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
  - Convention and Trade Show
- Cause-related marketing
UBIT Basics

<table>
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<tr>
<th>General Rule</th>
<th>Organization recognized as exempt does not pay income tax on most income received by organization</th>
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<td>Exception</td>
<td>If the income received is unrelated business income (UBI), it is subject to taxation. Organization must report and pay tax at corporate rate.</td>
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“The term “unrelated trade or business“ means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 ...”

Internal Revenue Code Section 513
(1) Trade or Business

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

(2) Regularly Carried On

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

- Need for income is not enough
- Association context – exempt purpose directed toward the improvement of members’ business conditions; activities to benefit members as a whole instead of individual businesses
- Rev. Rul. 81-138 - Chamber of Commerce’s lease of building 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 form certain controlled entities
  - Income received for the performance of services in exchange for tangible goods
Is the Income Taxable?

- Income that is generally excluded from UBIT
  - Passive income
- Income that is specifically excluded from UBIT
  - Interest income
  - Royalty income
  - Certain research income
  - Conference and Trade Show Revenue
  - Qualified Sponsorship income
  - Certain bingo games
  - Debt management plan services
  - Renting mailing list to another charitable organization

UBIT Exceptions:
Qualified Sponsorship Income
Putting it in Context

• **Sponsor Agreement - $25,000**
  – Official sponsor of educational seminar
  – Name recognition on website
  – Exhibit space at convention
  – Ability to use mailing list
  – Ability to use “official sponsor of Hix Association” on sponsor’s products
• **3 UBIT exceptions utilized, each with particular rules**
• **How to you identify?**

Qualified Corporate Sponsorship
IRC Section 513(i)

• **Overview**
  – Establishes “safe harbor”
  – When primary benefit is **acknowledgment**
    • Program
    • Organization as a Whole
  – Not used in **convention/tradeshow context** (though abiding by the guidelines is always recommended)
  – Not used in **regular periodicals** (though abiding by the guidelines is always recommended)
  – Not used for **contingent payments**

• **Primary Issues**
  – Return Benefit (2%)
  – Advertising vs. Acknowledgement
Structuring Sponsorship Agreements

1. Eligible for Safe Harbor?
   - Is The Sponsored Activity/Form of Sponsorship Recognition Covered by the Rules?

2. Is There a Return Benefit?
   - Acknowledgment or Advertising?
   - Other Return Benefits

3. Value Return Benefits
   - If Over 2%, Apply UBIT Rules

4. Structure Agreement Accordingly

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1. Eligible for Safe Harbor?

- Convention and trade show (exhibit booths, tickets to trade show, acknowledgment at trade show, etc.)
- Advertising or acknowledgement in regular periodical
  - Illustration: A textbook publisher makes a large payment to have its name displayed on the inside cover of a monthly magazine. (Reg § 1.513-4(f), Ex 10)
  - Includes online periodicals
  - Safe Harbor DOES apply to periodical primarily distributed in conjunction with a specific event
  - Public Interest Advertising – “You will not realize (UBIT) when you acknowledge the donations with public interest advertising (where the) advertisements acknowledge the contributing organizations’ sponsorship of the N project” consistent with corporate sponsorship rules (PLR 8749085)
2. Is There a Return Benefit? Acknowledgment or Advertising?

Acknowledgement
1. Name or logo
2. Description of Services/Product Lines, as long as use is not qualitative or comparative
   – But slogans which are an established part of identity are permissible
3. Contact Information, including list of sponsor’s location, telephone number, and/or internet address, including a hyperlink from the exempt organization’s website to the sponsor’s website
4. Product displays, visual depictions, product samples (whether products are sold or are free)

Advertisement
- Qualitative or comparative, price information, indications of savings or value, endorsements, inducement to purchase

Illustration
- “The T concert is sponsored by the Music Shop, located at 123 Main Street, telephone number 555-1234.”
- “Visit the Music Shop today for the finest selection of music CDs and cassette tapes.”
• **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)
  – **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)
• **Naming of Events:** “Coca-Cola Young Scholar’s Program” (TAM 9805001)
• **Established Slogans:** “Better Research, Better Health” (Reg § 1.513-4(f), Ex 9)

• **Website Listing:** List of sponsor names on website, including hyperlink to sponsor’s site (PLR 200303062)
• **Product Display:** Displays of automaker sponsor’s cars at event (Reg § 1.513-4(f), Ex 11)
• **Exclusive Sponsors** – Right to be sole sponsor of an event, or exclusive sponsor among competitors (Reg § 1.513-4(f), Ex 4)
  – But NOT exclusive providers
2. Is There a Substantial Return Benefit?
Value of Items Given to Sponsor

1. Outline ALL “Benefits”
   - Forms of Acknowledgment
   - Tickets to Events
   - Tickets to Dinners
   - Exhibit Space
   - Complimentary Advertisement in Magazine

2. Document Value

3. If Over 2%, Apply UBIT Rules
Illustration – 2% Return Value

• **Outline Benefits** - Anything given to sponsor (except acknowledgement)

• **Value and Apply 2% Rule** - Corporation makes $5,000 gift to the Hix Association (2% = $100)
  - **Ex. 1** - $60 Return Benefit – ALL Under 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)

3. Determine Value of Eligible Benefits & Apply UBIT Rules

• **Valuation Period**
  - Valuation is applied to each tax year of a multi-year agreement - impacts pay up-front agreements
    - Ex: $25,000, all paid in 1st year: out-year benefits will fall over 2%

• **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
4. Structure Your Contract Accordingly

- **Create Buckets for Various Sponsor Benefits**
  - Exempt Functions
  - Qualified Sponsorship
  - Passive Royalty
    - (Endorsement Could Go Here)
  - Convention & Trade Show
  - Taxable Benefits
    - Advertising, Specific Services, etc.
Basics for Sponsorship Contracts

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

UBIT Exceptions:
Royalty Income
Specific Exclusions - Royalties

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

Royalties – License of Name or Logo

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

• IRS has taken a strict position with royalty income

• Dual purpose relationships:
  – If service component minimum – likely not an issue
  – If service component significant
    • IRS will likely determine that none of the income is royalty income
    • Courts have looked to the entire relationship

Royalties – License of Name or Logo

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

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

Royalties – Mailing List Rental

• 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.

Convention & Trade Show
**Qualified Convention & Trade Show**

**Code Sec. 513(d)(3)(C)**

To qualify for the exclusion, the activity must be carried out by a qualifying organization and must meet all of the following conditions:

1. The activity must be conducted *in conjunction with* an international, national, state, regional, or local convention, annual meeting, or show conducted by the qualifying organization; *and*

2. One of the sponsor’s purposes must be (a) to promote and stimulate interest in, and demand for, the products and services of the industry in general, or (b) to educate attendees on new developments or products and services related to the organization’s exempt activities; *and*

3. The show must be designed to achieve that purpose (in item (2), above) through the character of its exhibits, and the extent of the industry products displayed.

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**Cause-Related Marketing**
Cause Marketing –
Commercial Co-Venture

• Attributes
  – Commercial entity uses your name or logo in its advertisements with promise to pay a portion of purchase price to you
    • "When you buy our new iPhone app, 50% of the purchase price will go to the Lincoln Center!"
  – 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

Regulation of Commercial Co-Ventures: State Law

• More than 40 states have laws that regulate various methods of fundraising, including charitable solicitations and CCVs
• About 20 states have laws that specifically regulate CCVs
• Purpose of laws – consumer protection
• Example: 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 because a maximum contribution was not referenced
  (GA Secretary of State press release: http://sos.georgia.gov/pressrel/pr991221.htm)
Regulation of Commercial Co-Ventures: State Law

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

Regulation of Commercial Co-Ventures: State Law

- State Law Requirements, Generally:
  - Registration
  - Bonding
  - Written Contract
  - Advertising Disclosures
  - Accounting & Recordkeeping

- Registration – Several states require advance registration by co-venturer, including AL, HI, IL, MA, ME and SC
- Bonding – A few states, including AL, MA and ME require the co-venturer to obtain a surety bond
Regulation of Commercial Co-Ventures: State Law

- **Written Contract** –
  - Many states (including NY and NJ) require a written contract, which must be filed with the state by co-venturer
  - Handful of states (including AR, CT, NH, and UT) require the charity to file a copy of the contract. Some states require specific terms to be included in contract, including:
    - Identification of charity or charitable purposes benefited
    - Description of sales promotion, including 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

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

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

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

How to Approach Commercial Co-Ventures

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