



30-SECOND SUMMARY It may seem logical for certain for-profit organizations to enter into business arrangements with nonprofits. Although both parties can certainly benefit from such an arrangement, the nonprofit must be diligent to structure the deal in such a way that it does not run the risk of losing its tax-exempt status due to too much UBIT-eligible revenue. There are alternatives. It is possible to tailor the partnership arrangement so that it is fully consistent with the nonprofit's tax-exempt status. Ideally, the two organizations would split the net return from the venture, with the nonprofit enjoying tax exemption. Another approach would be for the for-profit company to accept all the profits and donate some of the proceeds to the nonprofit.

The For-Profit Entity's Guide to Doing Business with Nonprofit Organizations

By Robert Falk and Jerald Jacobs

You are deputy general counsel of a Fortune 500 children's entertainment conglomerate. One day, the vice president of marketing comes into your office and says, "We need to form a tight bond with the Fish Are Friends, Not Food Foundation. They are doing amazing work and getting great press for it. We need their brand to promote our new character, 'Smiley the Shark.'" You're excited because your best friend from law school is now the general counsel for the Foundation. You assure your VP that you can get the deal done quickly.

So, you call your buddy Jane, and after catching up on her family and recent career moves, you explain what you would like to do with the Fish Are Friends, Not Food Foundation. “First, we are thinking that we will develop a line of stuffed fish toys under our brand that we will offer you wholesale, provided we are the exclusive provider of all toys for your organization. We’ll handle the toy production, and you will sell the product at a mark-up at all of your Foundation events and on your Foundation’s website. We expect that your Foundation will be responsible for handling distribution, sales and taxes on any profit. Of course, we expect that you will email your 2 million members, encouraging them to buy our line of children’s toys, and also tweet about the promotion and post on your Facebook page.

“We also plan to give you coupons for 20 percent off of the rest of our product line so you can include them in your mailers to your constituents. We’re going to make this campaign big. We are going to take advertisements out everywhere, including print media, television and online, to promote the sale, and your logo is going to be ubiquitous. Our advertising agency has already developed the campaign, and we’re ready to launch tomorrow. We are also going to do a launch event at our flagship store; however, we were hoping, based on our partnership with your Foundation, that your volunteers and employees could staff the event. Finally, of course, we want to be a major sponsor of your annual gala dinner, but we want advertising everywhere in the city promoting our role as your lead sponsor.

“So, what do you think?”

Jane is uncharacteristically quiet, and then her tone is cool. “Bill,” she says, “You’ve given us a lot to think about, but what you’re proposing creates a lot of issues for us. It’s going to take us a while to work through this proposal. I’m not even

sure your company or our organization has the capacity to manage this in the short term.”

You, of course, are dumbfounded. You have no idea why the win/win arrangements you proposed could be complicated. Further, you’re going to have to report back to your VP of marketing that the deal will not be finished as quickly as you had promised.

If you better understood the legal restrictions on nonprofits, you may have been able to propose a more realistic deal. Let’s talk about what you might be missing in the proposal.

Nonprofits care about taxes ... and so should you

Many outside of the nonprofit world assume that charities and other nonprofit organizations don’t pay any taxes. This is not always true. In fact, tax-exempt organizations are required to pay Unrelated Business Income Tax (UBIT) at corporate tax rates on the net income from activities not related to their exempt missions. Income from ventures with for-profit business partners often results in taxation. And since too much UBIT risks an organization’s whole tax exemption status, most try to avoid incurring UBIT whenever possible. If your proposal had reflected an understanding of UBIT and its consequences for the Foundation, your company would have a better chance of showing that it can be a trusted business partner.

UBIT applies to nonprofit organization revenue if three factors exist.

First, the source of the revenue must be from a “business” activity; usually, that means it must be something that for-profit businesses also do. A nonprofit engaging in selling products or services (e.g., toys) would ordinarily satisfy this factor.

Next, the business activity of the nonprofit must be carried on regularly. Usually, that means more than once a year. So a one-time limited campaign for the Foundation to offer toys might avoid the UBIT factor of “regularly carried on,” while a more continuous endeavor would certainly not.

Finally, for UBIT to apply, the revenue must be from a business activity that is not substantially related to the purposes for which the organization was originally granted tax exemption. Any business endeavor that you propose to a nonprofit should clearly relate to the goals of that organization. Just the need of a nonprofit to generate income does not satisfy the requirement. But selling toys that advance the nonprofit’s mission might be OK. Here, something as simple as including tags on the sea creature toys, tied to the Foundation’s mission to protect sea creatures, might be enough to avoid this UBIT factor.

Note that a nonprofit is only subject to taxation of its net revenue under the UBIT principle where all three factors are present: (1) a business activity that is (2) regularly carried on and that (3) does not relate substantially to the organization’s exempt purposes. Soundly



Robert Falk is the general counsel for the Human Rights Campaign and Human Rights Campaign Foundation. He also serves as the chair of ACC’s Nonprofit Committee and the president-elect of the ACC Washington Metropolitan Area Corporate Counsel Association (WMACCA) Chapter. rob.falk@hrc.org



Jerald Jacobs is a partner at Pillsbury Winthrop Shaw Pittman LLP. jerry.jacobs@pillsburylaw.com



DEFENSE LAWYERS. DEFENSE LEADERS.

Peer selected

Rigorously vetted

Pursuing knowledge, justice, and fellowship

For over 75 years, the members of Federation of Defense & Corporate Counsel have been national leaders in the courthouse and in-house. Our Defense Lawyers and Corporate Counsel – the elite group that drives the agenda and makes a difference.

**11th Annual
FDCC Corporate Counsel Symposium**



**Defending the Company:
Forecasting, Managing, and
Responding to Today's
Legal Threats**

September 17 – 19, 2014 | Arizona Biltmore | Phoenix, Arizona

To learn more about the Federation of Defense & Corporate Counsel, or register for the Symposium, visit

www.thefederation.org

avoiding any of the factors saves the nonprofit from UBIT.

The UBIT principle also has some exceptions. The tax does not apply to income derived from “passive” activities of the exempt organization, such as dividends from investments, interest from loans, rent from unused real estate (to the extent there’s no mortgage on it) and — perhaps most notably — royalties from licensing use of the organization’s name and sponsorship.

Affinity programs

Affinity programs, in which nonprofits license their names and sponsorships to the products or services of for-profit businesses, are very common (e.g., “Proud Sponsor of the US Olympic Team”). Credit card and insurance programs are especially familiar. That being said, your company could agree to pay a license royalty to the Fish Are Friends, Not Food Foundation in return for your use of the Foundation’s name on everything from giraffe plush toys to tandem bicycles — the key requirement for the Foundation is that its involvement in the arrangement be “passive.” That means that the Foundation cannot assist in marketing those items as proposed without risking UBIT on the royalties.

There is one alternative if it’s important to have the Foundation assist in marketing. The arrangement could be “bi-furcated” so that there are really two deals. In one, your company would pay a royalty, tax-exempt to the Foundation, for use of its logo and sponsorship for your company’s products. In the other, your company would pay marketing fees to the Foundation for its help in promoting the products. In the latter case, the Foundation would be subject to tax under the UBIT principle on its net marketing fees. This “bi-furcated” arrangement was “blessed” by the IRS in a 1999 settlement with AARP.

Why all of this concern about UBIT? It might seem intuitive that your

company’s offer to the Foundation is one that it cannot sensibly refuse, even if it had to pay some federal income tax on some or all revenue. In fact, though, if not structured correctly, these kinds of arrangements can have harsh consequences for nonprofit organizations.

First, a nonprofit organization cannot have unlimited UBIT-eligible revenue without risking its entire tax-exempt status. There is a vague “no more than insubstantial” limit on UBIT-eligible revenue; the IRS has never put a number on it. Most commentators warn that when an exempt organization’s revenue from UBIT-eligible activities reaches the range of 25 percent of the organization’s total revenue from all sources, the risk to loss of tax exemption is unacceptably high. There is an antidote to the problem of too much UBIT revenue. The organization could create a controlled for-profit taxable subsidiary of its own to handle the UBIT-eligible activities; that subsidiary would pay federal income tax on its net revenues like any other business. But there are ongoing administrative, accounting and legal expenses involved in this approach; it’s usually not worthwhile unless there will be considerable revenue involved.

Commercial co-ventures

From the way you’ve described your company’s intentions, it may be that neither you nor the Foundation will be satisfied with a mere sponsorship arrangement — in which the Foundation would license its name and sponsorship for your use in promoting its commercial products and in return for “passive” royalty revenue, possibly even with a small separate marketing agreement on the side yielding taxable revenue to the Foundation.

It may be that you are willing to tailor the arrangement so that it is fully consistent with the Foundation’s tax-exempt mission of protecting sea life, but operated as a joint venture between your company and the Foundation,

often called a “commercial co-venture” in this context. Ideally, your company and the Foundation would split the net return from the venture, with the Foundation’s share enjoying tax exemption. There are some hoops to jump through in this approach as well, both at the federal and state levels.

At the federal level, the IRS requires an exempt organization to exercise majority control over a commercial co-venture with a for-profit business in order for the revenue to be tax-exempt for the organization. Your company may cede control in any number of ways, including granting the nonprofit a majority vote on the co-venture’s governing board or a majority of the return realized; another viable approach is to divide management responsibilities to give the nonprofit control of those aspects of the venture relating to tax-exempt purposes. For example, perhaps the Foundation would have control over the design of the toy sea creatures, the “messages” used in labeling and marketing, and other such mission-related elements. There is no panacea here; the key will be working with the nonprofit to figure out what control it will need over the venture in order to avoid taxation, and tailoring the final arrangements to meet those needs.

Commercial co-ventures with charitable nonprofits are also subject to regulation in 24 states — a number certain to grow over the next decade. States regulating these co-ventures often require the business and the nonprofit to develop and register a written contract outlining the nature and purpose of the venture’s activities. There will also need to be an infrastructure to comply with state reporting requirements or other regulations. It makes sense for your company to be well-versed in your state’s regulations governing commercial co-ventures with nonprofits, both to streamline the process and to demonstrate understanding of the nonprofit’s needs.



Market Leader

In Enforcing Judgments & Arbitration Awards

Winning your case is only half the battle. As the value of judgments and arbitration awards coming out of large-scale disputes continues to rise, so does the challenge of enforcing them when assets are spread across an international network of financial institutions and structures.

Kobre & Kim LLP combines proven experience with cutting edge alternative fee structures, delivering the full spectrum of asset recovery services for US \$50 million~US \$1 billion+ judgments or arbitration awards.

- Global Coverage
- Innovative Fee Arrangements
- Integrated team of U.S., English and Offshore Lawyers
- Advice on Sales of Judgments and Awards

Cause marketing and corporate sponsorships

A third approach, avoiding the complexities of a classic affinity program or a commercial co-venture, would be for your company to just give some of the proceeds of these business activities to the Foundation. There are a couple of alternatives here. First would be a corporate sponsorship. Basically, your company makes a sponsorship payment to the Foundation — perhaps supporting a Foundation event or program with your company's funding and name (e.g., "The _____ Corporation Initiative on Ocean Education"). What limitations are there here?

As you might have guessed, federal tax exemption law comes into play again. The Foundation can accept corporate sponsorships as revenue exempt from income tax as long as the Foundation doesn't give back too much to your company, the corporate sponsor. Once again, knowing what's workable for a nonprofit can be the difference between a mutually beneficially corporate sponsor relationship, and one that the nonprofit is forced to decline — or accepts and has to deal later with unforeseen difficulties.

The recipient nonprofit tax-exempt organization is restricted in what it can provide in return to a business in connection with a corporate sponsorship payment. If

it provides too much benefit, the organization will face taxation.

First and foremost, expressions of recognition and gratitude by the nonprofit to the corporate sponsor are always appropriate and, by themselves, do not risk taxation to the nonprofit. Naming the sponsored event or program after the corporate sponsor's business or brand; thanking the corporate sponsor profusely for its generosity in the nonprofit's promotion of the event or program; even displaying or providing samples of the corporate sponsor's products or services in connection with the sponsored event or program are all OK. Going any further is problematic.

If the combined fair market value of all goods, services and other benefits that a business receives in return for its sponsorship exceeds 2 percent of the payment to the nonprofit, the nonprofit is at risk of taxation. Likewise, for the recipient nonprofit to advertise or promote the corporate sponsor's goods or services is per se providing too much benefit to the sponsor. In short, it's alright to use the corporate sponsor's logo or brand in acknowledging its support, but it's not alright to praise the business or what it does, and/or to urge patronage of the business. Broad thank you messages are good; however, crossing the line toward praising the products or services of the sponsor — much less

urging use of them — creates tax risk for the nonprofit. The nonprofit must stop short of advertising or promoting the corporate sponsor or its goods and services.

Thus, inclusion of your company's logo on the Fish Are Friends, Not Food Foundation's print and electronic advertising would likely not create tax liability, given that using your trademark would fit into the "use or acknowledgment" exception. Should you wish to flesh out your offer in other ways unlikely to create a substantial benefit, you could propose naming one of your signature toy fish after the Foundation or including your company's logo on the invitations for one of the Foundation's events. Your VP of marketing could even be the host of a Foundation dinner launching the relationship with the Foundation. There is a slew of ways that the Foundation can acknowledge your company's philanthropic activities without incurring a significant tax liability for the Foundation. Both entities just need to be flexible and creative.

There's another common approach for a company such as yours to help a nonprofit like the Foundation: cause marketing. For example, you could enter into an arrangement whereby you would agree to donate a sum of money to the Foundation for every sea creature toy that your company sells. You look good, the Foundation benefits, and customers feel good about their purchases. What are the pitfalls here? Virtually none for the Foundation as long as it is comfortable having its name associated with the products involved, and there is a clear understanding on exactly what reference will be made in promoting your products to the contributions to the Foundation, for how long, etc. For your company, obviously, you need to follow-through with your commitment. And there is no charitable tax deductibility to the customer for the

ACC EXTRAS ON... Nonprofit organizations

ACC Docket

The Water's Fine: Making a Career Transition to a Nonprofit Organization (Jul. 2012). www.acc.com/docket/nonprofit_jul12

QuickCounsels

Awarding Employee Bonuses in a Nonprofit Organization (May 2013). www.acc.com/quickcoun/nonp-empl_may13

Maximizing a Nonprofit's Insurance Coverage (Feb. 2013). www.acc.com/quickcoun/nonp-insur_feb13

Form & Policy

Master Terms for Third Party Charitable Sales Promotion and Licensing Agreement (Mar. 2006). www.acc.com/form/charity_mar06

ACC HAS MORE MATERIAL ON THIS SUBJECT ON OUR WEBSITE. VISIT WWW.ACC.COM, WHERE YOU CAN BROWSE OUR RESOURCES BY PRACTICE AREA OR SEARCH BY KEYWORD.

contribution your company is making to the Foundation, so that should be made clear to all.

The nonprofit's "brand"

It should be no surprise to companies like yours that nonprofit organizations care deeply about the integrity of their names and reputations (i.e., their "brands"). It is usually the single largest asset for any nonprofit, especially for charities that depend upon the trust and confidence that donors need before making contributions and that grant-making bodies need before making grants. Since donors and grant-makers rely so heavily on public opinion when assessing nonprofits, those nonprofits are incredibly sensitive about their "brands." Companies hoping to work with nonprofits must understand and respect that sensitivity.

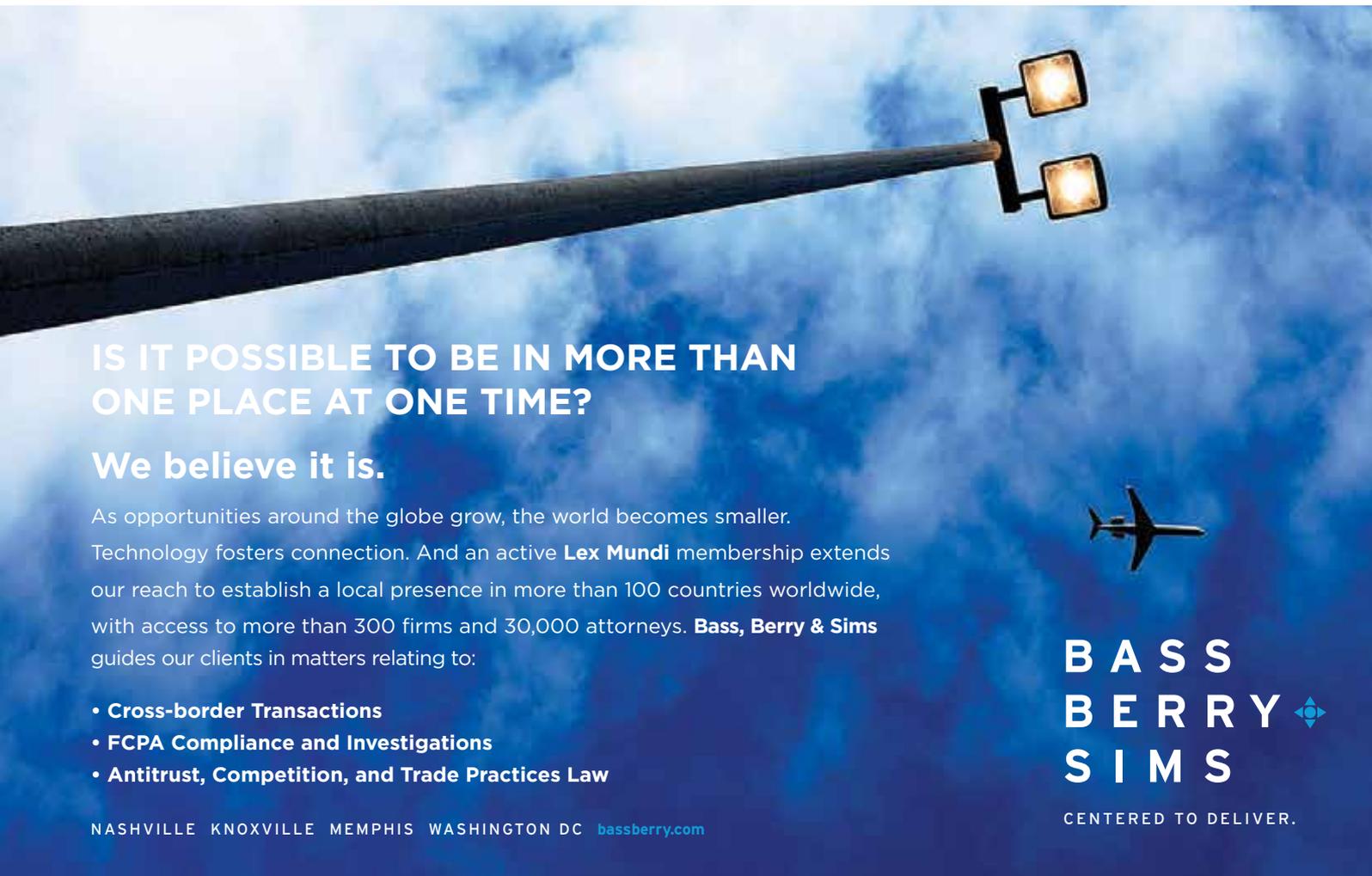
Don't expect a nonprofit to be casual about its relationship with

your company. Expect a carefully negotiated and detail-specific binding legal contract. Many nonprofits hold trademark registrations for their names and program titles. With or without registrations, though, expect a typical trademark license as part of the arrangement — each side, your company and the Foundation, licenses its names and logos under clear terms, conditions and limitations. Expect a nonprofit to understand all of the ramifications for its tax exemption arising from its dealings with a for-profit business, such as your company, and for those to be reflected in the contract as well. You may even be asked to indemnify the nonprofit — cover its liability — against claims that result from action or inaction of your company in connection with the arrangement. Many of these ventures will give a company access to the nonprofit's confidential donor or member mailing

list. Expect the nonprofit to be very fussy about how and when that list can be used; the nonprofit treasures its relationships with these constituents and cares deeply about communications with them.

You can do it

Having returned to your office and read this article, you scan the document on your computer screen outlining your pitch to the Fish Are Friends, Not Food Foundation. "What was I thinking?" you mutter, shaking your head. Your brain bursting with your knowledge of the unrelated business income tax, the ins and outs of affinity programs, the many ways to manage corporation sponsorships and a healthy excitement for future commercial co-ventures, you begin to edit. Thankfully, incorporating what you've learned only requires tweaking your pitch — not scrapping it altogether. **ACC**



IS IT POSSIBLE TO BE IN MORE THAN ONE PLACE AT ONE TIME?

We believe it is.

As opportunities around the globe grow, the world becomes smaller. Technology fosters connection. And an active **Lex Mundi** membership extends our reach to establish a local presence in more than 100 countries worldwide, with access to more than 300 firms and 30,000 attorneys. **Bass, Berry & Sims** guides our clients in matters relating to:

- **Cross-border Transactions**
- **FCPA Compliance and Investigations**
- **Antitrust, Competition, and Trade Practices Law**