APRIL 2009

Alternative Fundraising: What Every Nonprofit Should Know

Facing declining donations as a result of the economic downturn, some charitable organizations are turning to new sources of revenues and cash. These "alternative fundraising" techniques—including increased commercial activities, gala events, joint ventures with for-profit entities, and the use of debt to produce cash flow to fund operations and activities—can be extremely useful to organizations seeking to maintain their level of service in a difficult economic environment.

However, a nonprofit must carefully consider these techniques, as they may result in taxable income to the nonprofit and the prohibited use of the nonprofit's assets to benefit private individuals and for-profit entities.

The following alert discusses concepts that nonprofits should consider when planning transactions or agreements and identifies situations in which "alternative fundraising" techniques may implicate certain tax rules applicable to nonprofits.

Unrelated Business Taxable Income

General Rules

Although many nonprofit organizations enjoy tax-exempt status, certain activities may nonetheless give rise to taxable income for the organization. Generally, income from a nonprofit will be taxed as unrelated business taxable income ("UBTI") if three requirements are met:

(i) The income is from a trade or business;

(ii) The trade or business is regularly carried on by the nonprofit; and

(iii) The conduct of the trade or business is not substantially related to the organization's performance of its exempt functions.

Organizations considering commercial activities to raise funds—such as sales of goods—should therefore consider whether those commercial activities will produce unrelated business taxable income.

An activity constitutes a "trade or business" if it is carried on for the production of income from the sale of goods or performance of services. Generally, a trade or business includes only those activities that are carried on with a profit motive. An activity may also be considered a trade or business even if it is carried on in conjunction with similar activities that are related to the organization's exempt purpose.

For example, suppose a nonprofit provides computer training classes free of charge to low-income individuals in accordance with its exempt purposes. If the nonprofit then decides that it will also provide computer training classes to the general public at market rates, those classes may qualify as a trade or business. This rule ensures that tax-exempt nonprofit organizations engaging in unrelated business activities are not placed at a competitive advantage over organizations that are subject to tax.

The second UBTI requirement is that the trade or business must be "regularly carried on." An activity that is carried on in a manner consistent with that of comparable commercial activities of for-profit organizations meets this requirement. For example, if a nonprofit engages in an activity with the same frequency and continuity as that of a similar activity carried out by a for-profit organization, the activity will likely be considered regularly carried on by the nonprofit. Certain intermittent or seasonal activities may not amount to a regular trade or business by the organization if a for-profit entity would carry out those activities consistently throughout the year.

For example, a charitable organization that operates a sandwich stand at a state fair for only two weeks out of the year would not be regularly carrying on that business, as commercial sandwich providers would carry on that business throughout the year. Because determinations about whether activities are regularly carried on depend largely on the specific facts of the activity, nonprofits should consult a competent tax advisor before making conclusions on their own.

Finally, UBTI arises only when the conduct of the trade or business is not "substantially related" to the organization's performance of its exempt functions. In order for an income-producing activity to be substantially related to an organization's exempt purposes, the activity must contribute importantly to those exempt purposes. Determining whether the activity contributes importantly to an organization's exempt purposes requires an analysis of all the facts and circumstances, including the size and extent of the activities in comparison to the nature and extent of the exempt functions that they serve.

The Treasury Department has provided the following examples to distinguish between those activities that are substantially related and those that are not:

- A nonprofit operates a school for training children in the performing arts. It presents performances by its students and derives gross income from admission charges for the performances. The student performances are an essential part to their training, and as a result, the income realized from the performances contributes importantly to the organization's exempt purposes. Accordingly, the income generated from the performances does not constitute UBTI.

- A tax-exempt museum has a theater auditorium that is specifically designed and equipped for showing educational films in connection with its program of public education in the arts and sciences. The theater is a principal feature of the museum and is in continuous operation during the hours the museum is open to the public. In addition, the organization operates the theater as an ordinary motion picture theater for public entertainment during the evening hours when the museum is closed. The income generated from this after-hours operation is unrelated business taxable income.

As noted above, these examples are based on the facts and circumstances of each specific organization. As a result, a nonprofit should discuss its specific circumstances with a competent tax advisor to determine whether an activity is substantially related to its exempt functions.

Unrelated Business Taxable Income: Corporate Sponsorship Payments and Advertising

Two activities that frequently present UBTI concerns are corporate sponsorships for nonprofit organizations and advertising. The Internal Revenue Code specifically excludes "qualified sponsorship payments" from the definition of an unrelated trade or business, but the exclusion does not extend to activities that are considered "advertising."

Historically, the Internal Revenue Code treated the sale of advertising space in the nonprofit's newsletter or other publication as an unrelated trade or business, and thus, any income from the sale of such advertising would be taxable. The IRS took the position that the sale of such space was in direct competition with for-profit businesses.

In contrast, nonprofits generally are allowed to acknowledge the support of their donors in places such as their website or in a gala program. Over the years, however, these acknowledgements have come to more closely resemble advertisements. Moreover, nonprofits, at the behest of their donors, have been providing perquisites in recognition for their donations. As a result, Congress and the IRS began to question the point at which these donor acknowledgements cross the line and result in the sale of goods and services to the "donor."

In order to bring clarity to this area, Congress added a section to the tax code for "qualified sponsorship payments," which sets forth guidelines outlining the amount and type of recognition that a nonprofit may give to its donors.

The Treasury Regulations define a "qualified sponsorship payment" as a payment made 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." The use or acknowledgement of the name, logo, or product line of the person's trade or business in connection with the exempt organization's activities does not amount to a substantial return benefit.

Examples of use or acknowledgement include:

- Logos and slogans that do not contain qualitative or comparative descriptions of the sponsor's products or services;

- A list of the sponsor's locations, contact information or website address; and

- Value neutral displays or depictions of the sponsor's product-line.

Organizations holding gala events in which corporate sponsors are given space in an event program should be mindful of whether those arrangements represent "sponsorship payments" that are exempted from UBTI or "advertising" that would constitute UBTI. The inclusion of a page in a nonprofit's gala program that merely thanks a sponsor for contributing to the gala and provides the sponsor's name and contact information would be a "qualified sponsorship payment" excludable from UBTI.

Advertising, by contrast, is not considered a "use or acknowledgement" and results in a substantial return benefit to the sponsor. A page in the gala program exclaiming a particular sponsor's products to be superior to others would thus be an "advertisement," and payments received from the sponsor would be subject to tax.

Other categories of return benefits that will subject a sponsorship payment to tax include:

- Exclusive provider arrangements;

- Goods, facilities, services or other privileges; and

- Rights to use an intangible asset of the exempt organization.

Applicable Treasury Regulations, however, provide a limited exception for benefits below a certain value: the return benefit is disregarded if the fair market value of such benefit is not more than 2% of the amount of the sponsorship payment.

The following examples illustrate the differences between qualified sponsorship payments and advertising.

- A local charity organizes a marathon and walkathon at which it serves participants drinks and other refreshments provided free of charge by a national corporation. The corporation also gives the charity prizes to be awarded to winners of the event. The charity recognizes the assistance of the corporation by listing the corporation's name in promotional fliers, in newspaper advertisements of the event and on T-shirts worn by participants. The charity changes the name of its event to include the name of the corporation. The charity's activities constitute acknowledgment of the sponsorship. The drinks, refreshments and prizes provided by the corporation are a qualified sponsorship payment, which is not income from an unrelated trade or business.

- A noncommercial broadcast station airs a program funded by a local music store. In exchange for the funding, the station broadcasts the following message: "This program has been brought to you by the Music Shop, located at 123 Main Street. For your music needs, give them a call today at 555-1234. This station is proud to have the Music Shop as a sponsor." Because this single broadcast message contains both advertising ("For your music needs, give them a call today") and an acknowledgment, the entire message is advertising. The fair market value of the advertising exceeds 2% of the total

> payment. Thus, the advertising is a substantial return benefit, and none of the payment is a qualified sponsorship payment.

Because there are a number of factual situations that may fall within the grey area between advertising and qualified sponsorship payments, exempt organizations should consult a competent tax advisor to determine whether their specific activities generate UBTI.

Unrelated Business Taxable Income: Exceptions

Further complicating an already complex area of law, the Internal Revenue Code identifies numerous exceptions to the general unrelated business income tax rules.

One such exception—known as the volunteer exception—allows exempt organizations to engage in an unrelated trade or business if substantially all the work in carrying on the trade or business is performed without compensation. As an example, a tax-exempt orphanage that operates a retail store selling merchandise to the general public would ordinarily meet all three requirements of the UBTI test identified above. The store, however, would not be an unrelated trade or business if all of the work was performed by volunteers who received no compensation.

The "thrift store" exception similarly excludes from the definition of an unrelated trade or business a trade or business that consists of selling merchandise, substantially all of which was received by the organization as gifts or contributions. Thus, a high school that collects used clothing and household items from its students and faculty members and then sells those items to the general public could exclude from UBTI income received from those sales. Note, however, that this activity would not qualify under the "volunteer exception" described above if faculty members compensated by the school were working at the sale.

For purposes of both these exceptions, the term "substantially all" is usually interpreted as at least 85%.

A number of "passive" income items are expressly excluded from the calculation of UBTI. Among other items, the Code excludes the following, as well as deductions directly connected to the following, from UBTI: dividends; interest; annuities; payments with respect to securities loans; royalties; and certain rents. Each of these exceptions has specific requirements that must be met before the item can be excluded from UBTI. Rental income from real property, for example, is excluded from the UBTI calculation but rental income from personal property is generally not excluded. A nonprofit's income from leasing out space in its building is generally excluded from UBTI, but income from renting out vehicles is not.

As with all of the rules described above, the actual application of the exceptions to UBTI involves far greater complexity than can adequately be described in this alert. Nonprofits considering transactions or activities that potentially implicate the UBTI rules or the exceptions thereto should therefore seek the advice of a competent tax advisor.

Unrelated Debt-Financed Income

Facing cash shortfalls, some nonprofits may consider using debt to provide cash flow to fund activities and operations, to purchase facilities, or as part of investments.

Nonprofits, however, must be mindful that the use of property held subject to indebtedness may create "unrelated debt-financed income" that is taxable in a manner similar to UBTI.

The Internal Revenue Code imposes a tax on "unrelated debt-financed income," defined as income earned from "debt-financed property." Such property—subject to certain exceptions—is any property that is:

(i) Held to produce income, including rents, royalties, interest, and dividends; and

(ii) Is held subject to a mortgage or other indebtedness used directly or indirectly for the acquisition of the property.

A significant exception to this definition is that if at least 85% of a property is used for activities that are substantially related to the organization's charitable purpose (see the general discussion of substantially related activities, above) then the property is not "debt-financed property."

If, after taking certain deductions, a nonprofit has net income from a debt-financed property, then the organization must add a percentage to its UBTI calculated by comparing the amount of the debt and the organization's "adjusted basis" in the property of that income. This is the case even if the income that is earned would otherwise be excluded from UBTI under one of the exceptions described above.

For example, assume a nonprofit owns a four-story office building subject to a mortgage. The organization uses the lower two stories to house computers that the organization uses for administrative purposes; the organization rents the top two stories to a third party. Because the building is held subject to a mortgage, and because only 50% of the property is used for charitable purposes, the building is "debt-financed property." A portion of the rental income received from the top two stories of the building, calculated as described above, is therefore subject to the tax on unrelated debt-financed income.

Because of the complexity of the debt financing rules, including the potential applicability of various exceptions to those rules not discussed here, organizations that are considering transactions or investments that involve the use of debt should first consult with a competent tax advisor.

<u>Participation in Joint Ventures</u>

Nonprofits may also consider participation in "joint-venture" activities and transactions with for-profit entities and individuals to generate additional revenues. Joint ventures are enterprises in which two or more parties contribute assets or expertise with the expectation that the parties will share in the proceeds of the endeavor. Joint ventures are common in the for-profit world, as multiple parties often collaboratively make investments or participate in joint projects. When joint ventures involve the participation of nonprofits, however, special care must be taken to ensure that:

(i) Joint-venture activities do not impermissibly interfere with a nonprofit's obligation to operate exclusively for charitable purposes; and

(ii) Impermissible private benefits are not conferred through the joint venture.

The IRS has published little guidance for nonprofits entering into joint ventures, and thus the law in this area is not well-developed. There are, however, three general principles that nonprofits should keep in mind when considering joint ventures:

- The activities of a joint venture that is treated as a partnership for federal tax purposes and involves a nonprofit, including any activities not related to the organization's charitable purpose, will be attributed to the nonprofit;

- A nonprofit must retain control over all assets that it contributes to the joint venture; and

- The organization must not allow its assets to be used for the benefit of private parties.

The consequences of a nonprofit's failure to be mindful of these general principles when planning joint ventures may include UBTI or, worse, the revocation of an organization's tax-exempt status. Organizations considering joint-venture activities should therefore seek the advice of a competent tax advisor at the early planning stages of any joint-venture investment or transaction to ensure that the joint venture is appropriately structured.

A primary concern for nonprofits participating in joint ventures is that the activities of the venture will be attributed to the nonprofit participant. Thus, to the extent that the joint venture's activities are not substantially related to the organization's charitable purpose, income from the joint venture may be UBTI to the organization. Moreover, if the activities of the joint venture are unrelated to the organization's charitable purpose and those activities are "substantial," then the organization risks losing its tax-exempt status.

Nonprofits entering into joint ventures must also ensure that the organization retains control of the assets it contributes to the joint venture and that those assets are not used for private gain. To maintain appropriate control over the joint venture and any assets a nonprofit has contributed to that enterprise, the nonprofit must retain at least 50% voting control over the joint venture.

To further prevent a nonprofit's assets from being used for the benefit of private parties, and thereby conferring impermissible private benefits, the nonprofit must also ensure that all transactions with for-profit entities or private parties are on arm's-length terms in which the organization receives a fair-market value price for any goods, services, or rights it provides.

For example, the IRS dealt with the case of a university that formed a joint venture limited liability company (treated as a partnership for federal tax purposes) with a for-profit corporation that specialized in conducting interactive video training programs. The joint venture arranged and conducted video teacher training seminars using the university's curriculum and the for-profit corporation's expertise in interactive video technology. The IRS concluded that the joint venture did not affect the university's tax-exempt status, noting four primary factors:

- The university's activities relating to the joint venture were not substantial;

- The joint venture's activities were substantially related to the university's educational mission and thus did not give rise to UBTI for the university;

- The university held a 50% voting interest in the joint venture through the appointment of half of the limited liability company's directors; and

- The joint venture's organizational documents required that all contracts and transactions entered into "be at arm's length and that all contract and transaction prices be at fair market value determined by reference to the prices for comparable goods or services."

Although the IRS's ruling was a favorable one, it left significant unanswered questions regarding the level of joint venture activity that would be allowed before such activity became "substantial." Because of this uncertainty, as well as the complexity inherent in this area of the law, nonprofits considering participation in a joint venture should consult a competent tax advisor before moving forward with any joint venture.

Additional Resources

For additional information, please see IRS Publication 598 at:

http://www.irs.gov/pub/irs-pdf/p598.pdf