor's website
  - 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

VENABLE 15



## Illustrations – Acknowledgment

- 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)

VENABLE 16



## Illustrations – Acknowledgment

- 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)


VENABLE 17



## Illustrations – Advertising

- Name and Logo on Unrelated Items
  - Sponsor name on souvenir flags (purchased by the tax-exempt) 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)

VENABLE 18



## 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)
- Web Link 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.”

VENABLE 19



## 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)

VENABLE 20



## 2. Eligible for Safe Harbor?

- Convention and trade show
  - Exhibit booths, tickets to trade show, acknowledgment at trade show, etc.
- Advertising or acknowledgment 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 distributed primarily 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 UBIT
- What is a Royalty?
  - *Sierra Club v. Commissioner*: “Payments received for the right to use intangible property rights and that such definition does not include payments for services”
- 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



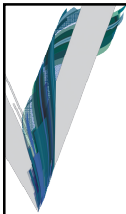
## Royalties – Mailing List Rental

- 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 – 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-Related 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 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 26 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>



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## 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-venture” 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]

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## Regulation of Commercial Co-Ventures: State Law

- State law requirements, generally:
  - Registration
  - Bonding
  - Written Contract
  - Advertising Disclosures
  - Accounting and Recordkeeping
- Registration – Several states require advance registration or notification by co-venturer, including AL, CA, HI, IL, MA, MS, and SC
- Bonding – AL and MA require the co-venturer to obtain a surety bond

VENABLE 37



## 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 good/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

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## 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 and 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]

VENABLE 39



## 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!

VENABLE 40



## Regulation of Commercial Co-Ventures: BBB Standards

- BBB Wise Giving Alliance Standards for Charity Accountability – [www.bbb.org/us/charity-standards](http://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)
    - Any maximum or guaranteed minimum contribution amount (e.g., up to a maximum of \$200,000)

VENABLE 41



## 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

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## 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).
- **Monitor Co-Venturer for Compliance.** No one 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 the start of the promotion.

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## Questions?

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# Speaker Biographies

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Jeffrey Tenenbaum chairs Venable's Nonprofit Organizations Practice Group. He is one of the nation's leading nonprofit attorneys, and also is a highly accomplished author, lecturer, and commentator on nonprofit legal matters. Based in the firm's Washington, DC office, Mr. Tenenbaum counsels his clients on the broad array of legal issues affecting charities, foundations, trade and professional associations, think tanks, advocacy groups, and other nonprofit organizations, and regularly represents clients before Congress, federal and state regulatory agencies, and in connection with governmental investigations, enforcement actions, litigation, and in dealing with the media. He also has served as an expert witness in several court cases on nonprofit legal issues.

Mr. Tenenbaum was the 2006 recipient of the American Bar Association's Outstanding Nonprofit Lawyer of the Year Award, and was an inaugural (2004) recipient of the *Washington Business Journal's* Top Washington Lawyers Award. He was only a handful of "Leading Lawyers" in the Not-for-Profit category in the prestigious *Legal 500* rankings for the last four years (2012-15). Mr. Tenenbaum was recognized in 2013 as a Top Rated Lawyer in Tax Law by *The American Lawyer* and *Corporate Counsel*. He was the 2015 recipient of the New York Society of Association Executives' Outstanding Associate Member Award, the 2004 recipient of The Center for Association Leadership's Chairman's Award, and the 1997 recipient of the Greater Washington Society of Association Executives' Chairman's Award. Mr. Tenenbaum was listed in the 2012-16 editions of *The Best Lawyers in America* for Non-Profit/Charities Law, and was selected for inclusion in the 2014 and 2015 editions of *Washington DC Super Lawyers* in the Nonprofit Organizations category. In 2011, he was named as one of Washington, DC's "Legal Elite" by *SmartCEO Magazine*. He was a 2008-09 Fellow of the Bar Association of the District of Columbia and is AV Peer-Review Rated by *Martindale-Hubbell*. Mr. Tenenbaum started his career in the nonprofit community by serving as Legal Section manager at the American Society of Association Executives, following several years working on Capitol Hill as a legislative assistant.

### REPRESENTATIVE CLIENTS

AARP  
 Academy of Television Arts & Sciences  
 Air Conditioning Contractors of America  
 Airlines for America  
 American Academy of Physician Assistants  
 American Alliance of Museums  
 American Association for the Advancement of Science  
 American Bar Association  
 American Cancer Society  
 American College of Cardiology  
 American College of Radiology  
 American Council of Education

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American Society of Association Executives

New York Society of Association Executives

American Friends of Yahad in Unum  
American Institute of Architects  
American Red Cross  
American Society for Microbiology  
American Society of Anesthesiologists  
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America's Health Insurance Plans  
Association for Healthcare Philanthropy  
Association for Talent Development  
Association of Clinical Research Professionals  
Association of Corporate Counsel  
Association of Fundraising Professionals  
Association of Global Automakers  
Association of Private Sector Colleges and Universities  
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Carbon War Room  
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Council on Foundations  
CropLife America  
Cruise Lines International Association  
Design-Build Institute of America  
Erin Brockovich Foundation  
Ethics Resource Center  
Foundation for the Malcolm Baldrige National Quality Award  
Gerontological Society of America  
Global Impact  
Goodwill Industries International  
Graduate Management Admission Council  
Habitat for Humanity International  
Homeownership Preservation Foundation  
Human Rights Campaign  
Independent Insurance Agents and Brokers of America  
Institute of International Education  
International Association of Fire Chiefs  
International Rescue Committee  
International Sleep Products Association  
Jazz at Lincoln Center  
LeadingAge  
The Leukemia & Lymphoma Society  
Lincoln Center for the Performing Arts  
Lions Club International  
March of Dimes  
ment'or BKB Foundation  
Money Management International  
National Association for the Education of Young Children  
National Association of Chain Drug Stores  
National Association of College and University Attorneys  
National Association of County and City Health Officials  
National Association of Manufacturers  
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National Defense Industrial Association  
National Fallen Firefighters Foundation  
National Fish and Wildlife Foundation  
National Propane Gas Association  
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National Retail Federation  
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Telecommunications Industry Association  
Trust for Architectural Easements  
The Tyra Banks TZONE Foundation  
U.S. Chamber of Commerce  
United States Tennis Association  
Volunteers of America  
Water Environment Federation  
Water For People  
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Recipient, New York Society of Association Executives' Outstanding Associate Member Award, 2015

Recognized as "Leading Lawyer" in *Legal 500*, Not-For-Profit, 2012-15

Listed in *The Best Lawyers in America* for Non-Profit/Charities Law (Woodward/White, Inc.), 2012-16

Selected for inclusion in *Washington DC Super Lawyers*, Nonprofit Organizations, 2014-15

Served as member of the selection panel for the *CEO Update* Association Leadership Awards, 2014-16

Recognized as a Top Rated Lawyer in Taxation Law in *The American Lawyer* and *Corporate Counsel*, 2013

Washington DC's Legal Elite, *SmartCEO Magazine*, 2011

Fellow, Bar Association of the District of Columbia, 2008-09

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## ACTIVITIES

Mr. Tenenbaum is an active participant in the nonprofit community who currently serves on the Editorial Advisory Board of the American Society of Association Executives' *Association Law & Policy* legal journal, the Advisory Panel of Wiley/Jossey-Bass' *Nonprofit Business Advisor* newsletter, and the ASAE Public Policy Committee. He previously served as Chairman of the *AL&P* Editorial Advisory Board and has served on the ASAE Legal Section Council, the ASAE Association Management Company Accreditation Commission, the GWSAE Foundation Board of Trustees, the

GWSAE Government and Public Affairs Advisory Council, the Federal City Club Foundation Board of Directors, and the Editorial Advisory Board of Aspen's *Nonprofit Tax & Financial Strategies* newsletter.

## PUBLICATIONS

Mr. Tenenbaum is the author of the book, *Association Tax Compliance Guide*, now in its second edition, published by the American Society of Association Executives. He also is a contributor to numerous ASAE books, including *Professional Practices in Association Management*, *Association Law Compendium*, *The Power of Partnership*, *Essentials of the Profession Learning System*, *Generating and Managing Nondues Revenue in Associations*, and several Information Background Kits. In addition, he is a contributor to *Exposed: A Legal Field Guide for Nonprofit Executives*, published by the Nonprofit Risk Management Center. Mr. Tenenbaum is a frequent author on nonprofit legal topics, having written or co-written more than 700 articles.

## SPEAKING ENGAGEMENTS

Mr. Tenenbaum is a frequent lecturer on nonprofit legal topics, having delivered over 700 speaking presentations. He served on the faculty of the ASAE Virtual Law School, and is a regular commentator on nonprofit legal issues for *NBC News*, *The New York Times*, *The Wall Street Journal*, *The Washington Post*, *Los Angeles Times*, *The Washington Times*, *The Baltimore Sun*, *ESPN.com*, *Washington Business Journal*, *Legal Times*, *Association Trends*, *CEO Update*, *Forbes Magazine*, *The Chronicle of Philanthropy*, *The NonProfit Times* and other periodicals. He also has been interviewed on nonprofit legal topics on Fox 5 television's (Washington, DC) morning news program, Voice of America Business Radio, Nonprofit Spark Radio, and The Inner Loop Radio.



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### HONORS

Recognized in *Legal 500*, Not-For-Profit, 2013 - 2015

Selected for inclusion in Washington, DC "Rising Stars" edition of *Super Lawyers*, 2013

### PUBLICATIONS

- December 19, 2013, New York Nonprofit Revitalization Act Signed into Law
- October 31, 2013, The New Nonprofit Revitalization Act
- October 16, 2013, New York Legislature Passes Nonprofit Revitalization Act: Comprehensive, Significant Changes to New York Nonprofit Corporation Law on Horizon
- October 15, 2013, Combinations and Alliances among Nonprofit Organizations
- July 30, 2013, New York Legislature Passes Nonprofit Revitalization Act: Comprehensive, Significant Changes to New York Nonprofit Corporation Law on Horizon
- June 25, 2013, Employee Leaves of Absence and Other Accommodations under the Law: What Every Nonprofit Needs to Know
- June 26, 2012, Agreeing to Convene: Spotting and Solving the Most Common Event Contract Pitfalls
- March 20, 2012, All About UBIT: What Nonprofit Leaders Need to Know
- November 18, 2011, The New DC Nonprofit Corporation Act Takes Effect on Jan. 1, 2012: Everything You Need to Know to Comply

- October 24, 2011, Unrelated Business Income Tax for Nonprofits: The Basics
- October 13, 2011, Traps on the Web: Legal Essentials on Social Media, Protecting Data, HR Policies, and More
- October 6, 2011, Nonprofit Strategic Partnerships: Building Successful Ones and Avoiding the Legal Traps
- September 20, 2011, Steering Clear of the Most Common Legal Hazards in Hotel, Convention Center and Meeting Contracts
- September 16, 2011, Playing by the Rules: A Fresh Look at Corporate Sponsorship & Affinity Program Income
- August 8, 2011, Cyberspace Risk: The Top Legal Traps for Associations
- June 16, 2011, Sponsorships, Advertising, Endorsements and Cause Marketing: Understanding Critical UBIT Issues for Nonprofits
- May 13, 2011, Online Social Media and Nonprofits: Navigating the Legal Pitfalls
- April 28, 2011, Steering Clear of the Most Common Legal Hazards in Hotel, Convention Center and Meeting Contracts
- April 20, 2011, Navigating Nonprofit Partnerships, Joint Ventures and Commercial Co-Ventures: How Arts Organizations Can Avoid the Legal Pitfalls
- March 29, 2011, Dangers and Opportunities: Navigating Nonprofit Partnerships, Collaborations, Joint Ventures and More
- March 8, 2011, Sponsorships, Advertising, Endorsements, and Cause Marketing - Understanding Critical UBIT Issues for Nonprofits
- February 3, 2011, Top Ten Legal Issues for Associations: Common Mistakes, and How to Avoid Them
- December 16, 2010, So You Want To Be On The Internet<sup>®</sup>
- December 6, 2010, Mergers, Alliances, Affiliations and Acquisitions for Nonprofit Organizations: Financial and Legal Issues
- November 10, 2010, Legal Issues in Publishing – Copyright and Reprint Requests
- November 3, 2010, Cyberspace Risk: What You Don't Know Could Hurt You
- September-October 2010, The Ins and Outs of Alliances and Affiliations, *Associations Now*
- September 24, 2010, Doing Business in a Changing Economy: Contracts, Liability, and Understanding Risk
- September 21, 2010, Legal Aspects of Social Networking and Online Media Platforms
- September 20, 2010, Best Practices for Negotiating Meeting Contracts in the Current Economy
- August 24, 2010, Association Alliances, Partnerships and Mergers
- May 7, 2010, Combinations and Alliances Among Nonprofit Associations
- January 26, 2010, The Building Blocks for a Successful Nonprofit Merger
- December 15, 2009, Best Practices for Negotiating Hotel Contracts in the Current Economy
- December 15, 2009, Hotel Contract Clauses That Work: Understanding the Fine Print
- April 16, 2009, Steering Clear of the Most Common Legal Hazards in Hotel, Convention Center, and Meeting Contracts
- March 12, 2009, IM N, R U? Managing the Nonprofit Legalities of Social Networking and Online Media Platforms
- November 18, 2008, The Ten Most Common Online Legal Pitfalls for Nonprofits...and How to Avoid Them
- September 16, 2008, Obtaining and Maintaining Tax-Exemption for Your Affiliates: The Mechanics, Pros and Cons of Group Exemption

## SPEAKING ENGAGEMENTS

- April 14, 2016, UBIT: What Your Nonprofit Needs to Know about Sponsorships,



## Advertising, Royalties, and Cause Marketing

- February 9, 2016, "Hotel Meeting Contracts: Navigating Legal Issues for Successful and Profitable Meetings," an AssociationTRENDS webinar
- November 12, 2015, "Leadership Succession: Is Your Nonprofit Prepared?" at the Third Annual Nonprofit Executive Summit
- October 19, 2015, "Advising and Serving on Nonprofit Boards" at the 2015 Association of Corporate Counsel Annual Meeting
- August 11, 2015, "An Insider's Guide to Grant Success" at the 2015 American Society of Association Executives Annual Meeting & Exposition
- August 6, 2015, Top Ten "Must Have" Provisions for Nonprofit Meeting Contracts
- October 31, 2013, What New York Nonprofits Need to Know about the New Nonprofit Revitalization Act
- October 16, 2013, "New York Legislature Passes Nonprofit Revitalization Act: Comprehensive, Significant Changes to New York Nonprofit Corporation Law on Horizon" for the New York Society of Association Executives
- June 25, 2013, Employee Leaves of Absence and Other Accommodations under the Law: What Every Nonprofit Needs to Know
- June 20, 2013, "Preparing an Online Social Media Policy: The Top Ten Legal Considerations for Your Nonprofit" at CAPLAW's 2013 National Training Conference
- June 27, 2012, WMACCA Non-Profits & Associations Forum: "Agreeing to Convene – Spotting and Solving the Most Common Event Contract Pitfalls"
- March 20, 2012, "All About UBIT: What Nonprofit Leaders Need to Know" for the Better Business Bureau of New York
- October 13, 2011, "Traps on the Web: Legal Essentials on Social Media, Protecting Data, HR Policies & More" for the Better Business Bureau of New York
- October 6, 2011, Nonprofit Strategic Partnerships: Building Successful Ones and Avoiding the Legal Traps
- September 20, 2011, "Steering Clear of the Most Common Legal Hazards in Hotel, Convention Center and Meeting Contracts" at Meeting Quest Charlotte
- September 16, 2011, "Playing by the Rules: A Fresh Look at Corporate Sponsorship & Affinity Program Income" at ASAE's Annual Association Law Symposium
- August 8, 2011, "Cyberspace Risk: The Top Legal Traps for Associations," 2011 ASAE Annual Meeting
- June 16, 2011, Sponsorships, Advertising, Endorsements and Cause Marketing: Understanding Critical UBIT Issues for Nonprofits
- May 18, 2011, "Mastering Tradeshow Contracts" at the 2011 Annual Association Law Symposium in Chicago
- May 17, 2011, "Legal Aspects/Issues of Social Media Platforms" for the Kansas Society of Association Executives
- May 13, 2011, "Cyberspace Risk: The Top Legal Traps for Associations," ASAE Finance, HR & Business Operations Conference
- April 29, 2011 - May 3, 2011, "Trends in Law, Practice and Management of Copyright and Licensing of Content" for the Council of Science Editors
- April 28, 2011, "Steering Clear of the Most Common Legal Hazards in Hotel, Convention Center and Meeting Contracts" at ASAE's 2011 Springtime Expo
- March 29, 2011, "Dangers and Opportunities: Navigating Nonprofit Partnerships, Collaborations, Joint Ventures and More" for Better Business Bureau New York
- March 8, 2011, Legal Quick Hit: "Sponsorships, Advertising, Endorsements, and Cause Marketing - Understanding Critical UBIT Issues for Nonprofits" for the Association of Corporate Counsel's Nonprofit Organizations Committee
- February 7, 2011, "Legal Update: What Every Tax-Exempt Association Should Know" for the Commercial Real Estate Development Association
- February 3, 2011, "Top Legal Issues for Tax-Exempt Associations" for the Mid-Atlantic Society of Association Executives
- December 6, 2010, Mergers, Alliances, Affiliations and Acquisitions for Nonprofit



#### Organizations: Financial and Legal Issues

- November 10, 2010, "Copyright and Reprint Requests" to the Coalition of Education Association Publications
- November 3, 2010, "Cyberspace Risk: What You Don't Know Could Hurt You," Nonprofit Risk Management Center
- September 24, 2010, "Doing Business in a Changing Economy: Contracts, Liability, and Understanding Risk," at the 2010 Annual Association Law Symposium in Washington, DC
- September 21, 2010, "Legal Aspects/Issues of Social Networking and Media Platforms" at the Texas Society of Association Executives Annual Conference
- September 20, 2010, "Best Practices for Negotiating Meeting Contracts in the Current Economy" at the Texas Society of Association Executives Annual Conference
- August 24, 2010, "Association Alliances, Partnerships and Mergers" at the 2010 Annual Meeting & Expo of the American Society of Association Executives (ASAE)
- August 14, 2010, "Overview of Association Law" at the National Institute of Governmental Purchasers Annual Conference
- August 4, 2010, "Avoiding Legal Pitfalls When Using On-Line Social Media" for the Indiana Grantmakers Alliance, in collaboration with various State Grantmakers Alliances
- April 13, 2010, Legal Quick Hit: "Best Practices for Negotiating Hotel Contracts in the Current Economy" for the Association of Corporate Counsel's Nonprofit Organizations Committee
- December 10, 2009, Two presentations on hotel contracts at PMPI's 4th Annual Mid-Atlantic Conference and Expo (MACE)
- September 25, 2009, American Society of Association Executives (ASAE) Annual Association Law Symposium
- June 22, 2009, Building Member and Supporter Buy-In Through Improved Governance Practices
- June 9, 2009, Legal Quick Hit: Copyright Law Basics and Pitfalls for Nonprofits
- April 16, 2009, Steering Clear of the Most Common Legal Hazards in Hotel, Convention Center and Meeting Contracts
- November 18, 2008, Association of Corporate Counsel Webcast: The Ten Most Common Online Legal Pitfalls for Nonprofits ... and How to Avoid Them
- 2008, "Developing Security Policies and Procedures to Protect Member Data" at the 2008 ASAE Association Technology Conference & Expo, Washington, DC
- 2007, "Legal Considerations in Nonprofit Mergers" at the Association of Corporate Counsel "Legal Quick Hit"
- 2007, "Overtime for Employees on Travel" at the Association of Corporate Counsel "Legal Quick Hit"
- 2007, "Board of Directors' Responsibilities" at the 2007 Society for Women's Health Research Board Orientation, Washington, DC
- 2007, "Update on Hotel Contracts: Attrition and Other Key Issues" at the Association of Corporate Counsel "Legal Quick Hit"
- 2007, "Intellectual Property Challenges in the Life of an Association" at the 2007 ASAE Annual Association Law Symposium, Washington, DC
- 2007, "Understanding and Managing Fiduciary Responsibility" at the 2007 Finance and Administration Roundtable, Washington, DC
- 2006, "Contracts Insurance & Liability: What Every Meeting Professional Should Know" at the 2006 ASAE Meetings Management Institute Issues in Hotel Meeting Contracts, ASAE Hotel Operations Program, Washington, DC
- 2006, "Opening General Session Panel: The Year in Review - Legal Style" at the 2006 ASAE Finance & Business Operations Symposium, Baltimore, MD
- 2006, "Legal Issues for Nonprofit Organizations" at the American College of Cardiology, 2006 General Scientific Session, Atlanta, Georgia

## Lakshmi Sarma Ramani, Esq.



Lakshmi Sarma Ramani is NAEYC's Chief Legal Officer. She manages the work of NAEYC's Office of General Counsel, which provides a full range of services in support of NAEYC's mission.

As a member of NAEYC's Executive Team, Ramani advises on legal issues arising out of NAEYC's activities and provides practical, ethical and effective legal advice. She leads corporate strategic and tactical legal initiatives and advises on legal strategies and their implementation to NAEYC staff, the NAEYC Governing Board, the Council for NAEYC Accreditation and the NAEYC Commission on Early Childhood Associate Degree Accreditation.

Lakshmi Sarma Ramani joined NAEYC in January 2014. Prior to joining NAEYC, she served as Senior Attorney-Corporate Services at The Nature Conservancy. While at The Nature Conservancy, Ramani advised executive management and staff on a broad range of substantive areas, including general business and corporate law, governance, tax, intellectual property, privacy, technology and fundraising and managed the legal resources for areas including global membership, marketing, fundraising, information technology and finance.



# Additional Information

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## ARTICLES

May 2013

### IRS RELEASES FINAL REPORT ON NONPROFIT COLLEGES AND UNIVERSITIES COMPLIANCE PROJECT: UBIT AND EXECUTIVE COMPENSATION LESSONS FOR ALL TAX-EXEMPT ORGANIZATIONS (ARTICLE – SHORT VERSION)

In October 2008, the Internal Revenue Service (the “IRS”) began work on the Nonprofit Colleges and Universities Compliance Project (the “Project”). The IRS sent out an initial compliance questionnaire to over 400 tax-exempt colleges and universities. Based on the responses, 34 colleges and universities – about 8.5% of the total number of institutions that originally received the questionnaire – were then selected for examination. The IRS has now completed 90% of these examinations. On April 25, 2013, the IRS released the Final Report on the Project, summarizing the findings from the completed examinations and representing the culmination of almost five years of research and analysis.

Although the Project has focused specifically on colleges and universities, the key points raised in the Final Report are applicable to all tax-exempt organizations. Lois Lerner, the Director of the IRS Exempt Organizations Division, recently stated in remarks accompanying the release of the Final Report that the issues discussed “may well be present elsewhere across the tax-exempt sector.” In particular, she emphasized that “all exempt organizations need to be aware” of the Final Report’s findings pertaining to unrelated business income and executive compensation.

#### Unrelated Business Income Findings

Unrelated business income (“UBI”) arises when a tax-exempt organization regularly carries on a trade or business that is not substantially related to the tax-exempt purposes of the organization. The Internal Revenue Code (the “Code”) imposes unrelated business income tax (“UBIT”) on an organization’s UBI, reduced by the organization’s related losses and deductions. The Final Report notes that 90% of the colleges and universities examined had misreported UBI on their Forms 990 and 990-T during the years under examination, and the resulting changes in the reporting of losses and net operating losses (“NOLs”) could result in over \$60 million in assessed federal taxes.

Among the colleges and universities examined, the IRS found that certain activities most commonly resulted in adjustments to UBIT liability. These included advertising; arena use; facility rentals; and the operation of fitness and recreation centers, sports camps, and golf courses. The Final Report explains that the IRS disallowed more than \$150 million in NOLs during the course of its Project-related examinations because the examining agents found that the institutions engaged in these types of activities failed to demonstrate the requisite connection between a trade or business and the activities generating losses.

Other common findings among the examined colleges and universities included misallocation of expenses between activities related to tax-exempt purposes and those unrelated to such purposes; errors in computation of NOLs and the substantiation of such amounts; and misclassification of activities as related to the institution’s tax-exempt purposes. It is interesting to note that the IRS identified numerous instances in which examined colleges and universities had reported net losses on activities “for which expenses had consistently exceeded UBI for many years.” The IRS determined that these activities were not carried on with a profit motive and, as such, disallowed the NOLs that flowed from those activities.

#### Executive Compensation and Other Compensation Findings

With regard to executive compensation, the Final Report focuses on certain procedural shortcomings among many colleges and universities. As organizations described in § 501(c)(3) of the Code, these colleges and universities are subject to the prohibition on “private inurement.” As such, if an organization is deemed to make payments or engage in activities that improperly inure to the benefit of its “insiders,” the IRS could seek to revoke the tax-exempt status of the organization. Alternatively,

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## RELATED INDUSTRIES

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and Associations  
Education

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under Code § 4958 (also known as the “intermediate sanctions” rules), the IRS may impose punitive excise taxes on the insiders receiving undue benefit from their tax-exempt organizations, as well as a parallel excise on the organization’s directors or managers that knowingly approved any “excess benefit transaction.”

These penalty taxes apply only if an organization pays an amount in excess of what would reasonably be paid by a similarly situated organization for comparable services. If a § 501(c)(3) organization pays reasonable compensation to its officers, directors, trustees, and key employees (“ODTKEs”), no excess benefit transaction occurs. Section 4958 and the accompanying Treasury Regulations provide that organizations may establish a rebuttable presumption that amounts paid by the organization to its ODTKEs are reasonable. In order to attain the rebuttable presumption, 1) the organization must appoint an “independent body” to review and determine the amount of compensation; 2) the independent body must rely on appropriate comparability data to set the compensation amount; and 3) the independent body must contemporaneously document its decisions in setting compensation.

In the Final Report, the IRS found that 20% of the colleges and universities examined would not have successfully established this rebuttable presumption. The key shortcomings included 1) the use of comparability data that was derived, at least in part, from organizations that were not “similarly situated” to the institution in question (based on factors such as location, endowment size, revenues, total net assets, number of students, selectivity in admissions, and age of the institution); and 2) the reliance on compensation studies that did not adequately document how and/or why certain comparability data was selected, and/or did not specify whether the amounts reported included salary only or also reflected other types of taxable and non-taxable compensation. While the Final Report reaches certain conclusions about the scale of compensation paid by colleges and universities to various ODTKEs, it does not provide the number of institutions under examination actually found to have engaged in an excess benefit transaction subject to excise taxation.

Finally, the IRS also opened employment tax examinations at 11 of the 34 colleges and universities. Each of these examinations resulted in upward adjustments to wages and assessment of additional tax, totaling over \$7 million. The reasons for these wage adjustments included common problems for all exempt organizations, such as failure to properly account for the value of the personal use of automobiles, housing, and travel in the wage calculation, as well as failures to properly classify individuals as employees or independent contractors.

### **Conclusions**

Colleges and universities, as well as other tax-exempt organizations, should carefully review the Final Report, as it provides clear insight into areas that the IRS will likely target in the future. When completing Forms 990 and 990-T and determining an organization’s UBIT liability, organizations should allow adequate time to consult with their legal counsel and accountants in order to ensure that expenses are accurately allocated, and that losses and NOLs bear the requisite relationship to the activity giving rise to UBI. If an organization will take the position that an activity is related, rather than unrelated, to its tax-exempt purposes, it should document the basis for that determination based on all pertinent facts and circumstances.

Additionally, organizations exempt under Sections 501(c)(3) or 501(c)(4) should closely review their methods for setting executive compensation and their use of comparability data. The payment of unreasonable executive compensation can lead to the imposition of intermediate sanctions or to the loss of exempt status. Organizations that hire compensation consultants should monitor the comparability data in use. Alternatively, organizations that do not engage outside consultants should review their own procedures for selecting comparability data to ensure that such data reflect the practices of similarly situated entities. In all events, organizations should ideally review their internal procedures to attain the rebuttable presumption of reasonableness with regard to compensation paid to all ODTKEs.

\* \* \* \* \*

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*This article is not intended to provide legal advice or opinion and should not be relied on as such. Legal advice can only be provided in response to a specific fact situation.*

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## RELATED PRACTICES

Tax-Exempt Organizations

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## ARTICLES

October 24, 2011

### UNRELATED BUSINESS INCOME TAX FOR NONPROFITS: THE BASICS

#### Overview

A tax-exempt organization is generally exempt from federal corporate income tax on income derived from activities that are substantially related to the organization's tax-exempt purposes. However, a tax-exempt organization may be subject to a federal corporate income tax on income derived from unrelated trade or business activities. This is known as the Unrelated Business Income Tax ("UBIT").

#### Definitions

An "unrelated trade or business" is any activity that meets all of the following three conditions:

- . The activity must be a trade or business;
- . The trade or business must be regularly carried on; and
- . The trade or business must not be substantially related to the purposes for which the organization was recognized as exempt from federal income tax.

An activity is considered a "trade or business" if the activity is carried on for the production of income from the sale of goods or the performance of services. Note that it is immaterial whether the activity generates a profit for purposes of determining whether the gross revenue derived from the activity is subject to UBIT. Further, if an organization engages in a substantial amount of non-exempt activities, it could potentially lose its tax-exempt status even if those activities do not generate a profit.

In determining whether an activity is "regularly carried on," the IRS will examine whether the activity is conducted often and continuously and how it is pursued. The IRS will compare these factors with the same or similar business activity of non-tax-exempt organizations. Discontinuous or periodic activities are generally not considered to be regularly carried on. However, periodic activities that are seasonal in nature will be considered to be regularly carried on if an exempt organization's periodic participation in such activities coincides with the participation of taxable businesses.

For an activity to be "substantially related" to the tax-exempt organization's exempt purposes, it must contribute importantly to the accomplishment of one or more of the organization's exempt purposes. If an activity is substantially related to the tax-exempt organization's exempt purposes, then the income from that activity will not be subject to UBIT. The organization's need to generate money to use for tax-exempt purposes is not sufficient to qualify as "substantially related."

#### Exceptions

**Subject to certain limitations, the following activities are specifically excluded from the definition of unrelated business income (the code sections in brackets represent the applicable provisions of the Internal Revenue Code where these exceptions are defined):**

- Dividends, interest, and annuity income [512(b)(1)]
- Royalties [512(b)(2)]
- Certain capital gains [512(b)(5)]
- Rents from non-debt financed real property [512(b)(3)]
- Certain research-generated income [512(b)(7), 512(b)(8), and 512(b)(9)]
- Qualified corporate sponsorship payments [513(i)]
- Qualified convention or trade show income [513(c)(3)]
- Income generated from volunteer labor [513(a)(1)]
- Income from certain bingo games [513(f)]
- Sales from donated merchandise [513(a)(3)]



- A trade or business carried on by a 501(c)(3) organization primarily for the convenience of its members, students, patients, officers, or employees [513(a)(2)]
- The exchange or rental of member and donor lists among other organizations tax-exempt under 501(c)(3) [513(h)(1)(B)]
- Distribution of low-cost items in connection with charitable solicitation [513(h)(1)(A)]
- Certain hospital services provided at or below cost [513(e)]
- Qualified public entertainment activity [513(d)(2)]
- Income from services provided under a federal license by a religious order or its educational institution [512(b)(15)]
- Qualified pole rentals by a mutual or cooperative telephone or electric company [513(g)]
- Member income of mutual or cooperative electric companies [512(b)(18)]
- Certain debt management plan services [513(j)]

### **Payment**

Organizations that generate at least \$1,000 of gross unrelated business income must file a Form 990-T, Exempt Organization Business Income Tax Return, to report unrelated business income and pay any tax due. The organization must file Form 990-T in conjunction with its annual information return (i.e., Form 990, Form 990-EZ, or Form 990-PF).

An organization may take a number of tax deductions when computing UBIT. The IRS permits a specific deduction of \$1,000. Similarly, the IRS permits deductions for net operating losses, provided that it does not take into account any amount of income or deduction that has been excluded from the unrelated business income calculation.

Organizations may take a charitable contribution deduction of up to 10 percent of the amount of unrelated business taxable income, computed without regard to the deduction for contributions. In addition, the IRS permits deductions for expenses that are “directly connected” with the carrying on of the unrelated trade or business. Note that special rules are applicable to the calculation of UBIT from advertising in periodicals.

If an organization regularly conducts two or more unrelated business activities, its unrelated business taxable income is the total of gross income from all such activities less the total allowable deductions attributable to such activities. Where the value of the income exceeds the allowable deductions, the organization must pay a tax on the net unrelated business taxable income. This tax is generally imposed at the applicable (graduated) federal corporate income tax rates. An organization must pay quarterly estimated taxes prior to its annual information return filing date if its expected tax for the year will be \$500 or more.

### **Protecting Tax-Exempt Status**

A tax-exempt organization could jeopardize its tax-exempt status if the gross revenue, net income, and/or staff time devoted to unrelated business activities is “substantial” in relation to the organization’s tax-exempt functions. To avoid jeopardizing its tax-exempt status, an organization substantially engaged in one or more unrelated business activities should consider creating one or more taxable corporate subsidiaries in which to house and carry out such activities.

Such subsidiaries are separate but affiliated organizations, generally wholly-owned by the parent tax-exempt organization. A subsidiary will pay corporate income tax on its net income. But the tax-exempt parent’s exempt status will remain. Moreover, the subsidiary can remit the after-tax profits to its parent as tax-free dividends. Note that using a pass-through entity – such as an LLC – to house unrelated business activities will not necessarily offer the same tax-related protections as a subsidiary organized as a C corporation.

### **Conclusion**

Evaluating whether a particular activity may generate UBIT requires a fact-intensive review. While this article provides an overview of UBIT and its exceptions, all entities are encouraged to carefully analyze the impact of activities on the organization’s tax-exempt status and its potential tax obligations.

\* \* \* \* \*

For more information, please contact authors **Jeffrey Tenenbaum**, **Matthew Journey** and **Lisa Hix**.

For more information about this and related industry topics, see [www.venable.com/nonprofits/publications](http://www.venable.com/nonprofits/publications).

For more information about Venable's nonprofit organizations and associations practice, see [www.venable.com/nonprofits](http://www.venable.com/nonprofits).

This article is not intended to provide legal advice or opinion and should not be relied on as such. Legal advice can only be provided in response to specific fact situations.



## ARTICLES

May 1, 2002

### CORPORATE SPONSORSHIP: THE FINAL REGULATIONS

On April 25, 2002, the Internal Revenue Service ("IRS") published final regulations (T.D. 8991) regarding the tax treatment of corporate sponsorship payments received by exempt organization. The release of these final regulations comes almost 10 years after an initial set of regulations were proposed, and almost five years since the enactment of a federal law, the *Taxpayer Relief Act of 1997* (Public Law 105-34, Section 965), that created a statutory safe harbor for sponsorship payments.

The final regulations are not significantly different from proposed regulations released in 2000. Perhaps the most notable change is the final regulations' inclusion of two new examples designed to demonstrate the IRS' position on whether providing an Internet hyperlink from a tax-exempt organization's Web site to a sponsor's Web site would jeopardize the tax-exempt organization's ability to treat a payment as subject to the corporate sponsorship safe harbor.

#### Background

In the early 1990s, the corporate sponsorship issue arose in connection with monies received by the sponsors of the Mobil Cotton Bowl college football game. The sponsoring organization was a tax-exempt organization that received a considerable payment from the Mobil Corporation. In exchange, the Cotton Bowl became known as the Mobil Cotton Bowl. On audit, the IRS determined that the money received by the Cotton Bowl organizers should be characterized as taxable advertising income, given the considerable exposure that the Mobil Corporation received in return for the payment. This action caused a stir in Washington, D.C. and led to the drafting of the first set of corporate sponsorship proposed regulations in 1993. The regulations were not finalized before the enactment of the 1997 law, which superseded those regulations.

The 1997 law amended the Internal Revenue Code of 1986 (the "Code") to provide that the receipt of "qualified sponsorship payments" by a tax-exempt organization does not constitute the receipt of income from an "unrelated trade or business." In addition, for Code Section 501(c)(3) public support test purposes, "contributions" include "qualified sponsorship payments" in the form of money or property (but not services). The new law created a new section of the Code (Section 513(i)) clarifying that these qualified sponsorship payments will not be considered taxable income to a tax-exempt organization. It is important to note that Code Section 513(i) is a "safe harbor" — if a payment received by an exempt organization does not meet the definition of a qualified sponsorship payment, it is not necessarily taxable income to the organization. Rather, such a payment may qualify for one of numerous exceptions to the unrelated business income tax ("UBIT"), or it might not otherwise meet the definition of what constitutes taxable unrelated business income.

Below is a description of key provisions of the final regulations.

#### Definition of "Qualified Sponsorship Payment"

A "qualified sponsorship payment" is defined as "any payment [of money, property or services] by any person engaged in a trade or business with respect to which there is no arrangement or expectation that the person will receive any substantial return benefit." In determining whether a payment is a qualified sponsorship payment, it is irrelevant whether the sponsored activity is related or unrelated to the recipient organization's tax-exempt purposes. It also is irrelevant whether the sponsored activity is temporary or permanent.

#### Definition of "Substantial Return Benefit"

A "substantial return benefit" is defined as any benefit *other than*: (i) goods, services or other benefits of "insubstantial value" (as described below); or (ii) a "use or acknowledgment" (as described below). Good, services or other benefits of "insubstantial value" are those that have an aggregate fair market value of not more than 2% of the amount of the payment. Note that if the fair market value of the benefits

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exceeds 2%, the entire fair market value (as opposed to the cost) of such benefits, not merely the excess amount, is considered a substantial return benefit.

A substantial return benefit includes:

- advertising (as described below);
- providing facilities, services or other privileges to the sponsor (or persons designated by the sponsor), unless such privileges are of "insubstantial value" (as described above);
- granting the sponsor (or persons designated by the sponsor) an exclusive or non-exclusive right to use an intangible asset (e.g., name, logo, trademark, copyright, patent) of the tax-exempt organization. Note that while payment for providing a sponsor with the right to use such an intangible asset will not constitute a qualified sponsorship payment, it may constitute a tax-free royalty; or
- designating a sponsor as an "exclusive provider" (defined below).

#### **Use or Acknowledgment**

As stated above, a substantial return benefit does not include a "use or acknowledgment" of the name or logo (or product lines) of the sponsor's trade or business in connection with the activities of the tax-exempt organization. Use or acknowledgment does not include advertising (as described below), but may include:

- sponsor logos and slogans that do not contain qualitative or comparative descriptions of the sponsor's products, services, facilities, or company;
- a list of the sponsor's locations (e.g., addresses), telephone numbers, facsimile numbers, or Internet addresses;
- value-neutral descriptions (including displays or visual depictions) of the sponsor's product line(s) or services;
- sponsor brand or trade names and product or service listings; and
- designating a sponsor as an "exclusive sponsor" (defined below).

Logos or slogans that are an established part of the sponsor's identity are not considered to contain qualitative or comparative descriptions. Mere display or distribution (whether for free or remuneration) of a sponsor's product by the sponsor or the tax-exempt organization to the general public at a sponsored activity will not be considered an inducement to purchase, sell or use the sponsor's product and thus will not affect the determination as to whether a payment constitutes a qualified sponsorship payment.

#### **Advertising**

"Advertising" is defined as any message or other programming material that is broadcast or otherwise transmitted, published, displayed, or distributed, and that promotes or markets any trade or business, or any service, facility or product. Advertising includes:

- messages containing qualitative or comparative language;
- price information or other indications of savings or value;
- an endorsement; or
- an inducement to purchase, sell or use any company, service, facility, or product.

A *single* message that contains both advertising and an acknowledgment is considered advertising. The above rules do not apply to activities conducted by a sponsor on its own (e.g., if a sponsor purchases broadcast time from a television station to advertise its product during commercial breaks in a sponsored program, the tax-exempt organization's activities will not thereby be converted to advertising).

#### **Hyperlinks**

The IRS addresses the provision of an Internet hyperlink in two new examples (Examples 11 and 12). In one example, providing an acknowledgment on a tax-exempt organization Web page that includes a link to the sponsor's Internet address (no specification is made as to whether the link in this example is to the sponsor's home page or to some other page on the sponsor's Web site) is determined not to be a substantial return benefit to the sponsor. In the second example, the tax-exempt organization ("X") provides a link to a page on the sponsor's Web site that includes an endorsement by the tax-exempt organization of the sponsor's product. The IRS states that "the endorsement is advertising," and thus "only the payment, if any, that X can demonstrate exceeds the fair market value of the advertising on the ... company's Web site is a qualified sponsorship payment." It is interesting to note that the IRS does not affirmatively state that the fair market value of the provision of the hyperlink on the tax-exempt organization's Web site would be considered advertising income to the organization in this example; rather, the example focuses on the value of the benefit conferred through the endorsement.

#### **Exclusivity Arrangements**

*Exclusive sponsor.* An arrangement that acknowledges the sponsor as the exclusive sponsor of a tax-exempt organization's activity, or the exclusive sponsor representing a particular trade, business or industry, generally will not, by itself, result in a substantial return benefit. For example, if in exchange for a payment, a tax-exempt organization announces that its event or activity is sponsored exclusively by the sponsor (and does not provide any advertising or other substantial return benefit to the sponsor), then the sponsor has not received a substantial return benefit.

*Exclusive provider.* An arrangement that limits the sale, distribution, availability, or use of competing products, services or facilities in connection with a tax-exempt organization's activity generally will result in a substantial return benefit. For example, if in exchange for a payment, a tax-exempt organization agrees to permit only the sponsor's products to be sold in connection with its event or activity, then the sponsor has received a substantial return benefit.

### **Allocation of Payment**

If there is an arrangement or expectation that the sponsor will receive a substantial return benefit with respect to any payment, then only the portion (if any) of the payment that *exceeds* the fair market value of the substantial return benefit (determined on the date the sponsorship arrangement is entered into) will be considered a qualified sponsorship payment. In other words, if, in exchange for a payment to a tax-exempt organization in connection with a sponsored event or activity, the sponsor receives advertising benefits as well as an acknowledgment, then UBIT will be assessed only on the fair market value of the portion allocable to the advertising benefits (subject to the burden of proof described below). However, if the tax-exempt organization fails to establish that the payment exceeds the fair market value of any substantial return benefit, then *no* portion of the payment will constitute a qualified sponsorship payment. The UBIT treatment of any payment (or portion thereof) that does not constitute a qualified sponsorship payment will be determined by application of the standard UBIT rules and exclusions. For example, payments related to a tax-exempt organization's provision of facilities, services or other privileges to the sponsor (or persons designated by the sponsor), advertising, exclusive provider arrangements, a license to use intangible assets of the tax-exempt organization, or other substantial return benefits, will be evaluated separately in determining whether the tax-exempt organization realizes any unrelated business taxable income.

### **Fair Market Value**

The fair market value of any substantial return benefit provided as part of a sponsorship arrangement is the price at which the benefit would be provided between a willing recipient and a willing provider of the benefit, neither being under any compulsion to enter into the arrangement, both having reasonable knowledge of the relevant facts, and without regard to any other aspect of the sponsorship arrangement.

### **Valuation Date**

In general, the fair market value of a substantial return benefit will be determined when the benefit is provided. However, if the parties enter into a binding, written sponsorship agreement, the fair market value of any substantial return benefit provided pursuant to that agreement is determined on the date the parties enter into the agreement. If the parties make a material change to a sponsorship agreement (including an extension or renewal of the agreement, or a more-than-incidental change to the amount of consideration), it is treated as a new sponsorship agreement as of the date the material change is effective.

### **Anti-Abuse Provision**

To the extent necessary to prevent avoidance of the "Allocation of Payment" rule described above, where the tax-exempt organization fails to make a reasonable and good faith valuation of any substantial return benefit, the IRS may determine the portion of a payment allocable to such substantial return benefit and may treat two or more related payments as a single payment.

### **Written Agreements**

The existence of a written sponsorship agreement will not, by itself, cause a payment to fail to constitute a qualified sponsorship payment. The terms of the agreement, not its existence or degree of detail, are relevant to the determination of whether a payment constitutes a qualified sponsorship payment. Similarly, the terms of the agreement, not the title or responsibilities of the individual(s) that negotiate the agreement, will determine whether a payment (or any portion thereof) made pursuant to the agreement constitutes a qualified sponsorship payment.

### **Contingent Payments**

A qualified sponsorship payment does not include any payment the amount of which is contingent, by contract or otherwise, upon the level of attendance at one or more events, broadcast ratings, or other factors indicating the degree of public exposure to the sponsored event or activity. The fact that a payment is contingent upon sponsored events or activities actually being conducted will not, by itself, cause the payment to fail to constitute a qualified sponsorship payment.

#### **Determining Public Support (for 501(c)(3) Organizations)**

With respect to 501(c)(3) organizations, qualified sponsorship payments in the form of money or property (but not services) will be treated as "contributions" received by the tax-exempt organization for purposes of determining public support to the organization.

#### **Deductibility of Payments by Sponsors**

The fact that a payment constitutes a qualified sponsorship payment that is treated as a contribution to the tax-exempt organization does not determine whether the payment is deductible to the sponsor as a business expense or as a charitable contribution.

#### **Exception for Trade Show Activities and Periodicals**

The unrelated business income exception for qualified sponsorship payments does not apply with respect to: (i) payments made in connection with qualified convention and trade show activities (which are governed by a separate exception in the Code); or (ii) income derived from the sale of advertising or acknowledgments in periodicals of tax-exempt organizations. For this purpose, the term "periodical" means regularly scheduled and printed material published by or on behalf of the tax-exempt organization that is not related to and primarily distributed in connection with a specific event conducted by the tax-exempt organization. The IRS clarified that periodicals may include some forms of electronic publication.

#### **Examples**

The final regulations issued by the IRS contain 12 detailed examples illustrating the application of the proposed regulations to the sponsorship and related activities of tax-exempt organizations.

## ARTICLES

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### ASSOCIATION ENDORSEMENTS: THE CURRENT STATE OF THE TAX LAW

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When an association endorses a vendor's product or service to its members - and is compensated by the vendor for that endorsement - is that compensation taxable to the association? In whole or in part? How can association endorsement contracts be structured to minimize the adverse tax consequences to the association? What can the association do or provide to the vendor that is still consistent with the tax-free treatment of such compensation? The answers to the questions have been slowly evolving in recent years. While definitive answers are still not available, it is important for associations to know where the law stands at this point in time so their endorsement deals can be structured to maximum tax advantage. This article seeks to accomplish that task. It also provides detailed, practical guidance for structuring association endorsement contracts, based on the current state of the law.

#### Background.

**Unrelated Business Income.** While income derived from association activities that are substantially related to the association's tax-exempt purposes is generally exempt from federal corporate income tax, income from unrelated business activities - regularly carried on business activities that are not substantially related to the association's purposes - is generally taxable as unrelated business income ("UBI"). However, in certain circumstances, even income from activities that fit this definition and that would otherwise constitute taxable income may be exempt from tax if the income qualifies for one of several *exclusions* from UBI contained in the federal tax code. One of the most important and widely-utilized exclusions is that for "royalty" income.

**Royalties.** "Royalties" (and deductions directly connected with royalties) are excluded in computing the unrelated business taxable income ("UBTI") of tax-exempt associations. This exclusion does not apply to debt-financed income or to royalties received from a "controlled subsidiary." The Internal Revenue Service ("IRS") defines a royalty as any payment received in consideration for the use of a valuable intangible property right, whether or not payment is based on the use made of the intangible property. Payments for the use (even on an exclusive basis) of trademarks, trade names, service marks, copyrights, photographs, facsimile signatures, and members' names are ordinarily considered royalties and are tax-free. However, payments for services (such as marketing or administrative services) provided in connection with the granting of this type of right are not royalties - and are generally taxable as UBI (unless such services are substantially related to the association's purposes, which, in most cases, they are not).

#### Examples.

1. In an example provided a federal appeals court in the *Sierra Club* case, if the Sierra Club manufactured and sold T-shirts with the organization's logo or other designs on them, the income earned from the sale of such T-shirts would be taxable, as the activity of manufacturing and selling T-shirts is not substantially related to the Sierra Club's tax-exempt purposes. However, if the Sierra Club created the designs to be screened onto the T-shirts and then licensed those designs to a T-shirt manufacturer in exchange for a fee (perhaps calculated as a percentage of gross T-shirt sales), that income would constitute tax-free royalty income.

2. In an example provided by the IRS in a pair of Revenue Rulings, payments for the use of a professional athlete's name, photograph, likeness, and/or facsimile signature (provided by and through a tax-exempt organization) are generally considered royalties. However, payments for personal appearances and interviews by the athlete (similarly provided by and through a tax-exempt organization) are not excluded as royalties and must be included as income from an unrelated trade or business.

**Endorsements.** When an association endorses a vendor's product or service (often referred to as an association "affinity" program) but does nothing to market the product or service to its members (leaving this task to the vendor), this can be viewed as, in essence, nothing more than an exclusive license of

the association's name, logo and (generally) membership mailing list to the vendor (in connection with the vendor's promotion and sale of that product or service to the association's members, and possibly to others in the industry as well). As stated above, if the association gets paid for this exclusive license - even if such payments are calculated as a percentage of gross sales of the endorsed product or service to the association's members - then the payments will constitute royalties and will be tax-free to the association. If, however, the association does market the product or service to its members, then the tax issues become more complex, as described more fully below.

Endorsements can be a useful means for associations to generate non-dues revenue from both members and non-members; promote the association's name and identity, and, by extension, the industry or profession in general; and provide a service (e.g., "tailored" products and services, discounted rates/fees, etc.) to members.

### **Evolving IRS Position.**

For many years, IRS rulings and court decisions have left associations uncertain as to the taxability of the endorsement arrangements described above, as well as of income earned from the rental of their membership mailing lists to others. The litigation that has been undertaken regarding the proper characterization of income as a (tax-free) royalty or as payment for services (and therefore taxable) has focused on the role of the association - namely, what is the association providing in exchange for its compensation. Is it merely providing a license of intangible property (and exercising quality control over its use), or is it also providing marketing and administrative services in connection with the license? In other words, is the vendor paying the association merely for its license of intangible property, or is it also paying for promotional and/or administrative services to be provided by the association?

Note that, even under the IRS' historic positions on this issue, payments for the licensing of intangible property are eligible for royalty treatment even if the intangible property (such as the association's name and logo) is licensed on an *exclusive* basis, and even if the payments are calculated as a percentage of *gross sales* of the product or service. As a cautionary note, payments calculated as a percentage of *net sales* of the product or service can turn otherwise tax-free income into taxable income, as income based on net revenues is indicative of a joint venture.

In the past, the IRS has taken the position that the provision of services of any kind by the association (even in de minimis amounts) in connection with an endorsement/licensing arrangement will "taint" all of the income earned under the arrangement and make it ineligible for royalty treatment, no matter how passive the association's role. In other words, the IRS has maintained that if the association did *anything* to generate the income beyond the licensing of its intangible property (and exercising quality control over the use of such property by the vendor), then all of the income generated under the arrangement would be taxable. Moreover, the IRS also has historically maintained that the provision of an association's membership mailing list to a vendor in connection with an endorsement arrangement will similarly taint all of the income earned under the arrangement, as the IRS has historically not viewed a mailing list as a form of intangible property.

In many respects, though, the courts that have addressed these issues have held very different views of them, consistently rebuffing the IRS' attempts to tax what the courts consider tax-free royalty income, expressly permitting certain limited association activity in connection with the licensing of intangible property, and clearly stating that association mailing lists are merely another form of intangible property.

Senior IRS officials have recently suggested in public comments that the IRS is considering abandoning its long-held positions on these royalty issues and submitting to the will of the courts that have addressed these issues of late. Moreover, at the suggestion of the U.S. Tax Court, the IRS reportedly is considering the institution of a new enforcement scheme whereby the provision of services (such as marketing or administrative services) by an association in connection with a royalty arrangement would not "taint" the royalty income (as the IRS has maintained in the past), but rather would generate a stream of taxable income for the provision of services, separate but alongside the tax-free royalties earned for the licensing of intangible property (e.g., name, logo, mailing list). The division of the association's two income streams presumably would be based on a fair market allocation.

While recent decisions by an array of federal courts provide guidance to associations in structuring endorsement and licensing arrangements, unless and until the IRS formally conforms its enforcement policy to these decisions, there remains ambiguity and many unclarified issues - and thus potential tax risk - in this area.

### **Options for Structuring Endorsement Arrangements.**



**1. Royalties-Only.** The endorsement or licensing contract that carries the lowest risk of unrelated business income tax ("UBIT") liability is one in which the association license(s) its name, logo and/or mailing list, exercises quality control over the use of its intangible property by the vendor, and not much more. However, even under this scheme, the IRS and the courts have indicated that the association may engage in certain limited activities without jeopardizing the tax-free royalty treatment of its income. Guidelines for what the association may and may not do under this scheme are set forth below.

**2. Royalties to Association; Services Income to Third-Party or Taxable Subsidiary.** If administrative and/or marketing services are required, from a tax perspective, it is generally preferable to "outsource" such services to an unrelated third-party, or to the association's taxable subsidiary (with the association and subsidiary entering into separate, independent contracts with the vendor). In a 1999 Private Letter Ruling issued to the American Association of Retired Persons ("AARP"), the IRS validated the use of an AARP-owned taxable subsidiary to provide such administrative and/or marketing services, provided it is done on an arm's length basis (e.g., fair market valuation of the payments to each entity, financial separation, employee time records, etc.).

**3. Royalties to Association; Services Income to Association.** If such services must be provided by the association directly, then separate, independent, unrelated contracts should be drafted to provide for the name, logo and/or mailing list licensing on the one hand, and the administrative and/or marketing services on the other - recognizing that (at least for now) such a bifurcation of contracts by no means ensures that the IRS will respect such bifurcation and not treat all of the income as UBI. The fees earned by the association should be divided between the two contracts pursuant to some fair market valuation. The former should be treated as tax-exempt royalty income; the latter as taxable UBI. Public comments by senior IRS officials indicate that for such a structure to be respected by the IRS (at least for now), evidence must exist that the contracts are truly separate and not interdependent - in other words, that the parties might have entered into one contract without entering into the other. If the contracts were entered into at significantly different points in time, for instance, this might constitute such evidence, according to IRS officials. In most cases, this will be very difficult to establish. Of course, at some point in the future, the IRS may officially determine that separate contracts are not necessary, and that a fair market division between the tax-free licensing and the taxable services can be done within the same contract. However, based on current IRS precedent, such an approach carries with it a certain degree of tax risk. In some cases, though, the unwillingness of a vendor to enter into separate contracts may give the association no practical choice.

**Guidelines for Drafting Association Endorsement Contracts.** In light of the recent court decisions and IRS rulings in this area and pursuant to current legal precedent, the following guidelines should be followed when drafting endorsement contracts to minimize an association's potential UBIT liability. Note that, among other things, the guidelines below set forth what activities an association may engage in and what an association may provide to an endorsed vendor without jeopardizing the tax-free royalty treatment of its endorsement income. The same guidelines apply for purposes of all three options set forth above. In each instance, the association earns a stream of royalty income, and the following guidelines describe what activities the association may engage in directly without jeopardizing the tax-free status of that income. Other activities that are not consistent with royalty treatment may be provided by the vendor, by the association's taxable subsidiary, by an unrelated third-party, or, if necessary, by the association itself (in exchange for a separate stream of taxable services income). The guidelines below presume that the provision of marketing and/or administrative services (by whomever will be providing them) will be addressed in a separate contract (or, if necessary, in a separate section of a single contract):

1. The contract should be called a "Royalty Agreement" or "License Agreement," and the fees to be earned by the association should be expressly referred to in the contract as "royalties."
2. The contract should specify that fees to be earned by the association are solely in consideration for the association's licensing of its intangible property (and not for any services), and such intangible property to be licensed should be specified (e.g., name, logo, membership list, facsimile signatures, letterhead stationery design, etc.). Moreover, the contract should expressly state that it is a wholly independent contract that is not tied to any other agreement or obligation of the association.
3. The contract should specify that the association may exercise quality control over all uses of its intangible property. Specifically, the contract should reserve to the association the right to review and approve in advance all marketing materials and all other uses of its intangible property in order to protect the association's name and goodwill. Note that under federal trademark law, trademark owners are obligated to exercise control and supervision over the use of their trademarks by others to avoid

jeopardizing their trademark rights. Moreover, the IRS has clearly stated that the exercise of such quality control rights is fully consistent with tax-free royalty income.

4. The contract should not list any required duties or activities pursuant to which the association will assist the vendor in the marketing or administration of its products or services (e.g., providing free advertising space in the association's magazine, providing free exhibit space at the association's trade show, drafting and sending letters to the association's members to promote the product or service, processing applications for the product or service, answering questions about or fielding problems with the product or service). All marketing and administration of the product or service should be conducted and paid for - at fair market rates - by the vendor, an unrelated third party, or the association's taxable subsidiary (e.g., the association's regular rates should be paid for advertising space in the association's publications, exhibit booth space at the association's trade shows, etc.). The association's programs or facilities (such as the association's magazine, trade show, membership mailings, or broadcast fax or e-mail system) may only be used to promote the vendor's product or service if such promotions are created and paid for by the vendor or a party other than the association. For instance, the association should not be involved in or pay for the cost of creating magazine advertisements, designing trade show booths, or drafting marketing letters. The association, may, however, review, edit and approve such items as part of the exercise of its quality control rights. However, the vendor or other party must then pay fair market value for the placement of the ad in the association's magazine (taxable advertising income to the association), for the exhibit booth at the association's trade show (tax-free trade show income to the association), or for the right to be included in an association membership mailing, new member packet, broadcast fax or e-mail, etc. (taxable advertising income to the association). The association should not share in the vendor's expenses for such items.

5. The association may list and refer to one or more endorsed products or services in printed lists of member benefits, but such listings should be of minimal descriptiveness so as to not be construed as ads or promotions on behalf of the vendor. Similarly, it should be permissible for a staff member or volunteer leader of the association to verbally mention an endorsed product or service at an association meeting or conference, but anything more than a brief mention in passing could be construed as a promotion of the vendor. If a listing of the endorsed product or service is provided on the association's Web site, it currently is unclear whether the association also may, consistent with royalty treatment, provide a hyperlink to the vendor's Web site. If the association charges other vendors for the right to maintain a hyperlink to their Web site on the association's site, then the association certainly should charge an endorsed vendor in the same manner. Moreover, the IRS has suggested informally that if the link goes directly to a page on the vendor's Web site where the endorsed product or service may be ordered, this is more likely to constitute the provision of an advertising service and should be paid for by the vendor. Even if the association does not otherwise charge vendors for the right to maintain hyperlinks, and even if the link is to the home page of the endorsed vendor's Web site, a modest charge to the endorsed vendor in consideration for this right would be prudent, at least unless and until the IRS says otherwise. Of course, such charges will constitute taxable income to the association.

6. It is permissible for the association to license the facsimile signature of one of its staff members or volunteer leader for use on a marketing letter that is drafted and paid for by the vendor; this is merely the licensing of intangible property. Moreover, it is permissible for the association to license its letterhead stationery design to the vendor for use in preparing such marketing letters - again a mere license of intangible property - so long as the vendor pays or reimburses the association for the costs of the printing and paper on which the letterhead design is printed. Finally, of course, the vendor should pay the costs of sending the letters (through whatever medium - mail, fax, e-mail, etc. - they are sent).

7. Always use *gross* income as a measurement tool for determining royalty payments (e.g., royalties calculated as a percentage of gross sales of the endorsed product or service to members). The association should never contract for any percentage of *net profits* from the sale of the product or service, as this is indicative of a joint venture and can turn otherwise tax-free royalty income into taxable UBI.

8. The contract should expressly state that it is not intended to create a "joint venture" or "partnership" between the parties. In addition, the contract should avoid the word "agent." The vendor should not be referred to as an agent of the association, nor should the association be referred to as an agent of the vendor.

9. The endorsed product or service always should be referred to as the vendor's product or service, and should never be referred to as a product or service of the association.

10. All miscellaneous documents, such as marketing materials, correspondence and board meeting



minutes, should be consistent with the contract. A "paper trail" that is inconsistent with the terms of the contract can undermine the beneficial tax treatment the association might otherwise enjoy.

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## ARTICLES

November 1, 1999

### UBIT FOR ASSOCIATIONS IN A NUTSHELL

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Although trade and professional associations are granted a general exemption from federal income tax by the Internal Revenue Code (the "Code") - for income from activities that are substantially related to the purposes for which the association was granted tax-exempt status - they nevertheless are potentially taxable for income derived from unrelated business activities. The Code defines an unrelated trade or business as "any trade or business the conduct of which is not substantially related (aside from the need of such organization for income . . .) to the exercise or performance by such organization of its . . . purpose or function constituting the basis for its exemption . . ."

The tax on unrelated business income first appeared in the Code in 1950. Congress' principal purpose in enacting the unrelated business income tax ("UBIT") was to provide a level competitive playing field for tax-paying business - so that tax-exempt organizations could not use their privileged tax status to unfairly compete with tax-paying businesses in activities unrelated to their purposes. But instead of prohibiting tax-exempt organizations from engaging in any business activities at all (and denying or revoking tax exemption because of such activities), it chose to specifically permit a certain degree of business activity by tax-exempt organizations, but to tax it like any other for-profit business. Thus, such business activities are permissible, so long as the activities are not a "substantial part of its activities." The tax applies to virtually all tax-exempt organizations, including associations and their related foundations.

The imposition of the unrelated business income tax is generally at the federal corporate income tax rates. Deductions are permitted for expenses that are "directly connected" with the carrying on of the unrelated trade or business. If an organization regularly carries on two or more unrelated business activities, its unrelated business taxable income ("UBTI") is the total of gross income from all such activities less the total allowable deductions attributable to such activities.

**Three-prong UBIT test.** It is important to note that not all business income is subject to taxation or to limitations: only "unrelated business income" as defined in the Code. Unrelated business income will only exist if three conditions are satisfied; if any one of the three is not present, then income from the activity will not be taxable. The income must be:

- (1) from a trade or business;
- (2) that is regularly carried on; and
- (3) that is not substantially related to the purposes for which the organization was granted tax exemption.

**Exclusions.** Even if all three conditions of the UBIT test are satisfied, there are numerous statutory exclusions (i) from the definition of an unrelated trade or business, and (ii) in the computation of UBTI, which can exempt otherwise taxable income from UBIT. Many such exclusions are potentially applicable to trade associations, while many are not. The most relevant exclusions include:

- Volunteer labor exception
- Qualified corporate sponsorship payments
- Qualified convention or trade show income
- Dividends, interest and annuities
- Royalties
- Rents from real property (non-debt-financed)
- Certain capital gains

**Taxable subsidiaries.** If the gross revenue, net income, and/or staff time devoted to unrelated business activities become "substantial" in relation to the tax-exempt functions of an association (thereby jeopardizing its tax-exempt status), the association can "spin off" one or more of the unrelated activities into a separate but affiliated entity, commonly referred to as a "taxable subsidiary." Such a

taxable subsidiary will pay corporate income tax on its net income, but can remit the after-tax profits to the parent association as tax-free dividends.

**Filing and payment requirements.** In computing UBTI, a specific deduction of \$1,000 is permitted. If an association has gross UBTI of \$1,000 or more during its fiscal year, it must file a completed IRS Form 990-T to report such income and pay any tax due. The Form 990-T is due at the same time as the Form 990, however, if an association expects its annual UBIT (after certain adjustments) to be \$500 or more, then it must make estimated tax payments throughout the year. The Form 990-T is not subject to public disclosure like the Form 990.