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UBIT: WHAT EVERY NONPROFIT CFO NEEDS TO KNOW ABOUT SPONSORSHIPS, ADVERTISING, ROYALTIES, AND CAUSE MARKETING

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Overview

Federal Tax-Exemption Background

Basics of federal tax exemption

Related income

Unrelated Business Taxable Income (UBTI)

Exceptions to and exclusions from UBTI

Unrelated Business Income Tax (UBIT) tax rates and rules
(including changes imposed by the federal *Tax Cuts and Jobs Act of 2017*)

IRS UBIT filing requirements

What Is Unrelated Business Income (UBI)?

Basics of federal tax exemption

Trade or business;

Regularly carried on; and

Not substantially related to
the organization's tax-
exempt purposes



What Is Unrelated Business Income?



All three prongs must be satisfied for UBI to exist; it is a facts-and-circumstances test

More than “insubstantial” total UBI can jeopardize an organization’s overall tax-exempt status, but alternatives such as taxable subsidiaries are available

Even if the three prongs of the UBIT test are satisfied, there are numerous specific exceptions from UBI that may apply

Don’t let the tax laws be the tail that wags the dog – if it makes more economic and business sense for your organization to earn UBI (and more revenue overall) instead of limiting your activities to keep the revenue tax-free, then do it; just be smart about utilizing offsetting directly connected expenses to minimize tax liability and keep an eye on overall UBI levels to protect the organization’s tax-exempt status

IRS Definition of Unrelated Trade or Business

Internal Revenue Code Section 513

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...**

1950 Congressional Enactment of UBIT Statute

C.F. Mueller Company (1951 Third Circuit Decision) – New York University Law School purchased the C.F. Mueller Company pasta manufacturing company, with all profits from the company dedicated to the Law School and its tax-exempt purposes

The Third Circuit Court of Appeals reversed the U.S. Tax Court's decision that had held that the Law School was no longer organized and operated exclusively for charitable purposes, relying on the then-“use-of-funds” test, thereby upholding the Law School's position and its tax-exempt status

In 1950, concerned about unfair competition against taxable entities, Congress enacted the UBIT statute, eliminating the use-of-funds test and imposing today's current UBIT regime, effective 1/1/51; with a few exceptions, the statute has been largely unchanged since then



Trade or Business?

• Profit motive – but actual profit doesn't matter (except with respect to recurring losses year after year, which can be problematic)

Does the activity resemble those conducted by taxable commercial entities? (Commerciality Doctrine)

Regularly Carried On

Principal factors to analyze: (i) Frequency and continuity with which the activity is conducted; and (ii) Manner in which the activity is pursued (especially as compared to comparable commercial activities of 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 Tax-Exempt Purposes

The need for income is not enough, and how the income is used is irrelevant

The activity must contribute importantly to the accomplishment of one of the nonprofit's tax-exempt purposes

Trade/professional association context:
“Particular Services”

- To be “related,” the activity must be primarily directed toward the improvement of its members’ business conditions, i.e., activities that benefit the industry/profession as a whole, instead of just individual businesses and professionals that pay for the service

It is often unclear where an association’s activity changes from principally benefitting and being directed at the industry as a whole (with only incidental benefits to individual members), to principally benefitting and constituting particular services to individual members

Real-life example of a wildlife conservation 501(c)(3) organization that turned an otherwise-unrelated business activity in a “related” one by accompanying the sale of office desk accessories that were imprinted with pictures of endangered species with literature about the endangered species and information about what you can do to help protect the species and support the organization.

Has the activity become too commercial? A religious shrine’s restaurant was open well before and after the hours of the shrine and extensively supported by local advertising. They went well beyond what was necessary to serve visitors to the shrine.

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 tax-exempt purposes of the organization

Income that Is Usually Treated as Unrelated Business Income (UBI)

Advertising income (includes ads in periodicals and moving banner advertisements on websites)(nonprofits' programs can be segregated into related and unrelated components for taxation purposes, with periodical subscription sales usually being related and advertising in periodicals almost always being unrelated)(special IRS regulations apply to calculating membership associations' UBIT from periodical advertising)(theoretical advertising exception from UBIT if all ads are strictly tied to all editorial content: *U.S. v. American College of Physicians* (U.S. Supreme Court, 1986))

Rental income received from debt-financed property

Payments from certain "controlled" entities (e.g., rents or royalties from majority-owned or -controlled subsidiaries)

Is the Income Taxable?

Income that is specifically excluded from UBI:

Qualified
corporate
sponsorship
income

Royalty income

Qualified
convention and
trade show income

Interest, dividends,
annuities, and
certain capital
gains

Certain non-debt-
financed rental
income from real
property

Volunteer labor
(85% or more
conducted by
unpaid volunteers)

Sale of donated
goods

Certain research
income

Certain bingo
games

Renting mailing list
to another
charitable
organization

UBIT SPECIFICS OF NOTE

- There is a \$1,000 corporate income tax deduction for UBIT
- UBI is taxed at the new, flat corporate income tax rate of 21% (previously, the tax rates were graduated, with a top rate of 35%)
- There is a tax deduction against UBI for directly connected expenses incurred to generate the UBI
- Net operating losses (NOLs) are generally permitted unless recurring for a number of years, which suggests no profit motive
- You can no longer offset losses from one unrelated business activity against gains from another unrelated business activity (profits and losses are determined per activity; known as the “silo” rule)
- Tax-exempt organizations now have to pay UBIT on certain employee fringe benefits, including parking, transportation benefits, and on-premises athletic facilities (but this UBIT is not subject to the “silo” rule)
- Quarterly estimated tax payments must be made at the federal and state levels for UBIT, and an IRS Form 990-T must be filed each year (comparable state tax filing as well)

UBIT Exceptions:

Qualified Corporate Sponsorship Income

Corporate Partnerships: Maximizing Income

Qualified Corporate Sponsorship Payments

Safe Harbor: There is no arrangement or expectation that the payor will receive a substantial return benefit (valued at 2% or less of the 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 nonprofit's activities
- Applicable to a broad range of temporary and permanent activities (including websites), *excluding*:
 - Trade show and convention activities (covered by another UBI exception)
 - Advertisements or acknowledgment in periodicals (e.g., magazines, newsletters)(but mere acknowledgements in periodicals may not trigger UBI)
 - Contingent payments

Illustration

ABC Corporation makes \$5,000 gift to the Philanthropy Foundation (2% = \$100)

Example #1 – \$60 return benefit – Safe harbor

\$20 educational event tickets

\$30 advertising in event program

\$10 board dinner

Example #2 – \$150 return benefit – No safe harbor (but not necessarily UBI)

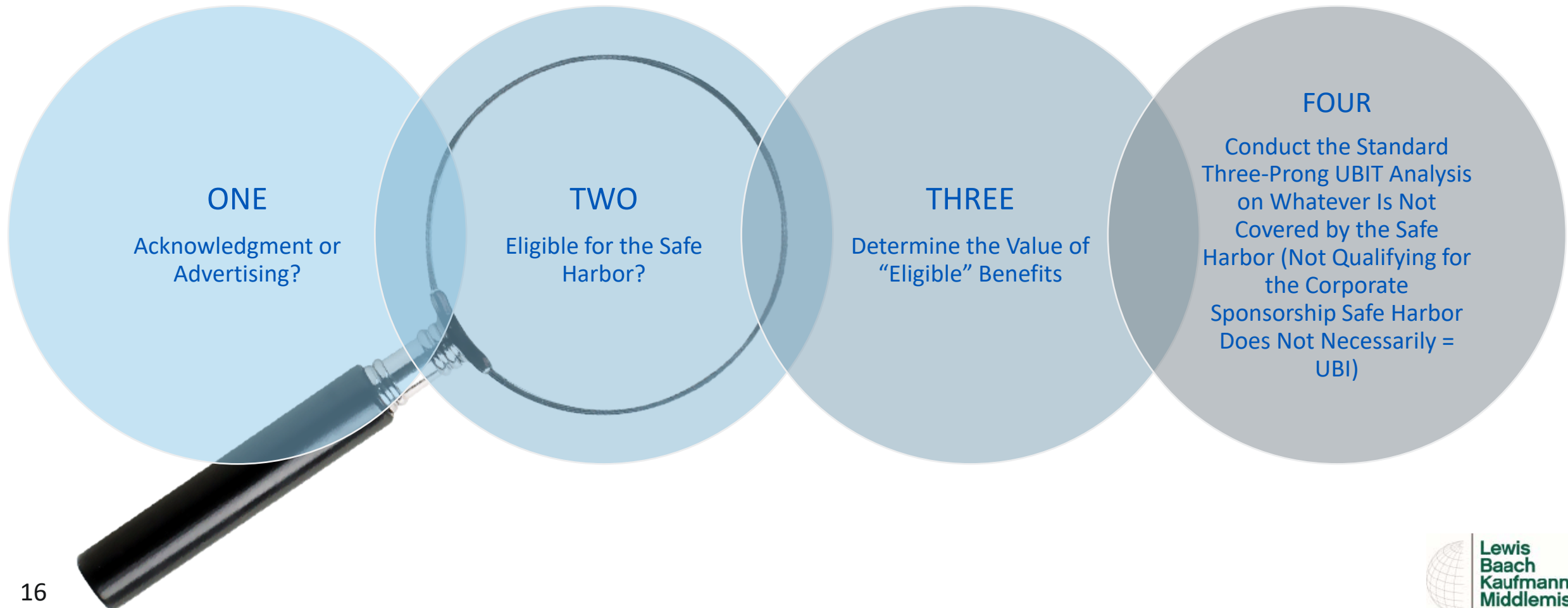
\$50 licensing rights (not taxed, passive royalty)

\$50 educational event tickets (not taxed, “related” income)

\$50 advertising in event program (taxed at market rates)

NOTE: The tax treatment of a donation or payment from a sponsor to a tax-exempt organization has no bearing on the tax deductibility of the donation or payment to the sponsor as a charitable donation or business expense; that analysis is separate and distinct, and is affected by issues such as donative intent, the value of benefits received in return, the tax status of the tax-exempt organization, and the connection to the payor’s business

Analyzing Benefits



Acknowledgement or Advertising?

Acknowledgment

- Name or logo
- Description of services or 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 address, telephone number, email address, and/or web address, including a hyperlink from the nonprofit's website to the sponsor's website (main landing page – not to product or service purchase page) (moving banner likely inconsistent with acknowledgment)
- Product displays, visual depictions, product samples (whether products are sold or are given out for free)

Advertisement

- Qualitative or comparative language, price information, indications of savings or value, endorsements, inducement to purchase, sell or use

Eligible for Safe Harbor?

Safe harbor does not apply to (apply standard UBIT analysis):

OVER 2%	Sponsorship payments where return benefit is over 2%; in such cases, only the portion (if any) of the payment that exceeds the FMV of the return benefit (at the time the arrangement is entered into or renewed) will be considered a qualified sponsorship payment
CONTINGENT PAYMENTS	Where the level of payment depends on attendance numbers, broadcast ratings, web hits, social media likes, etc. (but not if contingent on the event occurring at all)
EXCLUSIVE PROVIDER ARRANGEMENTS	E.g., right to be the exclusive provider of soft drinks at an event (Reg. §1.513-4(f), Ex. 6) – but exclusive sponsor arrangements are consistent with the safe harbor

Eligible for Safe Harbor?

CONVENTION OR TRADE SHOW	<p>Exhibit booths, tickets to trade show, acknowledgment at trade show, etc.</p> <ul style="list-style-type: none">• But generally covered by the convention and trade show UBI exception
ADVERTISING OR ACKNOWLEDGMENT IN PERIODICALS	<ul style="list-style-type: none">▪ The safe harbor does not apply to periodicals (print or electronic)▪ Illustration: A textbook publisher makes a large payment to have its name displayed on the inside cover of the nonprofit's monthly magazine (Reg. §1.513-4(f), Ex. 10)<ul style="list-style-type: none">• Because the magazine is a periodical, the safe harbor does not apply• Mere acknowledgment in an event program guide is likely covered by the safe harbor, but advertising in an event program guide is not (Reg. §1.513-4(f), Ex. 8)
MERE ACKNOWLEDGMENTS IN PERIODICALS (THANKING/ACKNOWLEDGING SPONSORS/DONORS) LIKELY STILL TAX-EXEMPT EVEN THOUGH NOT COVERED BY THE SAFE HARBOR	<p>Due to not satisfying the three-prong UBIT analysis</p>

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

UBIT Exceptions: Royalty Income

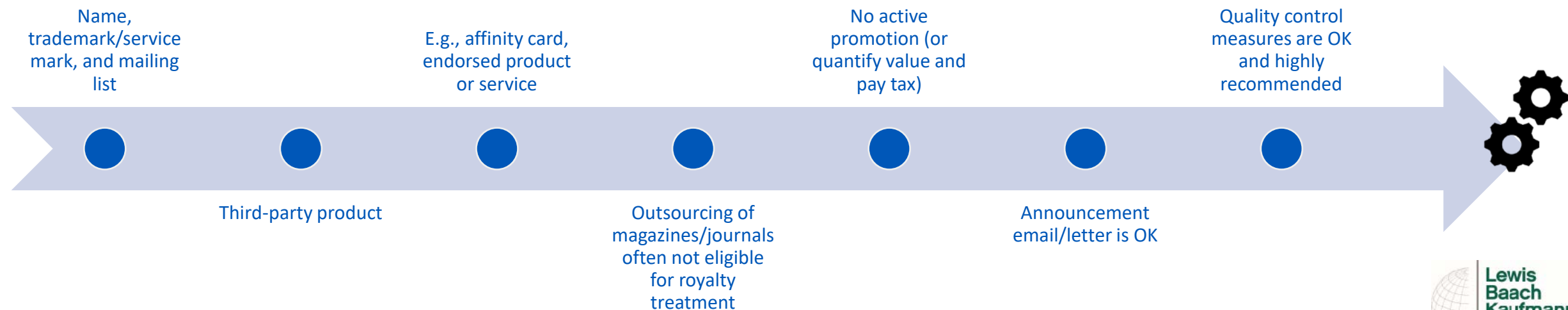
Specific Exclusions – Royalties

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:



Royalties – License of Name and/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
- An organization's activities are generally limited to those necessary to protect its reputation:
 - Review use of name and logo for quality and style
 - Limit the use of name and logo to approved circumstances

Evidence of other (usually service) relationship

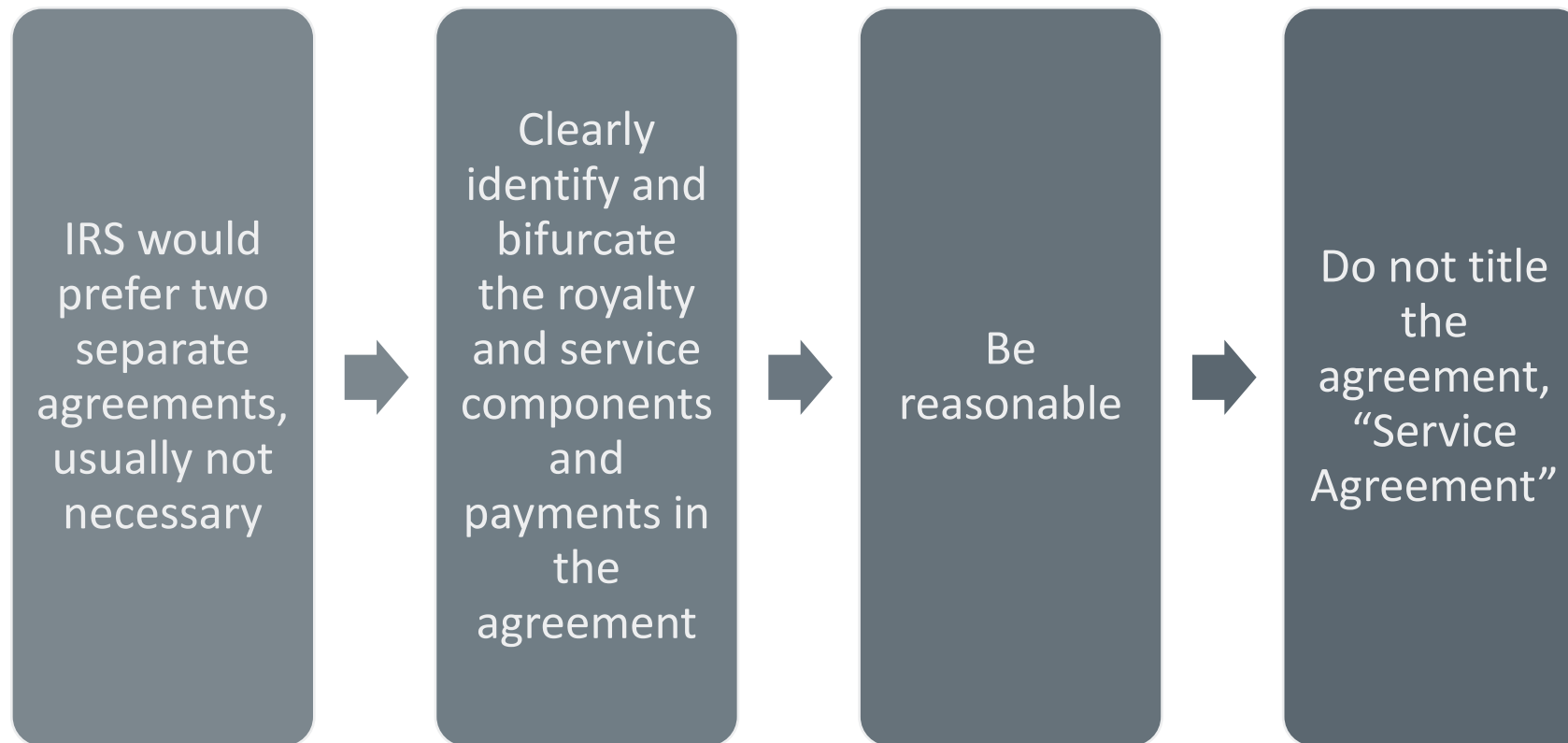
- Marketing services (promoting the product/service) and/or administrative services (helping to administer the program)
- Significant activities or rights, such as approval of editorial content and preparing articles in a periodical
- Existence of a *quid pro quo* transaction

Royalties – License of Name and/or Logo

- The IRS has taken a strict position with royalty income, but lost most of the litigation that transpired about 25 years ago, and the IRS' position has softened a bit over the years
- Dual-purpose relationships:
 - If the service component is minimum, this is likely not an issue and can all be treated as tax-free royalties
 - If the service component is significant:
 - The IRS will likely determine that none of the income is royalty income
 - Courts have looked to the entire relationship to determine what the nonprofit is actually getting paid for on a fair market basis (e.g., what is the value of the exclusive name/logo license (endorsement) versus the value of the services being provided?)

Royalties – License of Name and/or Logo

Dual-purpose relationships best practices:

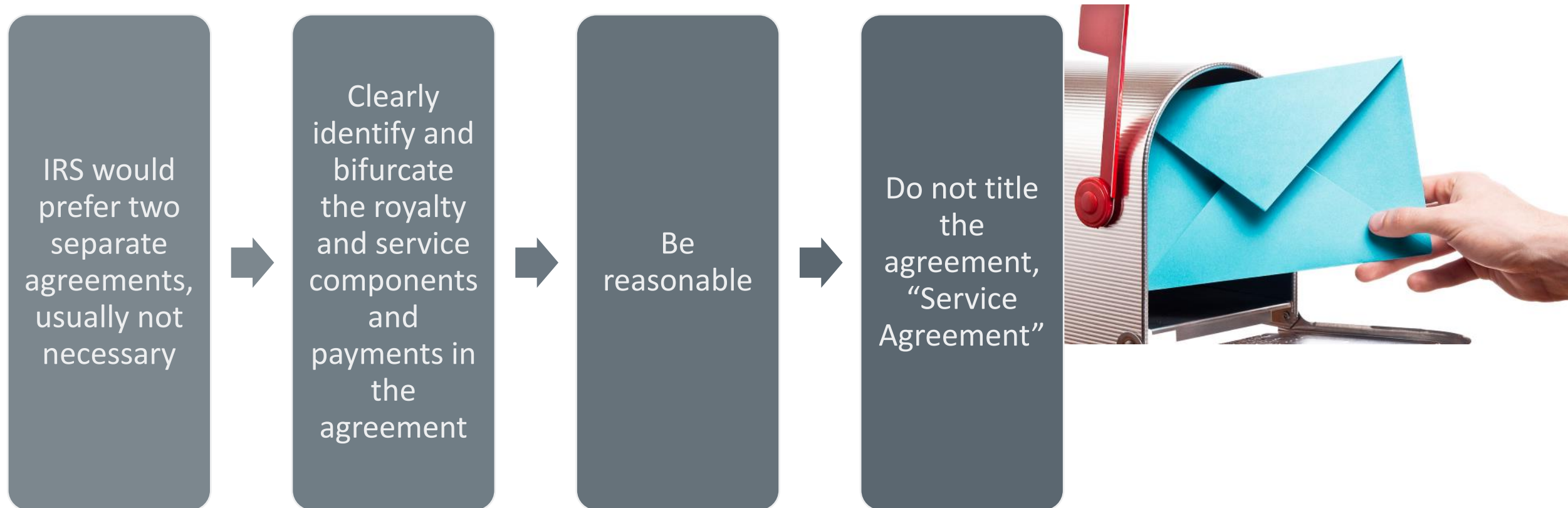


Royalties – Mailing List Rental

- Income from rental of mailing list to other 501(c)(3) tax-exempt organizations is expressly excluded from UBI under the federal tax code
- Rental of mailing list to taxable entities is excluded from UBI as royalties
- Courts have looked to whether the agreement requires “significant” activities
 - Usually UBI issues arise as 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 generate UBI issues

Royalties – Mailing List Rental

Dual-purpose relationships best practices:



Royalties – Affinity Credit Cards

- Courts have ruled that payments received by organizations through affinity credit 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 use of and the goodwill associated with the organization's name and logos, or a payment for promotional and mailing list management services – or both; if both, there needs to be a reasonable, fair market allocation between the two
- Courts have held that the amount of services provided does matter



Cause-Related Marketing

Cause-Related Marketing



Commercial Co-Ventures

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 purchase our new iPhone app, 50% of the purchase price will go to the Lincoln Center for the Performing Arts!

Frequently referred to as “charitable sales promotions” or “cause-related marketing”

Excellent fundraising and marketing mechanism for both the charity and commercial co-venturer

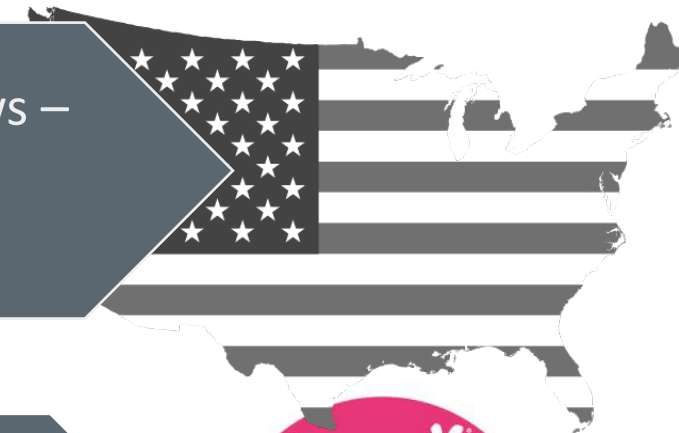
Regulation of Commercial Co-Ventures

State Law

More than 40 states have laws that regulate various methods of fundraising, including charitable solicitations and CCVs

Approximately 26 states have laws that specifically regulate CCVs

Purpose of laws – consumer protection



Example: General Mills/Yoplait “Save Lids to Save Lives” campaign in late 1990s to benefit the Breast Cancer Research Foundation

- Georgia Secretary of State concluded that the disclosures regarding the donation amount were misleading to consumers



Regulation of Commercial Co-Ventures

State Law

Statutory language and requirements vary by state → always check the language of the statute



NY's 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 things of value will benefit a charitable organization." [N.Y. Exec. Laws § 171-a]



Compared to broader MA statute:

- "[A]ny person who for profit or other commercial consideration conducts, produces, underwrites, arranges or sponsors a performance, event, or sale to the public of any good or service which is advertised in conjunction with the name of any charitable organization or as benefitting to any extent any charitable purpose." [Mass. Gen. Laws Ch. 68, § 18, 22-28]

Regulation of Commercial Co-Ventures

State Law

- State law requirements, generally:



- Registration: Several states require advance registration or notification by co-venturer; they include AL, CA, HI, IL, MA, MS, and SC
- Bonding: AL and MA require the co-venturer to obtain a surety bond

Regulation of Commercial Co-Ventures

State Law

Written Contract

- Many states (including NY and NJ) require a written contract, which must be filed with the state by the co-venturer
- A 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 the contract, including:



- Identification of charity or charitable purposes benefited
 - Description of sales promotion, including goods/services and estimated number to be sold
 - Description of offer to be made to the public regarding amount to be given to charity [N.Y. Exec. Law § 170-b(2)]
 - Terms relating to charity's right to cancel [N.Y. Exec. Law § 174-a]
 - Charity authorization, e.g., MA requires signature of two officers [Mass. Laws Ch. 68 § 22(a)]
 - Location, start and end dates of sales promotion
- Both parties must keep a copy of the contract

Regulation of Commercial Co-Ventures

State Law

■ Advertising Disclosures

- Ads must disclose anticipated portion of the sales price, percentage of the gross proceeds, dollar amount per purchase, or other consideration or benefit received by the 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
- California: Funds raised must be given to charity every 90 days during campaign [Cal. Government Code § 12599.2]

Regulation of Commercial Co-Ventures

State Law

- **Co-venturer obligations:** States generally impose requirements on the commercial co-venturer only

- **Charity obligations:**

A few states impose certain CCV requirements (filing of notice, contract and accounting) on the charity

Charities must be registered (and current in their annual reporting) to solicit funds under charitable solicitation laws in states where sales promotion will run

- Requirements vary by state. Check the statutes.

Regulation of Commercial Co-Ventures

Council of Better Business Bureaus Standards

BBB Wise Giving Alliance Standards for Charity Accountability

- www.bbb.org/us/charity-standards



BBB Wise Giving Alliance Standard 19 (often effectively enforced by state charity regulators):

- 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)

Federal Tax Law and Maximizing CCV Income

If a charity plays a wholly passive role, the funds it receives from the CCV should count as contribution income (and able to be counted toward the “public support” test), as royalty income (if so structured), or as a qualified corporate sponsorship (see below)

[illegible]

If a charity has a more active role (promotion-wise or otherwise) and/or provides any “return benefit” to the co-venturer (e.g., including the co-venturer’s name and logo on the charity’s website in connection with the promotion), then some UBI may be triggered

In that case, it may make sense to structure it as a qualified corporate sponsorship arrangement

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 the promotion's 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.

QUESTIONS & ANSWERS





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