Nonprofit Strategic Partnerships: Building Successful Ones and Avoiding the Legal Traps

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Overview & Introduction

Overview

Joint Activities

– Joint Programs – By Contract
– Subsidiary Entities – More Complex
  • LLCs
  • Corporations

Promotional and Fundraising Affiliations

– Corporate Sponsorships
– Licensing (Passive Royalty Income)

Need Drives Structure

Permanence/Up Start

Desired Flexibility

- Capitalization
- Recruiting and Pay
- Ability to Participate in Joint Ventures

Type of Activity

- Liability
- Tax-Exempt Status

Taxable Activities, Liability & Attribution

Substantiality

- Tax-Exempt Status at Risk if Non-Exempt Activities Constitute a "Substantial" Part of Exempt Organization's Activities or Income
- Undefined Concept, Generally 15% of Activities or Income
- House Unrelated Activities in Subsidiary to Avoid Jeopardizing Tax-Exempt Status

Liability – Tort, Bankruptcy, Etc.

Shield from Liability

- Financial Liability
- Vicarious Liability for Claims

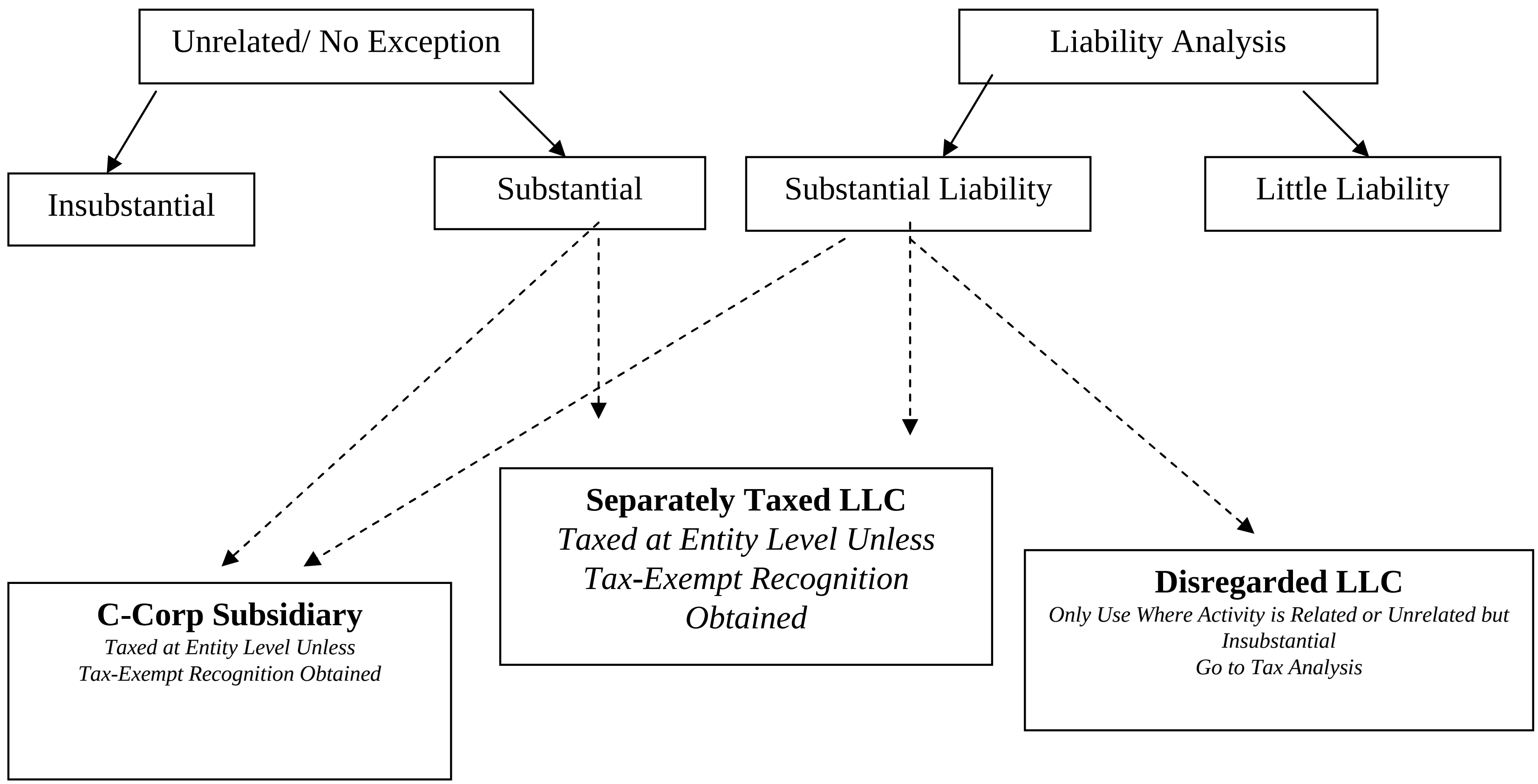
Insulation of Parent from Potential Liability

Liability for Legal Claims, Tort Claims

Bankruptcy, Other Financial Claims

Shield from Liability

Managing Activities and Program Liabilities



Options

Choosing a Form

Contract

Limited Liability Company

– Disregarded; Separately Taxed

Corporation

– For-Profit; Tax-Exempt

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Contract Clauses

Outline Respective Roles, Rights and Obligations of Partnership in Contract

Should Include the Following Provisions:

- Scope
- Exclusivity
- Ownership of IP
- Allocation of Risks/Indemnification
  - Financial Losses
  - Legal Claims
    - Can Be Difficult to Apportion Responsibility as Contemplated by Typical Indemnity
- Allocation of Costs
  - Contracts
  - Financial Contributions
- Distribution of Profits

Managing Liability
Related & Insubstantial Activities

Disregarded LLC

Single Member, Considered Branch or Division of Member for Tax Purposes

Shield From Liability (Legal, Not Tax)

Exempt from Federal Income Tax under Parent's Tax-Exempt Determination Letter

All Activities, Income and Expenses Report on Form 990 – *Taxation Dependent on Activity Analysis*

If Activities of Disregarded LLC Are Unrelated and Substantial, Could Jeopardize Tax-Exempt Status

Managing Liability & Taxation

Separately Taxed LLC

- Rights and Roles Outlined in Operating Agreement
- Treated as a Corporation for Tax Purposes
- Activities Not Attributed to Parent

C-Corporation

- Rights and Roles Outlined in Operating Agreement
- More Formal
- Can Issue Stock

Limited Liability Company

- An LLC Owned by Two or More Entities Can Be Disregarded
  - Exempt Owner Maintains Control
- Exempt Owner Treats Operations and Finances of the LLC as Its Own for Tax Purposes
- If LLC Activities Are Unrelated to the Owner's Exempt Purposes, Could Jeopardize Tax-Exempt Owner's Status
- However, If Advances Tax-exempt Purposes, Can Be Useful for Limiting its Owner's Liability on a Specific Project
- May Qualify for Tax-Exempt Status (See 2001 EO CPE Text Topic B)

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Separate LLCs and Corporations

Can Be Tax-Exempt or For Profit

May Be Controlled by Exempt Organization

Legal - Complete Protection from Legal Liability (Beware of “Mere Instrumentality” and Corporate “Piercing”)

Tax - Activities Not Attributed to Parent; Important Where Activities Are Unrelated

Choice Between LLC & C-Corp. Depends on Needs of Entity

Control

Financial Considerations

PLRs – Suggest Limits on Assets which May Be Transferred to a For-Profit Entity

Prudent Investor

- Director Review
- Rate of Return

Tax-Exempt Status

"Whole Joint Venture" – Where Nonprofit Contributes Substantially All of Its Assets.

- 51% of More of Voting Rights and/or Veto Power

Ancillary Joint Venture" – Portion of Resources Are Contributed

Tax-Exempt Status

– Control over Tax-Exempt Aspects of the Joint Venture

– Voting and Ownership Interests in the Joint Venture that Are Consistent with Capital Contributions

– Joint Venture Gives Priority to the Tax-Exempt's Purposes over Maximization of Profit for Participants in the Joint Venture

– Prohibition on Activities that Would Jeopardize the Tax-Exempt Owner's Tax-Exempt Status

Methods of Control

Program Guidance

Voting Rights

Rights to Appoint Board

Staffing

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Tax Implications for Parent Taxable Subsidiaries

Control

↓

Parent Receives Tax-Free Dividends

Less Control

↓

Parent Receives 512(b) Income Tax-Free

Slippery Slope of Control

An Entity Is a Controlled Organization if the Controlling Organization Owns:

By Vote or Value More than 50 Percent of a Corporation's Stock (for an Organization that Is a Corporation) or Beneficial Interest (for an Organization that Is an LLC)

Control of a Nonstock Corporation Means at Least 50 percent of the Directors or Trustees of Such Organization Are Either Representatives of, or Directly or Indirectly Controlled by, the Controlling Organization

Tax Implications for Separate Entity

- Tax-Exempt Activities Require Separate Tax-Exempt Determination to Avoid Taxation
  – But Can Bifurcate Activities
- Corporation Is Treated as a Separate Taxpayer, Subject to Corporate Income Tax at a Maximum Rate of 35%

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Tax Implications for Parent

If Not Controlled, IRC Section 512(b) Distributions Will Not Result in UBIT to Parent

1. Dividends (from Stock)
2. Interest (Typically from Extended Credit)
3. Royalties (Intellectual Property License)
4. Rent (Such as Rented Space)

But if a Subsidiary Is Controlled, 2-4 (Excluding Dividends) Do Not Apply

Net Unrelated Income Excess Benefits

- Controlling Organization Must Include the Payment as Unrelated Business Taxable Income (UBTI) to the Extent that the Payment Reduces the "Net Unrelated Income" (or Increases the "Net Unrelated Loss") of the Controlled Entity
- Also Be Aware of IRC Section 4958 Excess Benefit Application to Controlled Entities

Attribution and Corporate Piercing

Separateness

- Shared Staffing, but Separate Tracking
- Financial Separation

Corporate Formalities Important

- Regular Meetings
- Documentation

Fundraising and Promotional Affiliations

Corporate Partnerships Maximizing Income

Qualified Sponsorship Payments

- Payment with No Expectation of Substantial Return Benefit
- Disregarded Benefits:
  - Goods or Services, or Other Benefits, the Total Value of Which Does Not Exceed Two Percent of the Sponsorship Payment; and
  - Recognition, *i.e.,* Use or Acknowledgment of the Sponsor's Name, Logo, or Product Lines in Connection With the Nonprofit's Activities
- Payments Received for Advertising Are Characterized as UBI

Licensing Arrangements

Royalty: Payment for Use of Valuable Intangible Right

License Name, Mark and Mailing List, and Other Intellectual Property

No Active Promotion or Services (or Quantify Value and Pay Tax)

- Announcement Letter Okay
- Quality Control Measures Okay

Commercial Co-Ventures

Commercial Co-Venture ("CCV") – 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

For-Profit Business Uses Name and/or Logo of Charity for Purposes of Increasing Sales of Business's Products or Services and Increasing Revenue to Charity

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 Regulating Various Methods of Fundraising, Including Charitable Solicitations and CCVs

About 20 States Have Laws Specifically Regulating CCVs

New York Definition of "Commercial Co-Venturer" is Fairly Standard:

- "Any person who for profit is regularly and primarily engaged in trade or commerce other than in connection with the raising of funds or any other thing of value for a charitable organization and who advertises that the purchase of goods, services, entertainment, or any other thing of value will benefit a charitable organization." [N.Y. Exec. Laws § 171-a]

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 by Co-Venturer, Including AL, HI, IL, MA, ME and SC

Bonding – A Few States, Including AL, MA and ME, Require the Co-Venturer to Obtain a Surety Bond

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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 the CCV.
- Some States Require Specific Terms Regarding Sales Promotion, Charitable Purposes Benefitted, and Charity's Right to Cancel Be Included in the Contract.

Advertising Disclosures – Advertisements Must Disclose Anticipated Portion of Sales Price, % of Gross Proceeds, or Other Benefit Received by Charity.

Accounting & Recordkeeping – Most States Require CCV to Keep Records, Provide Charity (and Sometimes the State) with Final Accounting of Campaign, and Maintain Accounting for Specified Number of Years.

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.

Regulation of Commercial Co-Ventures: BBB Standards

BBB Wise Giving Alliance Standards for Charity Accountability – www.bbb.org/us/charity-standards

BBB Standard 19

– Should Clearly Disclose How Charity Benefits from the Sales Promotion

– Ensure That Sales Promotions Disclose the Following at the Point of Solicitation:

- 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);
- Duration of the campaign; and
- Any maximum or guaranteed minimum contribution amount (*e.g.*, up to a maximum of $200,000).

Questions and Discussion

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