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# THE TAXATION OF CAUSE-RELATED MARKETING

TERRI LYNN HELGE\*

## INTRODUCTION

As the economic downturn prolongs, charities are faced with the dual problems of decreased donations and increased demand for services.<sup>1</sup> In order to combat the increasing shortfall in revenues,<sup>2</sup> many charities are seeking creative ways to obtain funding. One potentially lucrative way to increase funding for the charity is to leverage the charity's brand name and goodwill by forming alliances with one or more for-profit corporations to allow the charity's name or logo to be used in marketing the corporation's products or services. This is known as cause-related marketing.<sup>3</sup>

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1. See generally LESTER M. SALAMON ET AL., JOHN HOPKINS UNIV. CTR. FOR CIVIL SOC'Y STUDIES, COMMUNIQUÉ NO. 14, IMPACT OF THE 2007-09 ECONOMIC RECESSION ON NONPROFIT ORGANIZATIONS (2009) (describing the impact of the current economic recession on the charitable sector).

2. See Derek N. Hassay & John Peloza, *Building the Charity Brand Community*, 21 J. NONPROFIT & PUB. SECTOR MARKETING 24, 25 (2009) (noting that charities have recently seen declines in direct donations and government support, and that there are an increasing number of charities competing for funding each year).

3. See Dennis R. Young, *Commercialism in Nonprofit Social Service Associations: Its Character, Significance, and Rationale*, in TO PROFIT OR NOT TO PROFIT 195, 198 (Burton A. Weisbrod ed., 1998) (defining cause-related marketing as involving "a relationship which ties a company, its customers and selected products to an issue or cause with the goal of improving sales and corporate image while providing substantial income and benefits to the cause" (citation omitted)); Karen Maru File & Russ Alan Prince, *Cause Related Marketing and Corporate Philanthropy in the Privately Held Enterprise*, 17 J. BUS. ETHICS, 1529, 1530 (1998) ("Although some definitions of cause related marketing restrict the concept to those instances when a company promises to make a charitable contribution contingent on customers' purchases, most define cause related marketing as corporate philanthropy organized around the marketing objectives of increasing product sales or enhancing corporate identity." (citations omitted)).

The birth of cause-related marketing occurred in 1983 when American Express announced a campaign to raise funds to renovate the Statue of Liberty and Ellis Island. Dwane Hal Dean, *Consumer Perception of Corporate Donations: Effects of Company Reputation for Social Responsibility and Type of Donation*, J. ADVERTISING, Winter 2003-4, at 91, 92. For every use of its credit card, American Express promised to donate a penny for the renovation of the Statue of Liberty-Ellis Island, and for every new card issued in the United States, American Express promised to donate a dollar. *Id.* The campaign was a success, and American Express donated \$1.7 million to the renovation of the Statue of Liberty-Ellis Island. *Id.* In contrast, American Express spent \$6.7 million promoting the Statue of Liberty renovation campaign. *Id.* Since 1983, corporate spending on cause-related marketing has devel-

By way of example, when the American Library Association needed \$25,000 to cover the cost of its upcoming conference in the early 1990s, it was able to turn its \$25,000 shortfall into a multi-million dollar promotional event with Microsoft.<sup>4</sup> The American Library Association turned to IEG—a company founded with the goal of establishing sponsorship as the fourth arm of marketing—for assistance. Upon reviewing the potential marketability of the American Library Association, Laren Ulkman, managing director of IEG Sponsorship Services, related “[a]nd we quickly said to them, ‘Don’t worry about your \$25,000. Do you realize that you have more retail outlets than McDonald’s and you have more cardholders than VISA?’”<sup>5</sup> IEG advised the American Library Association to start thinking of itself as a brand and to realize the organization’s overall potential market value. “We put together some packages for them,” Ulkman recalls, “which quickly led to ALA signing a \$10 million deal with Microsoft.”<sup>6</sup>

As the American Library Association example illustrates, charity branding is a valuable commodity.<sup>7</sup> A study conducted by Cone, Inc. reported that the most valuable charitable brand is the Y.M.C.A, having a reported value of \$6.4 billion.<sup>8</sup> Rounding out the top five were The Salvation Army at \$4.7 billion,<sup>9</sup> United Way of America at \$4.5 billion,<sup>10</sup> American Red Cross at \$3.1 billion,<sup>11</sup> and Goodwill Industries International at \$2.5 billion.<sup>12</sup> Many charities seek to capitalize on the value of their “brands”<sup>13</sup> by engaging in cause-related marketing alliances. Such alliances may include selling merchandise which prominently displays the

oped into a \$1.3 billion-a-year industry. Colleen DeBaise, *Cause and Effect: Linking a National Franchiser to a Charity Can Both Unify an Organization and Help Businesses Stand Out in Their Local Markets*, WALL ST. J., Apr. 30, 2007, at R9.

4. Mary Hutchings Reed, Nuts and Bolts of Sponsorship and Advertising Arrangements with Non-Profits, in ALI-ABA Course of Study, *Legal Issues in Museum Administration* (Mar. 29–31, 2006), at 602.

5. *Id.* at 602.

6. *Id.* at 603.

7. See James T. Bennett & Thomas J. DiLorenzo, *Health Charities: Reputation for Sale?*, CONSUMERS’ RES. MAG., July 1997, at 10, 14 (“[A] charity’s ‘brand name’ is by far its most valuable asset; indeed, without it no charity could long survive.”).

8. CONE, THE CONE NONPROFIT POWER BRAND 100, at 13 (2009), available at <http://www.coneinc.com/NonprofitPowerBrand100> (follow “The Cone Nonprofit Power Brand 100 Report” hyperlink).

9. *Id.*

10. *Id.*

11. *Id.*

12. *Id.*

13. “Brand” generally refers to the name recognition that distinguishes an organization from its competitors. See Adrian Sargeant, John B. Ford, & Jane Hudson, *Charity Brand Personality: The Relationship with Giving Behavior*, 37 NONPROFIT & VOLUNTARY SECTOR Q. 468, 469–70 (2008) (“[A] brand is quite simply—who you are, what you say and what you do.” (citation omitted)).

charity's name, logo, or trademark message in conjunction with a corporate partner (branded merchandise)<sup>14</sup> or allowing the charity's name or logo to be displayed on promotional products of the corporate partner (promotional merchandise),<sup>15</sup> with a portion of the sales proceeds of those promotional products donated to the charity.<sup>16</sup> Cause-related marketing activities generate significant revenues for charities—more than \$1 billion in 2005<sup>17</sup>—and both the number of charities engaging in cause-related marketing alliances and the number of corporate partners involved in these alliances continue to grow.<sup>18</sup>

It is important to distinguish cause-related marketing from corporate sponsorship. "Corporate sponsorship," refers to a relationship between a charity and a for-profit corporation in which the for-profit corporation primarily receives recognition for its support of the charity's mission or particular event. Corporations have historically invested marketing dollars in furthering community causes, with the residual effect of building the corporation's goodwill.<sup>19</sup> But when the for-profit corporation also receives, in return for its support of the charity, the right to use the name or logo of the charity to directly affect the sale of the corporation's product, the corporate sponsorship has morphed into cause-related marketing. Cause-related marketing is a more "direct effort to sell the [corporation's] products or ser-

14. See *infra* Part I.A.

15. See *infra* Part I.B.

16. See, e.g., Joanna L. Krotz, *Community Icon: Clarifying What Y.M.C.A. Stands For*, N.Y. TIMES, Nov. 17, 2003, at F31 (noting that the Y.M.C.A. has licensed the use of its name to form a "charity of choice" alliance with Sports Illustrated and to enter into cause-related marketing alliances with J.C. Penney, Kimberly-Clark and PepsiCo, "which will reap benefits from having their corporate identities associated with Y programs").

17. Anonymous, *Cause Marketing: After Two Decades of Growth, the \$1 Billion Spending Mark Is in Sight*, ADVERTISING AGE, July 28, 2003, at 2.

18. See, e.g., Alan R. Andreasen, *Cross-Sector Marketing Alliances: Partnerships, Sponsorships, and Cause-Related Marketing*, in NONPROFITS & BUSINESS 155, 175 (Joseph J. Cordes & C. Eugene Steuerle eds., 2009); Lauren Gard, *We're the Good Guys, Buy From Us*, BUS. WEEK, Nov. 22, 2004, at 72. One company decided to manufacture a separate brand to facilitate its cause-related marketing alliances. Berry Plastics Corp., a leading manufacturer of trash bags and other plastic packaging, introduced the "i Commit™" brand in 2008. *Breast Cancer; Berry Plastics Introduces i Commit™ Brand of "Pink" Trash Bags to Benefit Susan G. Komen for the Cure*, WOMEN'S HEALTH WKLY., Mar. 6, 2008, at 463. The i Commit™ brand is "a unique, stand-alone product line that will contribute a portion of every sale to charity." *Id.* Berry Plastics introduced the line with pink trash bags benefiting Susan G. Komen for the Cure. *Id.*

19. In addition, for income tax purposes, the corporation may consider the donation to the charity, which results in potential increased goodwill for the corporation, to be a deductible business expense rather than a charitable contribution, the deduction of which is limited to ten percent of the corporation's taxable income. See I.R.C. §§ 162, 170(b)(2) (2006); Treas. Reg. § 1.162-20(a)(2) (as amended in 1995) (providing that expenditures for institutional or goodwill advertising, which keep the corporation's name before the public, generally are deductible as ordinary and necessary business expenses under Section 162 of the Internal Revenue Code if the expenses are related to the patronage that the corporation might reasonably expect in the future).

vices by capitalizing on the public's desire to leverage their dollars: consumers can buy a product and support a good cause at the same time."<sup>20</sup> By engaging in cause-related marketing, "the corporation expects its sponsorship dollars to yield a measurable return not just in terms of public image and goodwill, but product sales as well."<sup>21</sup>

Cause-related marketing alliances provide mutual benefits to the charity and the corporate partner. Charities benefit by the amount of donations received directly from the campaign and by increasing resources and awareness of the charity and its mission.<sup>22</sup> The corporate partners benefit because cause-related marketing activities are generally profit motivated, with donations based upon consumer behavior in the form of purchasing the sponsoring company's products or services.<sup>23</sup> These benefits flowing to the corporate partner give cause for concern about the appropriate tax treatment of cause-related marketing alliances for the charity.

In general, charities are exempt from federal income tax,<sup>24</sup> and donations to charities may be deducted by donors in computing the donors' tax liabilities.<sup>25</sup> A predominant rationale for the special tax treatment and subsidies of the charitable sector hinges on the belief that charities provide services that are considerably different from, and in some cases better than, the services provided by their for-profit counterparts.<sup>26</sup> When the lines between charitable activity and for-profit activity cross, the justification for special tax treatment of the charitable sector weakens. Since the 1950s, a

20. Reed, *supra* note 4, at 615.

21. *Id.*

22. See Stacy Landreth Grau & Judith Anne Garretson Folse, *Cause-Related Marketing (CRM): The Influence of Donation Proximity and Message-Framing Cues on the Less-Involved Consumer*, J. ADVERTISING, Winter 2007, at 19, 20.

23. *Id.*

24. See I.R.C. § 501(a), 501(c)(3).

25. See I.R.C. § 170.

26. See generally Henry B. Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 YALE L.J. 54 (1981) (advocating a capital subsidy theory of tax exemption); Henry B. Hansmann, *The Role of the Nonprofit Enterprise*, 89 YALE L.J. 835 (1980); but see generally Rob Atkinson, *Altruism in Nonprofit Organizations*, 31 B.C. L. REV. 501 (1990) (altruism theory); Boris I. Bittker & George K. Rahdert, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 85 YALE L.J. 299 (1976) (income measurement theory); Evelyn Brody, *Of Sovereignty and Subsidy: Conceptualizing the Charity Tax Exemption*, 23 J. CORP. L. 585 (1998) (third sovereign theory); Nina J. Crimm, *An Explanation of the Federal Income Tax Exemption for Charitable Organizations: A Theory of Risk Compensation*, 50 FLA. L. REV. 419 (1998) (risk-compensation theory); Mark A. Hall & John D. Colombo, *The Donative Theory of the Charitable Tax Exemption*, 52 OHIO ST. L.J. 1379 (1991) (donative theory). For a summary of these major theories justifying the federal income tax exemption for charitable organizations, see Johnny Rex Buckles, *The Case for the Taxpaying Good Samaritan: Deducting Earmarked Transfers to Charity Under Federal Income Tax Law, Theory and Policy*, 70 FORDHAM L. REV. 1243, 1284-96 (2002) and John D. Colombo, *The Marketing Philanthropy and the Charitable Contributions Deduction: Integrating Theories for the Deduction and Tax Exemption*, 36 WAKE FOREST L. REV. 215 (1994).

tax known as the unrelated business income tax has been imposed on a charity's net income from a regularly carried on trade or business that is unrelated to the charity's tax-exempt purposes.<sup>27</sup> Often times, the justification for imposing this tax on a charity's net income from unrelated business activities is that such activities involve unfair competition with the charity's for-profit counterparts.<sup>28</sup>

Despite the widespread success of cause-related marketing, the Internal Revenue Service has issued little guidance on acceptable practices by charitable organizations engaged in cause-related marketing, leading to unpredictable and uncertain tax results. An analysis of the application of the unrelated business income tax regime and the prohibition on private benefit to cause-related marketing alliances reveals that modifications to existing Internal Revenue Service guidance should be made based on social, economic, and tax theory. To provide clarity to charities engaged in cause-related marketing alliances, I advocate the establishment of Internal Revenue Service guidance which sets forth a dual safe harbor under which charities could operate to claim that the revenue they receive from cause-related marketing alliances is exempt from the unrelated business income tax and that the cause-related marketing alliance does not result in impermissible private benefit.

Part I of this article provides a detailed discussion of cause-related marketing activities. Part II discusses the nature of the unrelated business tax in general and its potential application to cause-related marketing alliances. First, the sale of branded merchandise directly by the charity is addressed using a general unrelated business income tax analysis. Second, the income received by the charity in the form of a "royalty" from the sale of branded merchandise or promotional merchandise by the corporate partner

27. See John D. Colombo, *Reforming Internal Revenue Code Provisions on Commercial Activity by Charities*, 76 *FORDHAM L. REV.* 667, 670 (2007); Nathan Wirschafter, Note, *Fourth Quarter Choke: How the IRS Blew the Corporate Sponsorship Game*, 27 *LOY. L.A. L. REV.* 1465, 1470 (1994).

28. See Treas. Reg. § 1.513-1(b) (as amended in 1983) ("The primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete."); see generally Joseph J. Cordes & Burton A. Weisbrod, *Differential Taxation of Nonprofits and the Commercialization of Nonprofit Revenues*, 17 *J. POL'Y ANALYSIS & MGMT.* 195, 211 (1998) (comparing commercial activities of the nonprofit sector to those of its for-profit counterparts and concluding that "the differential taxation of nonprofits and for-profits creates opportunities for nonprofits to earn above-normal returns on commercial ventures"); but see Michael Rushton, *Why are Nonprofits Exempt From the Corporate Income Tax?*, 36 *NONPROFIT & VOLUNTARY SECTOR Q.* 662 (2007) (arguing that the justification for exemption from income tax on a charity's business activities should be rooted in the charity's inability to distribute profits from these activities to private individuals (unlike their for-profit counterparts) rather than concerns over unfair competition); John D. Colombo, *Commercial Activity and Charitable Tax Exemption*, 44 *WM. & MARY L. REV.* 487, 529-46 (2002) (questioning unfair competition as a justification for the unrelated business income tax).

is analyzed under the corporate sponsorship rules and the royalty exception. In addition, consideration is given to whether, in light of consumer perception of product endorsement by the charity, the income could be treated as advertising income subject to inclusion in the charity's unrelated business taxable income (UBTI) under existing law. This analysis reveals that existing guidance is conflicting, which leads to unpredictable and uncertain results. Therefore, I conclude this section with a call for Internal Revenue Service guidance on the unrelated business income tax treatment of revenues from cause-related marketing alliances which specifically takes into account the unique nature of cause-related marketing activities.

As discussed more fully in Part III, the nature and extent of the benefits for the corporate partner from the cause-related marketing alliance is troubling from a tax-exemption perspective. Cause-related marketing alliances allow a charity's most valuable assets, its brand and goodwill, to be used to benefit private entities. While the charity indeed benefits in return, the central concern needs to be whether the corporate partner is improperly benefiting from the use of the charity's brand or goodwill. If the corporate partner receives improper benefits, then the charity may violate the prohibition on private benefit, possibly jeopardizing the charity's tax-exempt status. With very little existing guidance on private benefit implications of cause-related marketing, charities need safe harbor guidance identifying cause-related marketing alliances that do not place a charity's tax-exemption at risk. Part III discusses the prohibition on private benefit, the application of the private benefit doctrine to cause-related marketing alliances, and the implications private benefit concerns should have in forming the appropriate safe harbor determination of cause-related marketing alliances. Part IV concludes with a suggested framework within which the safe harbor guidance I advocate should be considered, taking into account tax, economic, and private benefit concerns.

## I. NATURE OF CAUSE-RELATED MARKETING ACTIVITIES

Cause-related marketing activities are as diverse as the nonprofit sector. The alliances between charities and corporate partners can vary in a number of dimensions, including the number of corporate partners involved in the campaign, the length of the commitment and the level of investment by the corporate partner, the level of collaboration as brand-level or company-level, and the amount of donations to the charity as fixed or variable.<sup>29</sup> For purposes of this article, I have assumed that the cause-related

29. Andreasen, *supra* note 18, at 159-60.

marketing alliance does not create a joint venture or a partnership,<sup>30</sup> although some may be structured in this manner. Additionally, the type of products or services involved in the cause-related marketing alliance may involve what I refer to as “branded merchandise”<sup>31</sup> or “promotional merchandise.”<sup>32</sup> Finally, the benefits realized by the charity and the corporate partner may vary greatly from one alliance to the next and are divided into first-order benefits and second-order benefits.<sup>33</sup> First-order benefits refer to the direct financial remuneration received by the charity and the corporate

30. Even if a transaction is not formally structured as a partnership or joint venture, the Internal Revenue Service or a court may, in appropriate circumstances, recharacterize the arrangements as a partnership or joint venture. A partnership is “an association of two or more persons to carry on a business as co-owners for profit”, regardless of whether the persons intend to create a partnership or whether the association is called a “partnership,” “joint venture,” or other name. Rev. Unif. Partn. Act. § 101(6) (1997). Circumstances that are indicative of a partnership or joint venture include (1) sharing profits, (2) sharing losses, and (3) a mutual right of control or management of the enterprise. *See id.* at § 202(c). A charity that enters into a joint venture or partnership can implicate, among other things, concerns of whether the charity is improperly benefitting private interests and whether the charity will receive unrelated business income; however, the most significant concern is whether the arrangements will adversely affect the charity’s tax-exempt status. Historically, the Internal Revenue Service viewed joint ventures and partnerships with for-profit entities as impermissible vehicles for providing taxable entities with the opportunity to share in the net proceeds of an income-producing venture undertaken by the exempt organization. *See generally* Nicholas A. Mirkay, *Relinquish Control! Why the IRS Should Change Its Stance on Exempt Organizations in Ancillary Joint Ventures*, 6 NEV. L.J. 21 (2005). Exempt organizations participating in such arrangements were viewed as (i) failing to operate exclusively for charitable purposes, (ii) permitting inurement of the organization’s net earnings to private shareholders or individuals, or (iii) allowing significant private benefits. Since 1982, the Internal Revenue Service has been more accepting of such arrangements, as long as certain factors are present. A charity may generally form and participate in a partnership and continue to operate exclusively for charitable purposes if (i) “participation in the partnership furthers a charitable purpose,” and (ii) “the partnership arrangement permits the exempt organization to act exclusively in furtherance of its exempt purpose and only incidentally for the benefit of the for-profit partners.” Rev. Rul. 2004-51, 2004-1 C.B. 975. The determination of whether a nonprofit organization’s participation in a partnership furthers a charitable purpose “is not limited to whether the partnership provides some (or even an extensive amount of) charitable services.” *Id.* at 976 (quoting *St. David’s Health Care Sys. v. United States*, 349 F.3d 232, 243 (5th Cir. 2003)). The nonprofit partner also must have the capacity to ensure that the partnership’s operations further charitable purposes. *Id.* In each situation, the particular facts must be carefully evaluated. Private inurement and private benefit concerns can arise in a variety of ways in the context of a partnership or joint venture. For example, procedures for allocating profits and losses that fail to reflect the partners’ contribution to the partnership may result in private inurement or private benefit. *See* I.R.S. Gen. Couns. Mem. 39,732 (May 27, 1988). The specific facts must be carefully evaluated in every situation. If (i) the activities of a partnership attributed to an exempt organization constitute a substantial part of the exempt organization’s activities, and (ii) the partnership regularly conducts a trade or business that is not substantially related to the exempt organization’s exempt purposes, the exempt organization’s tax exempt status is threatened. In contrast, if the activities of the partnership do *not* constitute a substantial part of the exempt organization’s activities (and the organization does not otherwise engage in significant unrelated business activities), the organization’s exempt status is not threatened, but the organization may have UBTI. In determining whether the organization has UBTI, the partnership’s activities are evaluated as if those activities were performed directly by the exempt organization. *See* Rev. Rul. 2004-51, 2004-1 C.B. 975–76.

31. *See infra* Part I.A.

32. *See infra* Part I.B.

33. *See* Andreasen, *supra* note 18, at 158.



partner from the cause-related marketing campaign.<sup>34</sup> Second-order benefits are benefits expected to improve the charity's or the corporate partner's performance in the future.<sup>35</sup>

### A. *Branded Merchandising*

Branded merchandising involves the sale of a utilitarian item, such as a t-shirt, hat, pin, or bracelet, which bears the logo or trademark message of the charity. Branded merchandise is intended to promote the charity's cause or message by enabling supporters of the cause to wear items showing their support and encouraging others to talk about the message.<sup>36</sup> The charity will typically contract with one or more companies to manufacture the branded merchandise, and such companies may include their own logos on the branded merchandise as well. In some cases, the charity sells the branded merchandise on its own website to supporters of the charity's cause. In other cases, the corporate partner sells the branded merchandise through its own physical stores and web store. In still other cases, the branded merchandise may be offered through both the charity's website and the corporate partner's web store and physical stores. Normally, some portion of the proceeds or profits from the sale of the branded merchandise will benefit the charity.

One of the most celebrated branded merchandising alliances is that of the Lance Armstrong Foundation and Nike. Lance Armstrong, famed cancer survivor and seven-time Tour de France champion,<sup>37</sup> formed the Lance Armstrong Foundation in 1997 to inspire and empower people affected by cancer.<sup>38</sup> In 2004, the Lance Armstrong Foundation partnered with Nike to produce a yellow rubber bracelet bearing Lance Armstrong's trademark slogan for cancer survivors, LIVESTRONG.<sup>39</sup> Each bracelet was sold for one dollar, and all the proceeds from the sale of the bracelets were donated to the Lance Armstrong Foundation. Nike originally planned to produce only five million bracelets.<sup>40</sup> However, the bracelets became an instant

34. *Id.*

35. *Id.*

36. See Jill Lieber, *Brace Yourself: Wearing Support on Your Wrist*, USA TODAY, July 7, 2005, at 1C ("One of the reasons why [cause] bracelets are so successful is that people not only want to support good causes, but they also want to proclaim that they're doing that.").

37. See Alan Snel, *Lance's Legacy Likely to Keep Selling*, TAMPA TRIB., July 26, 2005, Money-sense, at 1.

38. Allen Salkin, *It's Not About the Bike*, N.Y. TIMES, June 22, 2008, Sports Tuesday, at 1.

39. See Sal Ruibal, *Armstrong Wristbands Yield \$63M to Fight Cancer*, USA TODAY, July 17, 2007, at 8C ("Livestrong has become something bigger, a way of life, a challenge, a goal, a way to set the bar higher.").

40. See Carolyn Shapiro, *Popular Lance Armstrong Wristbands Spawn Counterfeits*, BOSTON

success, and cause-minded fans clamored to have their own LIVESTRONG bracelet.<sup>41</sup> At one point, the LIVESTRONG bracelets were touted by the media as the “must-have” fashion accessory of the moment.<sup>42</sup> The success of the bracelets transformed into an entire line of LIVESTRONG merchandise, including cycling, running, and walking apparel; sports bags; and blankets, all bearing the color yellow and the LIVESTRONG slogan along with the trademark Nike “swoosh” symbol.<sup>43</sup> The LIVESTRONG collection is offered for purchase on the Lance Armstrong Foundation website<sup>44</sup> and both on Nike’s web store and in their physical stores. Nike donates 100 percent of the profits from its sale of the LIVESTRONG collection to the Lance Armstrong Foundation.<sup>45</sup> Nike’s alliance with the Lance Armstrong Foundation has raised over \$80 million to date.<sup>46</sup>

The success of the LIVESTRONG campaign quickly spread to other color-coded cause-related marketing alliances for charity causes.<sup>47</sup> One such prominent campaign is the American Heart Association’s “Go Red for Women” campaign, which uses a trademark red dress symbol to promote education on the risks of heart disease for women.

For the “Go Red” campaign, American Heart Association partners with companies to co-brand products that offer a portion of their proceeds to benefit its effort to educate women about heart disease. Calendar marker

GLOBE, Jan. 28, 2005. The original five million bracelets were sold exclusively in Nike stores. *Yellow Fever in the U.S. Gives Nike a Boost*, CHI. TRIB., Sept. 28, 2004, RedEye, at 13. Over 70 million LIVESTRONG bracelets have been sold to raise money for the Lance Armstrong Foundation. Salkin, *supra* note 38. Sales of the LIVESTRONG bracelets have produced more than \$63 million in support for the Lance Armstrong Foundation. Ruibal, *supra* note 39.

41. See, e.g., Alicia C. Shepard, *Wrist and Recuperation; Yellow Bracelet Makes Fashion—and Health—Statement*, WASH. POST, Oct. 26, 2004, at C09; Jeff Daniel, *\$1 “LIVESTRONG” Bracelet Forget Tiffany’s Is the Elite of Jewelry*, ST. LOUIS POST-DISPATCH, Aug. 1, 2004, at E01; see also Shapiro, *supra* note 40 (noting that the wild success of the bracelets spawned the production of similar bracelets in blue, green, pink, purple, red and yellow, bearing the label “Strength Courage Victory”).

42. See, e.g., John Kessler, *Wristbands Morph from Charity to Fad*, ATLANTA J. CONST., May 13, 2005, at A1; Grace Aduroja, *Fundraising with a Sense of Fashion; Wristbands Promoting Causes a Must-Have*, CHI. TRIB., Jan. 14, 2005, Metro, at 1 (“[T]he \$1 bracelets have graced the wrists of everyone from actress Angelina Jolie to President Bush and evolved from a fashionable fundraising item to an adolescent essential.”).

43. See Press Release, Nike, Inc., Nike and Lance Armstrong Foundation Launch LIVESTRONG™ Collection with All Profits Going to Lance Armstrong Foundation (July 17, 2007).

44. See LIVESTRONG Store, <http://store-laf.org/> (last visited Jan. 23, 2010).

45. Nike and Lance Armstrong Foundation Launch LIVESTRONG™ Collection, *supra* note 43.

46. Nike LIVESTRONG Collection, [http://www.nike.com/nikeos/p/livestrong/en\\_US/products](http://www.nike.com/nikeos/p/livestrong/en_US/products) (last visited Jan. 23, 2010) (The front of Nike’s LIVESTRONG store simply states “[w]ear yellow and help turn hope into action.”).

47. See Nancy Coltun Webster, *LIVESTRONG: Color Coded Causes*, ADVERTISING AGE, June 13, 2005, at 31.

[sic] Day-Timer offers a red planner that includes heart healthy recipes, activity and eating plan pages. Hanes offered a limited edition T-shirt that gave 70% of the proceeds and sold it through Macy's, a national American Heart partner . . . Swarovski's crystal version of the organization's red dress lapel pin spawned a line of jewelry called The Power of Love.<sup>48</sup>

Another prominent branded merchandising campaign is the (PRODUCT)<sup>Red</sup> campaign which supports The Global Fund to Fight AIDS, Tuberculosis, and Malaria (The Global Fund). Formed by U2 lead singer, Bono, The Global Fund's mission is to raise awareness and funds for AIDS, tuberculosis, and malaria relief worldwide.<sup>49</sup> Many high profile companies, such as Starbucks, Gap, and Microsoft, have partnered in a marketing alliance to offer red-colored products which bear the trademark (PRODUCT)<sup>Red</sup> symbol.<sup>50</sup> A portion of the proceeds from the sale of these products benefit The Global Fund; the amount varies from company to company.<sup>51</sup> As of December 2009, these cause-related marketing alliances have generated \$140 million for The Global Fund.<sup>52</sup>

These examples illustrate the popularity and prevalence of cause-related marketing alliances that involve branded merchandise. Common among these alliances is the use of a trademark color and symbol that evidence support for the charity's mission on the company's product. The main motivation for a consumer to purchase the product is to visibly display the consumer's support for the cause to others by wearing or displaying the product. This distinguishes branded merchandise from promotional merchandise.

### B. Promotional Merchandising

Promotional merchandising involves a commitment by the corporate partner to donate a specific amount of money or a percentage of the proceeds or profits from the sale of the specified product or service to the charity,<sup>53</sup> often with a financial cap.<sup>54</sup> Although not always the case, for

48. *Id.*

49. See The Global Fund, <http://www.theglobalfund.org/en/> (last visited Jan. 23, 2010).

50. See The Global Fund, Product Red, <http://www.theglobalfund.org/en/privatesector/red/> (last visited Jan. 23, 2010).

51. *Id.*

52. *Id.*

53. One study notes that if the marketer of the product decides to give more per purchase in a given marketing campaign, such increase in cost is likely to be passed on to consumers in one form or another. Michal Strahilevitz, *The Effects of Product Type and Donation Magnitude on Willingness to Pay More for a Charity-Linked Brand*, 8 J. CONSUMER PSYCHOL. 215, 217 (1999).

purposes of this article, I refer to “promotional merchandising” as including only those sales transactions in which the charity agrees to allow the corporate partner to place the charity’s name or logo on the promotional product. The charity typically receives a fee from the corporate partner for the use of the charity’s name or logo, which may be a fixed amount, or more typically, a specified percentage of the proceeds from the sale of the promotional product.<sup>55</sup> Normally, the charity retains the right to approve the way in which its name or logo is used on the promotional product.

One example of promotional merchandising is General Mill’s ongoing Yoplait yogurt campaign with the slogan “Save Lids to Save Lives.”<sup>56</sup> Each year, General Mills produces specially marked Yoplait yogurt containers with pink lids that prominently display the trademark pink ribbon symbol for breast cancer awareness. For each pink lid from a Yoplait yogurt container returned by customers to General Mills, General Mills promises to donate ten cents to the Susan G. Komen Breast Cancer Foundation, up to \$1.5 million per year.<sup>57</sup> To date, this cause-related marketing campaign has raised over \$25 million for the Susan G. Komen Breast Cancer Foundation.<sup>58</sup> The Yoplait campaign is just one of many cause-related marketing alliances formed to support breast cancer awareness and research.<sup>59</sup>

Another example of promotional merchandising is the Kohl’s Cares for Kids campaign, conducted throughout the year in local Kohl’s stores and on the Kohl’s website.<sup>60</sup> As part of this campaign, Kohl’s offers a specially marked line of children’s books and stuffed animals for purchase at five dollars each. All of the profits from the sales of this specially marked merchandise are donated to support children’s initiatives such as injury prevention; immunizations; and education programs for diabetes, asthma, and childhood obesity. To date, the program has raised over \$126 million for children’s health and education initiatives nationwide.

Companies engage in promotional merchandising as a marketing strategy to encourage sales of the promotional product. Purchasing promotional merchandise makes consumers feel good about supporting the charity’s cause. Studies of consumer behavior reveal that consumers are more

54. See Andreasen, *supra* note 18, at 161.

55. *Id.* at 159–161.

56. See Yoplait, Save Lids to Save Lives, <http://www.yoplait.com/sls1> (last visited Apr. 23, 2010).

57. *Id.* General Mills guarantees a minimum donation of \$500,000 per year. *Id.*

58. *Id.*

59. See, e.g., Mercedes M. Cardona, *Marketers Think Pink for Breast Cancer Awareness*, *ADVERTISING AGE*, Oct. 23, 2000, at 18.

60. See Kohl’s Cares for Kids Merchandise, <http://www.kohlscorporation.com/communityrelations/community02.htm> (last visited Jan. 23, 2010).

likely to purchase a product that supports a charitable cause over a competing product which does not.<sup>61</sup> In some cases, however, consumers may be motivated to purchase the product because the consumers believe that the charity is endorsing the promotional product by allowing the charity's name or logo to be placed on the product packaging or advertising for the product.<sup>62</sup> While a charity normally does not explicitly endorse the promotional product as part of the cause-related marketing alliance, consumer perception of apparent product endorsement is troubling and could have significant implications on the appropriate tax treatment of the cause-related marketing alliance for the charity, as further discussed below.

It is important to distinguish promotional merchandising from the use of certification marks by a charity. A certification mark is a symbol used to indicate that the product meets certain specified standards set by the mark's owner.<sup>63</sup> For example, the American Heart Association maintains a heart-check certification mark, symbolizing that the product meets the American Heart Association's criteria for "saturated fat and cholesterol for healthy people over age 2."<sup>64</sup> Usually in exchange for a fee, the mark's owner allows others to use the mark on their products as a symbol that the product meets certain standards, and thus the certification mark allows consumers to rely on the mark's owner for information about the seller's goods or services. Because consumers rely on the mark owner's approval of the mark's use, the Lanham Act imposes certain requirements on the owner for the mark to remain valid. In particular, the owner must be able to control the use of the mark, may not allow the mark to be used for purposes other than to certify, and must provide certification to all those who meet the relevant criteria for certification and request the certification. Thus, while companies may seek certification marks from charities which maintain them, such as American Heart Association, to promote the sale of their products, there is no representation that a portion of the sales of the products bearing the certification mark will benefit charity. Accordingly, the use of certification marks is distinct from promotional advertising encom-

61. See *infra* Part III.A.

62. See *infra* Part III.B.

63. See 15 U.S.C. § 1127 (2006).

64. American Heart Association, Heart-Healthy Grocery Shopping Made Simple, <http://www.americanheart.org/presenter.jhtml?identifier=2115> (last visited Jan. 23, 2010). Two commentators criticize the American Heart Association's heart-check program as indicating little more than the product meeting minimum government standards and chastise its policy of excluding companies having a corporate relationship with a tobacco company from the certification program: "Whatever one may think about smoking products, the fact that Post's Raisin Bran cannot carry the heart-check symbol, but Kellogg's Raisin Bran and even Kellogg's Fruit Loops can, suggests the inherent hollowness of the program's information." Bennett & DiLorenzo, *supra* note 7, at 11.

passed by cause-related marketing.<sup>65</sup>

### C. *Benefits of Cause-Related Marketing*

Cause-related marketing has been described as a “win-win” situation.<sup>66</sup> The benefits for both the charity and the corporate partner can be substantial. Commentators have divided the potential benefits from cause-related marketing alliances into two subsets: first-order benefits and second-order benefits.<sup>67</sup> As mentioned previously, first-order benefits involve direct financial remuneration to the charity and the corporate partner while second-order benefits involve gains which are expected to improve either side’s performance in the future.

For the charity, first-order benefits primarily include the donations that the charity receives directly from the cause-related marketing campaign. Second-order benefits for the charity may include favorable impact on the charity’s mission, enhanced visibility of the charity’s cause or message, and increased impact on new audiences.<sup>68</sup> The overall impact of first-order and second-order benefits on the charity is difficult to quantify, in part because research evidence on this issue is sparse.<sup>69</sup> Cause-related marketing activities generate significant revenues for charities—more than \$1 billion in 2005—and both the number of charities engaging in cause-related marketing alliances and the number of corporate partners involved in these alliances continue to grow.<sup>70</sup> However, the amount of pure donation revenue that may be lost as the result of engaging in cause-related marketing has not been quantified. Some research reports that individuals would not decrease their donations to a particular charity if that charity were involved in cause-related marketing, but other research has found that affinity card<sup>71</sup> users may decrease direct donations to the charity that is supported by the

65. This article does not address the tax implications of the use of certification marks by charitable organizations. It should be noted, however, that American Heart Association takes the position on its Form 990 that the revenue it receives from its heart-check program is related program service revenue, and thus exempt from taxation. *See, e.g.*, American Heart Association Form 990, Return of Organization Exempt From Income Tax, for the fiscal year ended June 30, 2008, at p. 3, available at [www.guidestar.org](http://www.guidestar.org).

66. *See, e.g.*, Webster, *supra* note 47; John W. Pracejus, G. Douglas Olsen, & Norman R. Brown, *On the Prevalence and Impact of Vague Quantifiers in the Advertising of Cause-Related Marketing (CRM)*, J. ADVERTISING, Winter 2003–4, at 19.

67. *See* Andreasen, *supra* note 18, at 158–181 (discussing the framework for first-order benefits and second-order benefits and evaluating the impact of these benefits on the charity and the corporate partner).

68. *Id.* at 159.

69. *Id.* at 175.

70. *See id.*

71. *See infra* note 149 and accompanying text.

affinity card.<sup>72</sup> Additionally, the potential negative second-order effects for the charity are substantial, including monetary loss from a failed alliance, consumer perception of excessive commercialism of the charity's goodwill, consumer bitterness over misperception or obscurity in the amount donated to the charity, and donor impression that the charity is "selling-out" by aligning with a corporate partner which produces products or services which are at odds with the charity's stated mission.<sup>73</sup>

For the corporate partner, the first-order benefit is largely the increased sales of the promoted product or services and the corresponding increased revenues from those sales.<sup>74</sup> Second-order benefits for the corporation may include increased corporate goodwill, increased brand loyalty, improved company morale, and increased support from investors.<sup>75</sup> The impact of cause-related marketing alliances on the financial performance of the corporate partner may be difficult to discover and measuring the second-order benefits to the corporate partner may be problematic.<sup>76</sup> However, one study noted a positive relationship between cause-marketing alliances and increased financial performance of the corporate partners in a majority of the cases studied.<sup>77</sup> Additionally, "[t]he rate of growth in cause-marketing alliances certainly implies that corporations think there are major second-order payoffs for cause-marketing alliances."<sup>78</sup>

## II. UNRELATED BUSINESS INCOME

Charities normally must pay tax on their unrelated business taxable income (UBTI).<sup>79</sup> UBTI consists of the gross income derived from any unrelated trade or business<sup>80</sup> regularly carried on by the charity (with some

72. See Andreasen, *supra* note 18, at 176; cf. Young, *supra* note 3, at 198 (explaining this phenomenon as "crowding out"—when donors believe their contributions are not needed because of increases in the charity's other source of revenues or because the character of those other revenues make the charity seem less desirable).

73. See Andreasen, *supra* note 18, at 177–181; Cordes & Weisbrod, *supra* note 28, at 12; cf. Hassay & Pelozo, *supra* note 2, at 38 ("[S]hoppers have also been known to boycott or disidentify with certain brands because of their charity affiliations.").

74. See Hassay & Pelozo, *supra* note 2, at 46 ("Research shows that 'doing good' is also good for business, and marketers have realized sales increases as a result of [cause-related marketing] efforts."); Nannette Byrnes, *Smarter Corporate Giving: Targeted Donations, Support for Volunteers, and Consumer Awareness Ads Are Paying Off*, BUS. WEEK, Nov. 28, 2005, at 68. When asked about the success of the Yoplait yogurt pink-lid campaign to benefit the Susan G. Komen Foundation, Chris Shea, president of the General Mills Foundation, noted "sales were healthy." *Id.*

75. See Andreasen, *supra* note 18, at 160.

76. *Id.* at 169.

77. *Id.*

78. *Id.*

79. I.R.C. § 511 (2006).

80. Treasury regulations imply that a charity's trade or business activities should be segregated

deductions and modifications).<sup>81</sup> Generally, an activity is an “unrelated trade or business” if it satisfies each element of the following three-part test: (i) the activity constitutes a “trade or business,” (ii) the activity is “regularly carried on” by the organization, and (iii) the conduct of the activity is “not substantially related to the performance of the organization’s exempt function.”<sup>82</sup> Each of these requirements is briefly discussed in turn below.<sup>83</sup>

into “specific business activities” to determine whether each set of “specific business activities” is regularly carried on and whether a trade or business is “related” or “unrelated” to a charity’s exempt purposes. Treas. Reg. § 1.513-1(b)–(c)(1) (as amended in 1983). In particular, in determining whether a trade or business is “related” or “unrelated” to an organization’s exempt purposes, the regulations distinguish between particular subclasses of the same general activities:

Activities . . . from which a particular amount of gross income is derived do not lose identity as trade or business merely because they are carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization. Thus, for example, the regular sale of pharmaceutical supplies to the general public by a hospital pharmacy does not lose identity as trade or business merely because the pharmacy also furnishes supplies to the hospital and patients of the hospital in accordance with its exempt purposes or in compliance with the terms of section 513(a)(2).

Treas. Reg. § 1.513-1(b). The foregoing example treats a hospital’s sale of pharmaceutical supplies to the general public and the hospital’s sale of such supplies to patients as two distinct activities. *Id.* The Ninth Circuit Court of Appeals also appears to distinguish between particular subclasses of the same general activities when applying the unrelated business income tax. *See Sierra Club, Inc. v. Comm’r*, 86 F.3d 1526 (9th Cir. 1996). In *Sierra Club*, the Ninth Circuit analyzed “[t]he income Sierra Club received from . . . two business arrangements.” *Id.* at 1527. First, the court considered whether the charity was taxable on the income it generated by renting its mailing list to third parties for use in direct mail solicitations. The court concluded that this income constituted “royalties,” which are exempt from unrelated business income tax. *Id.* at 1536. Second, the court considered whether the charity was taxable on the income it generated by providing its mailing list to a financial institution for use in marketing an “affinity” credit card featuring the charity’s logo. The court stated that this income might constitute royalties, or might not, depending on a factual issue (whether the charity provided services in connection with the affinity card program). *Id.* at 1536–37. The court remanded the case to the Tax Court to resolve that issue. *Id.* at 1537.

81. I.R.C. § 512(a)(1) (2006).

82. Treas. Reg. § 1.513-1(a).

83. Engaging in an unrelated trade or business could also have significant implications on the tax-exempt status of the charity. If the charity engages, to more than an insignificant extent, in activities that lack a substantial relationship to the charity’s exempt purpose, the charity may lose its exempt status under Section 501(c)(3) of the Internal Revenue Code. *See* I.R.C. § 501(c)(3) (2006); Treas. Reg. § 1.501(c)(3)-1(c)(1) (as amended in 2008). In determining whether an unrelated activity is more than incidental to an organization’s exempt activities, all the circumstances must be considered, including the size and extent of the trade or business and the size and extent of the activities which are in furtherance of the exempt purposes. Treas. Reg. § 1.501(c)(3)-1(e)(1). Courts and the Internal Revenue Service generally consider (i) the amount of income derived from the activity in comparison to total income, (ii) the amount of expenditures for the activity in comparison to total expenditures, and (iii) the amount of time the organization’s employees devote to the activity in comparison to total hours worked. Although no bright line rule exists with respect to any of these inquiries, one case, by way of example, determined that an organization formed to promote agriculture and horticulture did not qualify for exemption when about 30 percent of the organization’s gross income was derived from the operation of a racetrack, an unrelated activity. *Orange County Agric. Soc’y, Inc. v. Comm’r*, 893 F.2d 529 (2d Cir. 1990). Another case denied a social club tax exempt status when 11 to 17 percent of its gross receipts from its rental, restaurant, and bar service business came from nonmembers (and thus did not further its exempt purposes). *Pittsburgh Press Club v. United States*, 615 F.2d 600, 606 (3d Cir. 1980); *see also*



### A. In General

Taxation of a charity's income from commercial activities has been traditionally justified on the basis of preventing potential unfair competition with for-profit providers of similar goods and services and protecting the erosion of the corporate tax base.<sup>84</sup> The Supreme Court has adopted the prevention of unfair competition as the underlying policy of the UBTI rules stating that "[t]he undisputed purpose of the unrelated business income tax was to prevent tax-exempt organizations from competing unfairly with businesses whose earnings were taxed."<sup>85</sup> Tax-exempt organizations purportedly present two forms of unfair competition. First, because their profits are not subject to tax, tax-exempt organizations could engage in predatory pricing practices by charging less for similar goods and services than their for-profit competitors, thereby driving competitors out of the market.<sup>86</sup> Second, tax-exempt organizations could more easily accumulate capital, allowing tax-exempt organizations a greater ability to expand, which in turn gives them an unfair advantage over their competitors.<sup>87</sup> There are other policies supporting the enforcement of the UBTI rules besides unfair competition;<sup>88</sup> however, unfair competition is the most often touted.<sup>89</sup>

New Faith, Inc., 64 T.C.M. (CCH) 1050 (1992) (denying exempt status to alleged nonprofit public benefit corporation when 80 percent of its gross expenditures and 100 percent of its gross revenues came from operation of lunch trucks providing food to general public for scheduled "donations"); Living Faith, Inc. v. Comm'r, 950 F.2d 365 (7th Cir. 1991) (denying exempt status to alleged religious organization when its only current activities consisted of operating two restaurants and health food stores in the same manner as commercial operations, aside from the presence of religious literature at the establishments). In contrast, IRS General Counsel Memorandum 32,361 expressed doubt that a charity's operation of a dining room, café, and bar in its community center were more than incidental to the organization's exempt functions. I.R.S. Gen. Couns. Mem. 32,361 (July 27, 1962). Although 60 percent of the organization's gross revenues were derived from such activities, (i) the dining rooms and kitchen occupied a small percentage of the community center space, (ii) on average, thirty-four meals were served per day, (iii) the dining room and bar were not open to the general public, (iv) operations were too small, specialized, and sporadic to be financially self-sustaining, and (v) the volume of sales was too small to cover the fixed costs thereof. *Id.*

84. See, e.g., Colombo, *supra* note 28, at 529-34; Kevin M. Yamamoto, *Taxing Income from Mailing List and Affinity Card Arrangements: A Proposal*, 38 SAN DIEGO L. REV. 221, 252-53 (2001).

85. *United States v. Am. Bar Endowment*, 477 U.S. 105, 114-15 (1986).

86. Yamamoto, *supra* note 84, at 253.

87. *Id.* at 254.

88. Other policy considerations for limiting commercial activity of charities include: (1) diversion of charitable managers' attention and resources from the core charitable mission; (2) creation of inefficiencies in the capital markets or the distribution of goods and services; (3) problematic determination of a charity's true need for indirect government subsidy through tax exemption; and (4) exposure of charitable assets to liability risk. Colombo, *supra* note 28, at 534-46.

89. See, e.g., Treas. Reg. § 1.513-1(b) (as amended in 1983) ("[T]he primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete."); I.R.S. Tech. Adv. Mem. 91-47-007 (Nov. 22, 1991)

## 1. Trade or Business Requirement

Since one of the main policy reasons for imposing UBTI on charities is to maintain a level playing field between for-profit organizations and tax-exempt charities, the meaning of trade or business for UBTI is consistent with its definition for purposes of the income tax rules applicable to for-profit organizations.<sup>90</sup> The term “trade or business” generally includes any activity carried on for the production of income from the sale of goods or performance of services.<sup>91</sup> In evaluating this criterion, courts and the Internal Revenue Service consider whether the organization has a profit motive<sup>92</sup> and whether the organization’s activity competes with that of for-profit enterprises.<sup>93</sup> In determining whether a profit motive exists, significant weight is given to objective factors such as whether the activity is similar to profit-making activities conducted by commercial enterprises.<sup>94</sup> The mere fact that the activity is conducted as a fund-raising activity of the charity is not sufficient to conclude that the activity is not a trade or busi-

(“[T]he notion of unfair competition is the underlying reason for the enactment of the tax on unrelated business income . . .”).

90. For purposes of section 513, “the term ‘trade or business’ has the same meaning it has in section 162. Treas. Reg. § 1.513-1(b). Section 162 of the Internal Revenue Code governs the deductibility of trade or business expenses. In that context, the U.S. Supreme Court has declared that “to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and . . . the taxpayer’s primary purpose for engaging in the activity must be for income or profit.” *Comm’r v. Groetzinger*, 480 U.S. 23, 35 (1987).

91. I.R.C. § 513(c) (2006); Treas. Reg. § 1.513-1(b).

92. The most important element as to whether the activity is a trade or business is the presence of a profit motive. In the context of a tax-exempt organization, the U.S. Supreme Court declared that the inquiry should be whether the activity “‘was entered into with the dominant hope and intent of realizing a profit.’” *United States v. Am. Bar Endowment*, 477 U.S. 105, 110 n.1 (1986) (quoting *Brannen v. Comm’r*, 722 F.2d 695, 704 (11th Cir. 1984)). When the activity involved is highly profitable and involves little risk, courts generally infer the presence of a profit motive. *See, e.g., Carolinas Farm & Power Equip. Dealers Ass’n v. United States*, 699 F.2d 167, 170 (4th Cir. 1983) (“[T]here is no better objective measure of an organization’s motive for conducting an activity than the ends it achieves.”); *La. Credit Union League v. United States*, 693 F.2d 525, 533 (5th Cir. 1982) (finding that a profit motive existed based on the fact that the organization was extensively involved in endorsing and administering an insurance program that proved highly profitable); *Fraternal Order of Police v. Comm’r*, 87 T.C. 747, 756 (1986) (reasoning that the organization’s advertising activities were “obviously conducted with a profit motive” because the activities were highly lucrative and with no risk or expense to the organization), *aff’d*, 833 F.2d 717 (7th Cir. 1987).

93. Treas. Reg. § 1.513-1(b); *see, e.g., Louis W. & Maud Hill Family Found. v. United States*, 347 F. Supp. 1225, 1228–29 (D. Minn. 1972). When applying this test, the Internal Revenue Service may take into account a key purpose of the unrelated business income tax: to prevent unfair competition between taxable and tax-exempt entities. “[W]here an activity does not possess the characteristics of a trade or business within the meaning of section 162, such as when an organization sends out low cost articles incidental to the solicitation of charitable contributions, the unrelated business income tax does not apply since the organization is not in competition with taxable organizations.” Treas. Reg. § 1.513-1(b). *But see La. Credit Union League*, 693 F.2d at 542 (“[T]he presence or absence of competition between exempt and nonexempt organizations does not determine whether an unrelated trade or business is to be taxed.”).

94. *Ill. Ass’n of Prof’l Ins. Agents v. Comm’r*, 801 F.2d 987, 992 (7th Cir. 1986).

ness.<sup>95</sup>

In determining the existence of a trade or business, the level of the organization's activity is also an important factor. For example, the Eighth Circuit Court of Appeals determined that the receipt of payments by a tax-exempt organization in connection with the organization's involvement with insurance plans did not constitute a trade or business because the organization's activities were not extensive and were not of the type generally associated with a trade or business.<sup>96</sup> The organization's activities were limited to the purchase of group policies offering coverage to its members; the provision of membership lists to the insurance brokerage company that handled all of the promotion, marketing, and administration of the program; and the allowance of the use of the organization's endorsement by the insurance company and the insurance brokerage company.<sup>97</sup> By contrast, organizations that actively sponsor and promote similar insurance programs and that provide administrative services for the insurance company or the insurance brokerage company have been found to be engaged in a trade or business.<sup>98</sup>

## 2. Regularly Carried On Requirement

Even if a charity is engaged in an activity for profit, that activity will not constitute a trade or business unless the charity is "involved in the activity with continuity and regularity."<sup>99</sup> Section 512 sets forth this requirement in another way: to be an "unrelated trade or business," an activity must be "regularly carried on."<sup>100</sup> In determining whether a business activity is "regularly carried on," the most important considerations are the fre-

95. See *Am. Bar Endowment*, 477 U.S. at 115 (stating that a charity cannot escape taxation by characterizing an activity as fundraising, because otherwise "any exempt organization could engage in a tax-free business by 'giving away' its product in return for a 'contribution' equal to the market value of the product").

96. *Am. Acad. of Family Physicians v. United States*, 91 F.3d 1155, 1159-60 (8th Cir. 1996).

97. *Id.* at 1159.

98. See, e.g., *Am. Bar Endowment*, 477 U.S. at 107, 119; *Tex. Farm Bureau v. United States*, 53 F.3d 120, 123-25 (5th Cir. 1995); *Nat'l Water Well Ass'n v. Comm'r*, 92 T.C. 75 (1989); *Prof'l Ins. Agents of Mich. v. Comm'r*, 78 T.C. 246 (1982), *aff'd*, 726 F.2d 1097 (6th Cir. 1984). For example, in *National Water Well Association*, the Tax Court held that dividends received by a tax-exempt organization in connection with an insurance program was trade or business income where the organization agreed to (1) provide assistance to the insurance company in promoting, endorsing and sponsoring the program, (2) make known the availability of the program to the organization's members, (3) exclusively use the insurance company for its program and not sponsor or endorse the programs of any other insurance company, and (4) provide extensive administrative services in connection with the program, including facilitating the collection of premiums by providing the insurance company with member information. 92 T.C. at 92-94.

99. *Comm'r v. Groetzinger*, 480 U.S. 23, 35 (1987).

100. I.R.C. § 512(a)(1) (2006).

quency and continuity with which the activities are conducted<sup>101</sup> and the manner in which the activities are pursued.<sup>102</sup> In general, a business activity is regularly carried on if the activity is conducted with a frequency, continuity, and manner similar to comparable commercial activities.<sup>103</sup> “Income producing or fund raising activities lasting only a short period of time [are] not ordinarily . . . treated as regularly carried on if they recur only occasionally or sporadically,” and are not regarded as regularly carried on “merely because they are conducted on an annually recurrent basis.”<sup>104</sup> Furthermore, in determining whether a charity’s business activities are “regularly carried on,” the activities of the charity’s agents may be taken

101. Neither the Treasury regulations nor the Ninth Circuit’s opinion in *Sierra Club* consider whether “specific business activities” should be defined broadly or narrowly when determining whether a set of specific business activities is “regularly carried on.” Nevertheless, these authorities suggest that specific business activities should be defined narrowly, distinguishing between distinct subclasses of the same general activities. The Treasury regulations state that the regularly carried on requirement “must be applied in light of the purpose of the unrelated business income tax to place exempt organization business activities upon the same tax basis as the nonexempt business endeavors with which they compete.” Treas. Reg. § 1.513-1(c)(1) (as amended in 1983). Arguably, this purpose is best served by defining activities narrowly. A charity with a broad range of disparate business activities (that collectively are “regularly carried on,” but individually are not) does not represent a competitive threat to any taxable enterprise.

102. Treas. Reg. § 1.513-1(c)(1).

103. *Id.* For example, “[w]here income producing activities are of a kind normally conducted by nonexempt commercial organizations on a year-round basis, the conduct of such activities by an exempt organization over a period of only a few weeks does not constitute the regular carrying on of trade or business.” *Id.* § 1.513-1(c)(2)(i). Similarly, “income producing or fund raising activities lasting only a short period of time will not ordinarily be treated as regularly carried on if they recur only occasionally or sporadically.” *Id.* § 1.513-1(c)(2)(iii).

104. Treas. Reg. § 1.513-1(c)(2)(iii); see also *id.* § 1.513-1(c)(2)(i) (“Where income producing activities are of a kind normally undertaken by nonexempt commercial organizations only on a seasonal basis, the conduct of such activities by an exempt organization during a significant portion of the season ordinarily constitutes the regular conduct of trade or business.”). In making this determination, it is essential to identify the appropriate nonexempt commercial counterpart to the exempt organization’s activity, because the manner in which the nonexempt commercial counterpart conducts its similar activities has an important bearing on whether the activity is considered to be carried on year-round, on a seasonal basis or intermittently. For example, a tax-exempt organization’s annual Christmas card sales program was determined to be regularly carried on when conducted over several months during the holiday season because, although nonexempt organizations normally conduct the sale of greeting cards year-round, the Christmas card portion of the nonexempt organizations’ sales was conducted over the same seasonal period. *Veterans of Foreign Wars, Dep’t of Mich. v. Comm’r*, 89 T.C. 7, 32-37 (1987). By contrast, when an exempt organization’s fundraising activities are conducted on an intermittent basis, such activities are generally considered not to be regularly carried on. See Treas. Reg. § 1.513-1(c)(2)(iii) (stating that fundraising activities lasting only a short period of time will generally not be regarded as regularly carried on, despite their recurrence or their manner of conduct); *Suffolk County Patrolmen’s Benevolent Ass’n v. Comm’r*, 77 T.C. 1314 (1981), *acq.*, 1984-2 C.B. 2 (determining that the conduct of an annual vaudeville show one weekend per year and the solicitation and publication of advertising in the related program guide which lasted eight to sixteen weeks per year was intermittent and not regularly carried on.). *Cf.* Treas. Reg. § 1.513-1(c)(2)(ii) (“[E]xempt organization business activities which are engaged in only discontinuously or periodically will not be considered regularly carried on if they are conducted without the competitive and promotional efforts typical of commercial endeavors.”).

into account.<sup>105</sup> Courts and the Internal Revenue Service disagree as to whether a charity's preparation time in organizing and developing an income-producing activity may be taken into account.<sup>106</sup>

### 3. Substantially Related Requirement

If a charity's trade or business activity is determined to be regularly carried on, the next inquiry is whether such activity is substantially related to the organization's charitable, educational, or other purpose constituting the basis for its exemption from federal income tax.<sup>107</sup> A trade or business is a "related business" if the "conduct of the business activities has [a] causal relationship to the achievement of exempt purposes (other than through the production of income)."<sup>108</sup> It is important to emphasize that mere production of income from the activity to enable the charity to carry out its charitable activities is not enough to justify the activity as substantially related to the charity's exempt purposes. The causal relationship must be substantial in that the business activity must contribute importantly to the accomplishment of the organization's exempt purposes.<sup>109</sup> This is an inherently factual determination.<sup>110</sup>

For example, the American Red Cross, a charity organized to provide emergency relief to those in need, sells a Ready-to-Go Emergency Preparedness Kit containing all the essentials that may be needed in an emergency.<sup>111</sup> The American Red Cross reports the revenues from the sale of

105. *State Police Ass'n of Mass. v. Comm'r*, 72 T.C.M. (CCH) 582 (1996), *aff'd*, 125 F.3d 1 (1st Cir. 1997).

106. *See NCAA v. Comm'r*, 92 T.C. 456 (1989) (finding that NCAA's sale of advertisements for annual championship program was "regularly carried on," in part because of the amount of preliminary time spent to solicit advertisements and prepare them for publication), *rev'd*, 914 F.2d 1417 (10th Cir. 1990) (holding that this activity was not regularly carried on, because only the time spent conducting the activity, not the time spent in preparations, is relevant to that determination), *action on dec.*, 1991-015 (July 3, 1991) (indicating that the Internal Revenue Service will continue to litigate the issue).

107. *See* I.R.C. § 513(a) (2006); Treas. Reg. § 1.513-1(d)(1).

108. Treas. Reg. § 1.513-1(d)(2).

109. *Id.*

110. For example, in Revenue Ruling 78-145, the Internal Revenue Service held that the sale of plasma by a tax-exempt organization engaged in collecting and maintaining blood products for use by hospitals for red blood cell transfusion was related to the blood bank's exempt purposes where the blood bank sold by-product plasma from which red blood cells had been removed for the hospitals' use and plasma salvaged from blood nearing the end of its shelf life. Rev. Rul. 78-145, 1978-1 C.B. 169. By contrast, the sale of plasma obtained from donors through a procedure by which the red blood cells were already removed and replaced in the donors was determined not to be related to the blood bank's exempt purposes because such plasma was obtained solely for resale. *Id.*

111. Katie Lawson, Red Cross Ready-to-Go Kit Quick to Receive National Recognition (Jan. 23, 2008), <http://www.redcross.org/portal/site/en/menuitem.1a019a978f421296e81ec89e43181aa0/?vgnextoid=669022daedd4b110VgnVCM10000089f0870aRCRD&vgnextfmt=default>.

these first aid kits as exempt from its UBTI because the sale of first aid kits is substantially related to the organization's mission of emergency response and preparedness.<sup>112</sup> If the same first aid kits were sold by a natural history museum, it would be difficult to find a causal relationship between the sale of the first aid kits and the museum's purpose to educate the public about natural history. Therefore, the revenues from the sale of the first aid kits by the natural history museum would be included in the museum's UBTI.

#### 4. Relevant Exceptions

If the activity in question is considered to be an unrelated trade or business under general principles, certain relevant statutory exceptions may, if applicable, still allow the charity to exclude from the charity's UBTI any payments it receives from the activity.<sup>113</sup> The statutory exceptions and modifications to the UBTI treatment of a charity's income-producing activities attempt to exempt those income-producing activities that are passive in nature or conducted in such a manner as to not pose any competitive threat to for-profit entities. For cause-related marketing alliances, two statutory exceptions are particularly relevant. The first exception relates to qualified sponsorship payments,<sup>114</sup> and the second exception relates to royalties received by the charity.<sup>115</sup> The next two sections discuss these exceptions in more detail and provide relevant historical background for these exceptions as they might apply to cause-related marketing alliances.

#### B. College Bowl Games Kick Off the Debate

Preceding the enactment of the qualified sponsorship rules, the Internal Revenue Service issued a private ruling concerning the display of a corporate sponsor's name or logo in return for the sponsorship of a collegiate football game,<sup>116</sup> which has come to be known as the "Mobil Cotton Bowl Letter."<sup>117</sup> In the Mobil Cotton Bowl Letter, the Internal Revenue Service considered benefits afforded to Mobil Oil Company as the sponsor of the Cotton Bowl collegiate football game and to John Hancock Insur-

112. See, e.g., American National Red Cross Form 990, Return of Organization Exempt From Income Tax, for the fiscal year ended June 30, 2008, at p. 8, available at [www.guidestar.org](http://www.guidestar.org).

113. See generally I.R.C. §§ 512-513 (providing for certain exceptions and modifications to the determination of a charity's UBTI).

114. See I.R.C. § 513(a).

115. See I.R.C. § 512(b)(5).

116. I.R.S. Priv. Ltr. Rul. 92-31-001 (Oct. 22, 1991); see also I.R.S. Tech. Adv. Mem. 91-47-007 (Aug. 16, 1991).

117. See Wirschafter, *supra* note 27, at 1465.

ance as the sponsor of the Sun Bowl collegiate football game.<sup>118</sup> Under the sponsorship agreements, the corporate sponsor designed the game's name and logo, which included the corporate sponsor's name and logo.<sup>119</sup> The game logo was used in all "official uses," including, but not limited to, identification, advertising, pennants, promotional material, and official use of the game's name on television, on the radio and in the print media.<sup>120</sup> The logo also appeared in the stadium and on the player's uniforms.<sup>121</sup> The Internal Revenue Service ruled that the sponsorship payments to the exempt organization operating the sporting event constituted UBTI because the corporate sponsor was receiving advertising benefits.<sup>122</sup> The Internal Revenue Service considered the benefits to Mobil Oil Company and John Hancock Insurance to entail much more than mere recognition of the sponsor's generosity (which would not result in UBTI).<sup>123</sup>

The position of the Internal Revenue Service on the UBTI treatment of the corporate sponsor's payments in the Mobil Cotton Bowl Letter led to a heated debate on the appropriate treatment of sponsorship payments.<sup>124</sup> Taken to its extreme, the Mobil Cotton Bowl Letter would prevent public recognition of sponsors of libraries, academic chairs, museum wings, public radio, and little league associations unless the charity was willing to treat the sponsorship money received as UBTI.<sup>125</sup> In the face of backlash from the charitable community, the Internal Revenue Service softened its position on the UBTI treatment of corporate sponsorship payments and issued proposed audit guidelines that sought to distinguish between incidental donor recognition and taxable advertising services.<sup>126</sup> These proposed audit guidelines would have exempted most corporate sponsorship

118. Charles T. Crawford, *IRS Softens Its Position on Sponsorship as Advertising*, 79 J. TAX'N 214, 214 (1993).

119. *See id.*; I.R.S. Tech. Adv. Mem. 91-47-007.

120. *See* I.R.S. Tech. Adv. Mem. 91-47-007.

121. Wirtschafter, *supra* note 27, at 1476.

122. *Id.* at 1465.

123. *See* I.R.S. Tech. Adv. Mem. 91-47-007. One author notes that John Hancock Insurance received over \$5 million worth of publicity in exchange for its \$1 million sponsorship fee and \$600,000 advertising cost for the John Hancock Bowl in 1991. Crawford, *supra* note 118, at 214. An officer of John Hancock commented: "The bowl is an extraordinarily efficient media buy. It would cost us a great deal more money to help influence sales by normal advertising." DENNIS ZIMMERMAN, CONGRESSIONAL RESEARCH SERVICE, CRS REPORT FOR CONGRESS NO. 92-157E, CORPORATE TITLE SPONSORSHIP PAYMENTS TO NONPROFIT COLLEGE FOOTBALL GAMES: SHOULD THEY BE TAXED? 8 (1992).

124. *See, e.g.*, Wirtschafter, *supra* note 27, at 1487-93 (describing the controversy between the Internal Revenue Service and the charitable community); Crawford, *supra* note 118, at 214 (noting the enormous potential adverse effect of the Mobil Cotton Bowl ruling on the charitable community, which at that time received over \$1.1 billion annually in sponsorship fees).

125. *See* Crawford, *supra* note 118, at 215.

126. *Id.* at 214.

arrangements from UBTI treatment, but would have captured college bowl games.<sup>127</sup> The following year, the Internal Revenue Service further softened its position and issued proposed regulations that would also exclude sponsorship of most college bowl game arrangements from UBTI treatment.<sup>128</sup> The proposed regulations were issued in the face of Congress approving a provision (in a bill that was later vetoed) exempting qualified sponsorship payments received in connection with “qualified athletic events” from UBTI treatment.<sup>129</sup>

The culmination of this debate was the enactment of an exemption from UBTI for certain corporate sponsorship payments. Under section 513(i) of the Internal Revenue Code, the receipt of qualified sponsorship payments by a charity does not constitute the receipt of income from an unrelated trade or business, and instead, the payment is treated as a charitable contribution to the charity.<sup>130</sup> A “qualified sponsorship payment” is “any payment<sup>131</sup> 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.”<sup>132</sup> A “substantial return benefit” is any benefit other than a “use or acknowledgement”<sup>133</sup> of the corporate sponsor and certain disregarded benefits.<sup>134</sup> Substantial benefits include the charita-

127. *Id.* at 214–15.

128. *Id.* at 215.

129. See Revenue Act of 1992, H.R. 11, 102d Cong. § 7303 (1992).

130. I.R.C. § 513(i) (2006); Treas. Reg. § 1.513-4(a) (2002). The Treasury Regulations provide the following example of a qualified sponsorship payment:

M, a local charity, organizes a marathon and walkathon at which it serves to participants drinks and other refreshments provided free of charge by a national corporation. The corporation also gives M prizes to be awarded to the winners of the event. M 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. M changes the name of its event to include the name of the corporation. M’s activities constitute acknowledgement of the sponsorship.

*Id.* § 1.513-4(f), example 1.

131. “Payment” means “the payment of money, transfer of property, or performance of services.” *Id.* § 1.513-4(c)(1).

132. *Id.* For purposes of these rules, it is irrelevant whether the sponsored activity is temporary or permanent. *Id.*

133. The permitted “uses or acknowledgements” under the qualified sponsorship payment rules include (i) “logos and slogans that do not contain qualitative or comparative descriptions of the payor’s products, services, facilities or company,” (ii) “a list of the payor’s locations, telephone numbers, or Internet address,” (iii) “value-neutral descriptions, including displays or visual depictions, of the payor’s product-line or services,” and (iv) “the payor’s brand or trade names and product or service listings.” *Id.* § 1.513-4(c)(1)(iv). “Logos or slogans that are an established part of the payor’s identity are not considered to contain qualitative or comparative descriptions.” *Id.*

134. *Id.* § 1.513-4(c)(2). A benefit is disregarded if “the aggregate fair market value of all the benefits provided to the payor or persons designated by the payor in connection with the payment during the organization’s taxable year is not more than two percent of the amount of the payment.” *Id.* § 1.513-4(c)(2)(ii). If this limit is exceeded, the entire benefit (and not just the amount exceeding the two percent threshold) provided to the payor is a substantial return benefit. *Id.*



ble organization's provision of facilities, services, or other privileges to the sponsor; exclusive provider relationships;<sup>135</sup> and any license to use intangible assets of the charitable organization.<sup>136</sup> "If there is an arrangement or expectation that the payor will receive a substantial return benefit with respect to any payment, then only the portion, if any, of the payment that exceeds the fair market value of the substantial return benefit is a qualified sponsorship payment."<sup>137</sup> The exempt organization has the burden of establishing the fair market value of the substantial return benefit.<sup>138</sup> If the organization fails to do so, "no portion of the payment constitutes a qualified sponsorship payment."<sup>139</sup>

The tax treatment of any payment that does not represent income from a qualified sponsorship payment is governed by general UBTI principles.<sup>140</sup> The mere fact that the payments are received in connection with the corporate sponsor receiving a substantial return benefit does not necessitate the payments constituting UBTI. For example, in a memorandum released by the Internal Revenue Service in October 2001, examples of certain exclusive provider relationships were addressed.<sup>141</sup> Significantly, one example involved a contract between a soft drink company and a university, under which the soft drink company would be the exclusive provider of soft drinks on campus in return for an annual payment made to the university.<sup>142</sup> Exclusive provider relationships are explicitly named as a substantial return benefit; therefore, the arrangement did not qualify as a qualified sponsorship payment. Because the soft drink company maintained the vending machines, there was no obligation by the university to perform any services on behalf of the soft drink company or to perform any services in connection with the contract.<sup>143</sup> Accordingly, the university did not have the level of activity necessary to constitute a trade or business. Since the contract also provided that the soft drink company was given a license to market its products using the university's name and logo, the portion of the

135. The Treasury Regulations define an "exclusive provider" relationship as any arrangement which "limits the sale, distribution, availability, or use of competing products, services or facilities in connection with an exempt organization's activity." *Id.* § 1.513-4(c)(2)(vi)(B). "For example, if in exchange for a payment, the exempt organization agrees to allow only the payor's products to be sold in connection with an activity, the payor has received a substantial return benefit." *Id.*

136. *Id.* § 1.513-4(c)(2)(iii)(D).

137. *Id.* § 1.513-4(d).

138. *Id.*

139. *Id.*

140. *Id.* § 1.513-4(f).

141. See *IRS Issues Field Memo on Exclusive Providers and UBIT*, 2001 TAX NOTES TODAY 192-26 (Oct. 3, 2001).

142. *Id.*

143. *Id.*

total payment attributable to the value of the license would be excluded from the university's UBTI as a royalty payment.<sup>144</sup>

### C. Affinity Cards Pave the Way

Because royalties are passive in nature, the receipt of royalty income by a tax-exempt organization does not result in unfair competition with taxable entities.<sup>145</sup> Accordingly, section 512 of the Internal Revenue Code provides that a charity's UBTI generally does not include royalties.<sup>146</sup> A royalty is defined as a payment that relates to the use of a valuable right, such as a name, trademark, trade name, or copyright.<sup>147</sup> The royalty may be in the form of a fixed fee or a percentage of sales of the products bearing the charity's name and logo. In addition, the tax-exempt organization may retain the right to approve the use of its name or logo without changing the determination that the income from the transaction is a royalty. By contrast, the payment for personal services does not constitute a royalty.<sup>148</sup>

The application of the royalty exclusion to the licensing of a charity's name and logo to a for-profit company for inclusion on the company's product was first tested in the affinity card context. Generally, an affinity credit card arrangement provides that a credit card company may use the exempt organization's name in connection with a credit card, and the organization will receive a certain percentage, or "royalty," from the income generated by the credit card.<sup>149</sup> There seems to be little doubt that the payment to an exempt organization solely for the use of the organization's name constitutes a royalty.<sup>150</sup> The problem, however, in the affinity credit

144. *Id.* The exclusion for royalties received by an exempt organization is discussed in Part II.C, *infra*.

145. *See* *Sierra Club Inc. v. Comm'r*, 86 F.3d 1526, 1533 (9th Cir. 1996); Yamamoto, *supra* note 84, at 268–69 ("The allowance for excluding passive sources of income from the UBIT was due to Congress's belief that such sources of income would not take the organization any time to run and not create a serious threat to for-profit businesses.").

146. I.R.C. § 512(b)(2) (2006); Treas. Reg. § 1.512(b)-1(b) (as amended in 1992). A charity's UBTI would include royalties derived from debt-financed property. Treas. Reg. § 1.512(b)-1(b).

147. Rev. Rul. 81-178, 1981-2 C.B. 135.

148. *Id.*

149. *See, e.g.*, Yamamoto, *supra* note 84, at 225–26; *see also* *Sierra Club*, 86 F.3d 1526 (example of typical affinity card arrangement). In *Sierra Club*, the Sierra Club entered into an agreement with American Bankcard Services for American Bankcard Services to offer to Sierra Club members a Visa or Mastercard which bore Sierra Club's name on the front and logo on the back. *Id.* at 1528. In exchange for the use of its name and logo, Sierra Club would receive a monthly royalty equal to 1.5 percent of total Sierra Club cardholder purchases. *Id.*

150. *See* Rev. Rul. 81-178, 1981-2 C.B. 135, situation 1. For example, fees paid to an exempt organization by vendors who sold souvenirs bearing the organization's name and logo constituted royalty income exempt from UBTI. I.R.S. Priv. Ltr. Rul. 98-21-049 (Feb. 23, 1998); *see also* Yamamoto, *supra* note 84, at 292–95 (concurring with the practice of treating income received from the license of a charity's name and logo for inclusion on an affinity card as a royalty).

card context is that these arrangements typically include the use of the organization's mailing list as well. The Internal Revenue Service formerly challenged the exclusion of revenues from affinity card arrangements from UBTI, asserting that (i) payments for the use of an organization's mailing list constitute payments for services, and (ii) payments for the use of both an organization's name and mailing list, pursuant to the same agreement, may not be segregated. The Internal Revenue Service argued that the entire payment fails the royalty test and is UBTI, even though part of the payment is clearly for the organization's endorsement.<sup>151</sup> In *Sierra Club Inc. v. Commissioner*, the Ninth Circuit Court of Appeals rejected the Internal Revenue Service's aggregation argument and analyzed the income received from the use of the organization's name and the use of the mailing list separately.<sup>152</sup>

Of particular importance in the royalty context is the amount of services the charity performs in exchange for the payment received. In order to maintain the royalty exemption for the payments received, the charity may not perform more than *de minimus* services in connection with the arrangement.<sup>153</sup> If the charity performs too many services, then the payment is instead considered compensation for personal services and no longer qualifies as a passive royalty.<sup>154</sup> As a result, the payments received are typically included in the charity's UBTI.

While there is little guidance on the types of services permitted in connection with royalties for the use of a charity's name or logo, the case law discussing the types of permitted services in the mailing list context is instructive. The Tax Court has repeatedly held that payments received by a tax-exempt organization from the rental of its mailing list to third parties constitute "royalties," at least where the organization does not provide ancillary services to the payor.<sup>155</sup> The Claims Court has adopted a less favorable position.<sup>156</sup> In *DAVI*, the charity, Disabled American Veterans, took a very active role in developing and promoting its mailing list through quasi-

151. See I.R.S. Priv. Ltr. Rul. 93-21-005 (Feb. 23, 1993) (where the Internal Revenue Service ruled that the mailing list rental "subsumed" the other aspects of the affinity card agreement); I.R.S. Priv. Ltr. Rul. 93-06-030 (Nov. 18, 1992) (revoking I.R.S. Priv. Ltr. Rul. 92-20-054 (Feb. 20, 1992)); I.R.S. Priv. Ltr. Rul. 92-22-001 (Sept. 30, 1991).

152. *Sierra Club*, 86 F.3d at 1536.

153. *Id.* at 1533-35.

154. *Id.*

155. See *Common Cause v. Comm'r*, 112 T.C. 332 (1999); *Miss. State Univ. Alumni, Inc. v. Comm'r*, 74 T.C.M. (CCH) 458 (1997); *Sierra Club, Inc. v. Comm'r*, 65 T.C.M. (CCH) 2582 (1993), *aff'd in relevant part*, 86 F.3d 1526 (9th Cir. 1996); *Disabled Am. Veterans v. Comm'r (DAV I)*, 94 T.C. 60 (1990), *rev'd on other grounds*, 942 F.2d 309 (6th Cir. 1991).

156. See *Disabled Am. Veterans v. United States (DAV I)*, 650 F.2d 1178 (Ct. Cl. 1981).

commercial means. The charity joined the Direct Marketing Association, “regularly attended meetings and conventions where persons interested in direct mail matters assemble,” and augmented its own list by renting other organizations’ lists and mailing trinkets to potential donors from those lists.<sup>157</sup> Conversely, the charity augmented its income by renting its list to other organizations, taking an active role in that process. In renting the names on its donor list, the charity followed the usual trade practice of the direct mail industry.<sup>158</sup> The court concluded that “DAV’s list rentals are the product of extensive business activity by DAV and do not fit within the types of ‘passive’ income set forth in section 512(b).”<sup>159</sup> Therefore, the court held that the charity’s income from these rentals could not be classified as “royalties.”

The continued vitality of *DAV I* is uncertain. The Tax Court refused to follow *DAV I* when considering essentially the same facts for different tax years in *DAV II*.<sup>160</sup> Furthermore, *DAV I* can be distinguished from cases in which the exempt organization itself does nothing more than provide its list to a third party. For example, in *Sierra Club*, the Ninth Circuit Court of Appeals contrasted the activities of the Sierra Club with those of the Disabled American Veterans:

Here, Sierra Club contracted with others to perform those services that the Court of Claims held constituted ‘extensive business activity’ in *DAV I*. The government argues that it does not matter that Sierra Club paid others to perform services such as sorting by zip code and providing the names on labels—Sierra Club was still in the business of selling and marketing its mailing lists. Sierra Club, on the other hand, correctly points out that it did not participate in any of the business activities that could be considered providing services. It did not market its lists, sort the lists, provide the lists on labels, or provide any other service to the list users. Nor did it pay [a contractor] to perform these services. [The contractor] billed [subcontractors] for these services, who in turn billed the

157. *Id.* at 1182–83.

158. *Id.* at 1184. According to the *DAV I* court:

To obviate the need for the responsible DAV official to devote a substantial portion of his time to responding to inquiries concerning DAV’s list rental terms, “rate cards” were prepared and sent to those list brokers who had previously arranged rentals from the DAV’s list. Rates were set by DAV on a level consistent with the rates which DAV was then paying to rent lists from other organizations. The “rate cards” DAV sent to list brokers set forth the various rates charged by DAV (per 1,000 names), the additional charges applicable for various selections (such as by zip code or by recent donors), the form in which the names could be made available (such as on magnetic tape or on heat transfer, gummed or Cheshire labels), and the number of names available in various categories.

*Id.* (citation omitted).

159. *Id.* at 1189.

160. *DAV II*, 94 T.C. 60.

list renter.<sup>161</sup>

Similarly, in a subsequent case, the Ninth Circuit distinguished the activities of certain tax-exempt alumni associations in exploiting their mailing lists (through an affinity credit card program), from the more extensive activities of the Disabled American Veterans:

Unlike the exempt institution in [*DAV I* and *DAV II*], the alumni associations did not follow the usual practices of the direct mail industry in renting its mailing list, did not regularly rent the list out, and did not use thousands of hours of staff time to administer rentals. . . . The Tax Court found that the few telephone responses to members regarding the credit cards were “*de minimis* and were done to protect petitioner’s goodwill with its members,” a finding well supported in the record.<sup>162</sup>

The court’s decision also clarified that “the royalty exclusion cannot be an all-or-nothing proposition,” and rejected the Service’s contention that “even a little bit of service taints all the royalties.”<sup>163</sup>

Still, in *Sierra Club*, the Ninth Circuit acknowledged that excludable royalties are typically passive in nature and explained that the passivity requirement is consistent with the overall treatment of UBTI.<sup>164</sup> The main purpose behind enactment of the UBTI provisions was to prevent an unfair advantage when tax-exempt organizations compete with for-profit entities.<sup>165</sup> Congress excluded certain income from UBTI, such as royalties, since their passive nature is not likely to result in unfair competition with the for-profit counterparts.<sup>166</sup> The court clarified that excludable royalties involved the payment for the use of a property right, but that a payment for services performed by the property owner in conjunction with that use would not be considered excludable royalty income.<sup>167</sup>

In *Sierra Club*, the Ninth Circuit did not discuss whether the services performed by the charity in connection with the use of the charity’s

161. *Sierra Club Inc. v. Comm’r*, 86 F.3d 1526, 1535–36 (9th Cir. 1996).

162. *Or. State Univ. Alumni Ass’n v. Comm’r*, 193 F.3d 1098, 1101–02 (9th Cir. 1999).

163. *Id.* at 1101; *but see* *Tex. Farm Bureau v. United States*, 53 F.3d 120 (5th Cir. 1995) (holding that where an exempt organization provided an insurance company with office space, stationary, postage, secretarial and clerical help, office supplies, furniture, and equipment to promote and administer the insurance company’s business, the exempt organization could not as an “afterthought” characterize a portion of its revenue from this arrangement as royalties for the use of the exempt organization’s name).

164. *Sierra Club*, 86 F.3d at 1533–34.

165. *Id.* at 1533.

166. *See id.*

167. *Id.* at 1532.

name or logo on the affinity card would preclude royalty treatment for the affinity card payments and remanded the case to the Tax Court for further findings of fact on this issue. In a subsequent case, however, the Ninth Circuit affirmed that royalty treatment was appropriate when the charity performed a *de minimus* amount of services in connection with the affinity card arrangement.<sup>168</sup> The Tax Court has also held in several cases that a *de minimus* amount of services provided would not preclude royalty treatment for the use of an organization's name or logo in the affinity credit card context.<sup>169</sup> Based on such cases, the Internal Revenue Manual now indicates that the Internal Revenue Service will consider payments under affinity credit card arrangements royalties as long as only minimal services are provided by the exempt organization's members or employees.<sup>170</sup>

More recently, the Internal Revenue Service privately ruled that royalties received by a charity from the license of the charity's intellectual property to a for-profit company for use in the company's commercial activities were excluded from the charity's UBTI under the royalty exception.<sup>171</sup> Under the license agreement, the charity retained the right to review the designs and proposed uses of the charity's intellectual property, inspect the commercial counterpart's facilities where the product was manufactured, and inspect the commercial counterpart's books and records annually.<sup>172</sup> The Internal Revenue Service determined that these services performed by the charity in connection with the licensing arrangement were *de minimus*.<sup>173</sup> Moreover, the licensing agreement was narrowly tailored to protect the charity's ownership of its intellectual property by giving the charity absolute discretion to reject proposed uses of the property, providing notice on every unit displaying the charity's mark that it was used with the charity's permission, and allowing the charity to approve and limit mass media advertising of the product.<sup>174</sup> The Internal Revenue Service concluded that

168. Or. State Univ. Alumni Ass'n v. Comm'r, 193 F.3d 1098 (9th Cir. 1999).

169. See *Common Cause v. Comm'r*, 112 T.C. 332 (1999); *Sierra Club, Inc. v. Comm'r*, 77 T.C.M. (CCH) 1569 (1999); *Miss. State Univ. Alumni, Inc. v. Comm'r*, 74 T.C.M. (CCH) 458 (1997).

170. See I.R.S., INTERNAL REVENUE MANUAL § 7.27.6.7.3 (CCH 1999) ("The Service's administrative approach in the area of affinity credit cards is that affinity card cases should be resolved in a manner consistent with existing court cases. In the cases decided in favor of the taxpayer, the facts showed that the involvement of the exempt organization was relatively minimal, and the organizations generally hired outside contractors to perform most services associated with exploitation of the use of intangible property. Thus, courts concluded that the payment was for the intangible property rather than for services of the organization's members or employees. In the one case decided in favor of the government—[*DAV I*—the organization's employees provided extensive services in connection with the list rental.").

171. I.R.S. Priv. Ltr. Rul. 2006-01-033 (Oct. 14, 2005).

172. *Id.*

173. *Id.*

174. *Id.*

the income that the charity would receive from the arrangement was “vastly out of proportion with the time and effort” the charity would expend.<sup>175</sup> Therefore, it could only be compensation for the use of the charity’s intellectual property.<sup>176</sup>

#### *D. Beyond Affinity Cards into Uncharted Territory*

Based on the success of the taxpayer in establishing royalty treatment for the use of a charity’s name or logo in the affinity card cases, at first blush it would appear that similar treatment would be automatically afforded to the payments received for the use of a charity’s name or logo in cause-related marketing alliances. Upon closer examination, however, important distinctions between affinity cards and cause-related marketing alliances appear which may significantly impact the unrelated business income tax treatment of cause-related marketing alliances. First, as a fundamental matter, the affinity card cases establish only that a charity may perform an insubstantial amount of services in connection with the arrangement and still receive royalty treatment. The question of what services are substantial still remains. Second, consumer perception of apparent endorsement of the product bearing the charity’s name or logo was not prevalent in the affinity card context, but is an issue for cause-related marketing alliances. Thus, a question arises: if a charity allows its name or logo to be used in a manner that consumers perceive to be an apparent endorsement of the product, should the payments the charity receives from the cause-related marketing alliance be treated as advertising revenue rather than royalties? Third, many cause-related marketing alliances involve the sale of the branded merchandise by the charity itself; in the affinity card context, charities did not market the affinity cards. Thus, to the extent the charity is engaged in active sales of the branded merchandise, the charity cannot rely on the royalty exception to exclude the revenues it receives from those sales from the charity’s UBTI. Finally, cause-related marketing alliances generally involve prominent recognition by the charity of the corporate partner on the charity’s website and in print materials. Such recognition can further complicate the analysis of the appropriate UBTI classification of the revenue from the cause-related marketing alliance.

This section discusses the possible unrelated business tax treatment of income received from cause-related marketing based on existing law and guidance. First, the sale of branded merchandise directly by the charity is

175. *Id.*

176. *Id.*

addressed using a general UBTI analysis. Second, the income received by the charity in the form of a “royalty” from the sale of branded merchandise or promotional merchandise by the corporate partner is analyzed under the application of the corporate sponsorship rules and the royalty exception. In addition, consideration is given to whether the income could be treated as advertising income, and thus subject to inclusion in the charity’s UBTI under existing law. This analysis reveals that existing guidance is conflicting, and it leads to unpredictable and uncertain results. Therefore, I conclude this section with a call for Internal Revenue Service safe harbor guidance which specifically takes into account the unique nature of cause-related marketing activities.

### 1. Sales of Branded Merchandise Conducted Directly by the Charity

A charity which directly sells merchandise bearing the charity’s name, logo, or other cause-related message would analyze whether the receipts from the sale of such merchandise are UBTI under the general three-prong UBTI test.<sup>177</sup> The sale of branded merchandise typically is an activity carried on for the production of income from the sale of goods. By way of example, the annual sale of Christmas cards has been considered a trade or business,<sup>178</sup> as has the isolated publication, sale, and distribution of a single book.<sup>179</sup> Additionally, a charity would normally engage in the sales of the branded merchandise continuously throughout the year.<sup>180</sup> Accordingly, the sale of branded merchandise would be considered a regularly carried on trade or business. Whether the receipts from the sale of branded merchandise are UBTI would depend on whether the sale of the merchandise is substantially related to the charity’s exempt purpose.

Where a charity sells merchandise, the merchandise is examined on an item-by-item basis to determine if sales of such merchandise further the organization’s exempt purposes.<sup>181</sup> Generally, if the primary purpose of an item is utilitarian, ornamental, or token, selling such an item is not substantially related to the organization’s exempt purposes.<sup>182</sup> In contrast, if the

177. See *supra* Part II.A.

178. See *Veterans of Foreign Wars, Dep’t of Mich. v. Comm’r*, 89 T.C. 7 (1987).

179. See Rev. Rul. 69-430, 1969-2 C.B. 129.

180. See Robert A. Wexler & Alice M. Anderson, *Internet Guidance Should Reconcile Old Law With a New Medium*, 12 J. TAX’N EXEMPT ORGS. 187, 183 (2001) (“If the storefront remains on line on an ongoing basis, it will almost always be an activity that is regularly carried on. In these situations, the issue will likely turn on whether the items sold are substantially related to the organization’s exempt purpose.”).

181. See *e.g.*, I.R.S. Tech. Adv. Mem. 97-20-002 (Nov. 26, 1996).

182. See, *e.g.*, I.R.S. Priv. Ltr. Rul. 2002-22-030 (Mar. 4, 2002); I.R.S. Tech. Adv. Mem. 80-24-111 (Jan. 3, 1980).



utilitarian aspects of the item are incidental to the item's relationship to the organization's exempt purpose, the sale of such an item is considered to be substantially related to the organization's exempt purpose.<sup>183</sup> In addition, merely placing an exempt organization's name or logo on an item otherwise unrelated to its exempt purpose will not prevent sales proceeds from constituting UBTI.<sup>184</sup> However, in several private rulings, the Internal Revenue Service has reached the contrary conclusion regarding the sale of t-shirts and similar items bearing an organization's name or symbol when additional facts indicated that the sales furthered the organization's exempt purpose.<sup>185</sup>

In one private ruling issued in 1986, the Internal Revenue Service ruled that the sale of t-shirts and other items depicting a hand washing symbol to health care facilities such as hospitals, day-care centers, and nursing homes, and to individuals through pharmacies, advanced a charity's exempt purposes by disseminating information about the importance of hand washing.<sup>186</sup> The primary purpose of the organization was to improve the health care provided to children and others in hospitals, day-care centers, and nursing homes, and to educate the public about the need for cleanliness in caring for the sick.<sup>187</sup> In particular, the organization focused on the importance of hand washing as a means of preventing infection.<sup>188</sup> The organization disseminated its message through the sale of posters, coloring books, t-shirts, and buttons that displayed the organization's hand washing symbol and text message.<sup>189</sup> The organization sold the items to hospitals and other institutions dealing with children and to the general public through pharmacies.<sup>190</sup> The Internal Revenue Service found that the sale of these items did not result in UBTI.<sup>191</sup>

In another private ruling issued in 1993, the Internal Revenue Service considered an exempt organization's sale of t-shirts, caps, and other items

183. See I.R.S. Tech. Adv. Mem. 86-05-002 (Sept. 4, 1985); I.R.S. Tech. Adv. Mem. 83-28-009 (Mar. 30, 1983).

184. See, e.g., I.R.S. Tech. Adv. Mem. 83-26-003 (Nov. 17, 1982).

185. Private letter rulings are directed only to the taxpayers to whom they are addressed and may not be used or cited as precedent by other taxpayers. I.R.C. § 6110(k)(3) (2006). Furthermore, the Internal Revenue Service is not bound by the position it takes in a particular private letter ruling and is free to reach the contrary conclusion for another taxpayer under a similar set of facts. Nonetheless, private letter rulings may be relied upon by a taxpayer to establish substantial authority for the tax treatment of an item reported on a return. Treas. Reg. § 1.6662-4(d)(3)(iii) (as amended in 2003).

186. I.R.S. Priv. Ltr. Rul. 86-33-034 (May 20, 1986).

187. *Id.*

188. *Id.*

189. *Id.*

190. *Id.*

191. *Id.*

bearing the organization's name and logo.<sup>192</sup> The exempt organization's functions were related to law enforcement and included the promotion of fraternalism among its members and the improvement of its members' working conditions.<sup>193</sup> The organization sold the items to organization members and nonmembers, but most purchasing nonmembers worked for the organization.<sup>194</sup> Members were offered the items at cost, while nonmembers paid a higher price to cover the administrative costs of selling to nonmembers.<sup>195</sup> The Internal Revenue Service concluded that the t-shirt and other sales encouraged fraternalism among the organization's members by promoting identification of, commitment of, and friendship among its members, so that such sales were substantially related to the organization's exempt purposes and did not result in UBTI.<sup>196</sup>

Most recently, the Internal Revenue Service privately ruled in 2007 that the sale of merchandise bearing the symbol for breast cancer awareness by a charity formed to educate the general public about early detection of breast cancer was substantially related to the charity's exempt purpose.<sup>197</sup> Thus, the proceeds from the sale of the breast cancer awareness branded merchandise were excluded from the charity's UBTI.<sup>198</sup> The branded merchandise described in the ruling included pins, apparel, home and office products, jewelry, and special gifts.<sup>199</sup> All branded merchandise either displayed a pink ribbon, the universal symbol for breast cancer awareness, or were the color pink, the universal color for breast cancer awareness.<sup>200</sup> Included with the packaging of each item was a bookmark providing the charity's recommended three-step approach to positive breast health and the charity's toll-free number and web address.<sup>201</sup> The Internal Revenue Service concluded that the sale of the branded merchandise "reminds and encourages those who wear, display, or see the images, about breast cancer. The sale of these items further enhances [the charity's] message that early detection of breast cancer and positive breast health practice save lives and is, accordingly, related to the organization's exempt purposes."<sup>202</sup>

Even though the branded merchandise sold by a charity typically has

192. I.R.S. Tech. Adv. Mem. 94-36-001 (Sept. 24, 1993).

193. *Id.*

194. *Id.*

195. *Id.*

196. *Id.*

197. I.R.S. Priv. Ltr. Rul. 2007-22-028 (Mar. 9, 2007).

198. *Id.*

199. *Id.*

200. *Id.*

201. *Id.*

202. *Id.*

some utilitarian value, such as a t-shirt, hat, wristband, or pin, it appears that if the charity carefully links the sale of the branded merchandise to the spreading of the charity's message, the sale of the branded merchandise would be considered substantially related to the charity's exempt purpose.<sup>203</sup> Disseminating the charity's message through the sale of branded merchandise bearing the charity's message in text or symbol form (i) promotes thought and discussion of the charity's message, and (ii) enhances the circulation of this message through a rather remarkable display of grassroots public support.<sup>204</sup> The link between the sale of the branded merchandise and the dissemination of the charity's message is often enhanced by including in the individual merchandise packaging an educational brochure explaining the message that the charity is trying to promote.<sup>205</sup>

The charity's position would be significantly weakened if the charity's primary purpose in selling branded merchandise is to generate income. For example, in the 1970s, Disabled American Veterans conducted a fundraising campaign which offered donors certain low-cost items known as "premiums," such as books, maps, and wrist-watch calendars, in exchange for a specified contribution to the charity.<sup>206</sup> In *DAVI*, the court cast the transactions as the outright sale of the premiums and determined the income from

203. Conducting sales through a third-party vendor should not change this result. The Internal Revenue Service has accepted that appropriately conducted sales of certain items to the public through unrelated retailers do not result in UBTI. In Technical Advice Memorandum 95-50-003, the Internal Revenue Service considered whether a museum received UBTI by selling a variety of items in its on-site stores, wholesale to retailers and gift stores, and by mail order. I.R.S. Tech. Adv. Mem. 95-50-003 (Sept. 18, 1995). The items sold included books about the historical period the museum covered, period toys, and exhibit reproductions, among other things. In determining whether UBTI resulted from the sale of these items, the Internal Revenue Service focused almost exclusively on the nature of the items sold, and concluded that sales of those items did not result in UBTI, whether sold on-site or through retailers. The only issue raised by the sales to retail stores and gift shops was whether the sales were conducted on a larger scale than was reasonably necessary for the performance of the museum's exempt functions. *Id.*; see Treas. Reg. § 1.513-1(d)(3) (as amended in 1983).

204. See Hassay & Pelozo, *supra* note 2, at 38 (noting that the purchase of branded merchandise provides supporters of the charity "with a more visible, symbolic statement about their identification with the organization and or cause. Moreover, these purchases are often used as 'badges' that allow supporters to define themselves in public.").

205. In Technical Advice Memorandum 91-38-003, the Internal Revenue Service considered whether a historic estate's retail and wholesale sales of flowers and plants to florists and garden centers constituted UBTI. I.R.S. Tec. Adv. Mem. 91-38-003 (June 24, 1991). Although the Internal Revenue Service concluded that UBTI *did* result from the wholesale activity based on the facts presented, it noted, "where educational and other similar descriptive materials concerning the exempt purposes of the [charity] accompany the plant item at the point of sale, it is our view that such sales would be substantially related to exempt purposes." *Id.*; see also I.R.S. Tech. Adv. Mem. 83-28-009 (Mar. 30, 1983) (reasoning that the sale of early American period pieces by a museum may contribute importantly to the accomplishment of the museum's exempt purposes if such items are sold with descriptive literature explaining their historical or artistic significance).

206. *DAVI*, 650 F.2d 1178, 1183 (Ct. Cl. 1981).

some of the sales to be UBTI.<sup>207</sup> Disabled American Veterans argued that the sales of the premiums were related to its exempt purpose because the inclusion of the premiums in solicitation letters drew attention to the letters, which explained the charity's mission and objectives.<sup>208</sup> The court rejected this argument, noting that Disabled American Veterans initiated the premium program in an effort to increase contributions and discontinued the program when it was no longer an effective revenue-producer.<sup>209</sup> Accordingly, the only causal relationship between the premium program and the accomplishment of Disabled American Veterans' exempt purposes was the production of income for those purposes,<sup>210</sup> which is explicitly excluded as a sufficient relationship.<sup>211</sup>

Internal Revenue Service interest in the sales of the branded merchandise may increase as the scope and extent of sales increase. The Treasury Regulations provide that "[i]n determining whether activities contribute importantly to the accomplishment of an exempt purpose, the size and extent of the activities involved must be considered in relation to the nature and extent of the exempt function which they purport to serve."<sup>212</sup> Therefore,

where income is realized by an exempt organization from activities that are in part related to the performance of its exempt functions, but which are conducted on a larger scale than is reasonably necessary for performance of such functions, [the gross income] of the activities in excess of the needs of the exempt functions constitutes gross income from the conduct of unrelated trade or business.<sup>213</sup>

Thus, the more popular the branded merchandise becomes, the more the sales of the branded merchandise will increase and the more likely the charity will become subject to this type of attack. However, one could argue that the increased sales should be viewed as proportionally increasing

207. *Id.* at 1190–91. The court determined that the sale of the \$2 and \$3 premiums was not a trade or business activity because the markup on these items was so high that these sales did not compete with sales by for-profit businesses. *Id.* at 1187. However, the sales of the \$5 premiums were competitively priced, and therefore constituted a trade or business activity. *Id.* A few years after *DAV I* was decided, an exclusion from UBTI was added for the provision of "low-cost" items in connection with the solicitation of charitable contributions. See I.R.C. § 513(h). Currently, an item can be valued at \$9.60 or less and be considered "low-cost." Rev. Proc. 2009-50, sec. 3.25(1), 2009-45 I.R.B. 471.

208. *DAV I*, 650 F.2d at 1189.

209. *Id.*

210. *Id.*

211. See I.R.C. § 513(a) (2006).

212. Treas. Reg. § 1.513-1(d)(3) (as amended in 1983).

213. *Id.*

the dissemination of charity's message by, among other things, allowing persons to view, consider, and spread the charity's message to others.<sup>214</sup>

While existing guidance lends support to a claim by a charity that the revenues received from the sale of branded merchandise are excluded from the charity's UBTI, the preceding countervailing authority undercuts this claim. The only guidance directly on point in this area is in the form of private letter rulings, which may not be used as precedent by other taxpayers and are not binding on the Internal Revenue Service for persons other than the taxpayer to whom the private ruling is addressed.<sup>215</sup> Accordingly, the Internal Revenue Service is free to reconsider the position it has taken in these private rulings. Furthermore, the foregoing case law and the Treasury Regulations contain some troubling precedent which may limit the extent to which a charity may conduct sales of branded merchandise and still claim exclusion of the revenues from UBTI. Therefore, charities engaged in direct sales of branded merchandise do not have as much certainty as they would like in their position that the revenues from the sale of branded merchandise are excluded from UBTI.

## 2. Sales of Branded Merchandise and Promotional Merchandise Conducted by the Corporate Partner

For sales of branded merchandise directly by the corporate partner and sales of promotional merchandise conducted by the corporate partner, different considerations apply in determining whether the income received by the charity from the arrangement is excluded from the charity's UBTI. As mentioned previously, most cause-related marketing alliances involve recognition of the corporate partner's participation by the charity on its website and in print materials. Thus, this section first analyzes the possible application of the corporate sponsorship rules to cause-related marketing alliances. Cause-related marketing alliances also involve payment for the use of the charity's name, logo, or trademark; accordingly, this section next analyzes the application of the royalty exception to cause-related marketing alliances. Finally, because consumer perception of product endorsement by the charity might be considered as a factor in the UBTI analysis, this section analyzes whether the income received from cause-related marketing alliances could be included in UBTI as advertising income.

214. See I.R.S. Tech. Adv. Mem. 95-50-003 (Sept. 18, 1995) (reasoning that a museum's sales through retail stores appropriately advanced the museum's exempt purposes by (i) making periodicals available to a broader segment of the public; (ii) enhancing the public's understanding of that period; and (iii) encouraging a broader segment of the public to visit the museum).

215. See I.R.C. § 6110(k)(3).

a. *Corporate sponsorship rules do not (fully) address the issue.*

The corporate sponsorship rules were enacted to address the situation where the charity uses the corporate sponsor's logo on the charity's materials. Cause-related marketing alliances typically involve the use of the charity's name or logo on the corporate partner's products. At first blush, the corporate sponsorship exception seemingly would not apply to cause-related marketing. However, cause-related marketing alliances often involve the charity's recognition of the alliance by acknowledging the corporate partner on the charity's website or print materials. Therefore, a charity may claim that at least a portion of the payment received is a "sponsorship payment" and attempt to treat that portion separately from the other revenue received from the cause-related marketing alliance. In particular, this may be the case where the alliance guarantees the charity a minimum "contribution" from the corporate partner from the sale of the promotional merchandise.

In order for a sponsorship payment received by a charity to be excluded from the charity's UBTI as a qualified sponsorship payment, the affiliation cannot provide a substantial return benefit to the corporate partner.<sup>216</sup> A "substantial return benefit" is any benefit other than a "use or acknowledgement" of the corporate sponsor.<sup>217</sup> Importantly, substantial benefits include any license to use intangible assets of the charitable organization.<sup>218</sup> Since cause-related marketing alliances grant the corporate partner a license to use the charity's name and logo on the product, such a right would be a substantial return benefit. Nonetheless, the portion, if any, of the payment that exceeds the fair market value of the license to use the charity's name or logo may still be a qualified sponsorship payment.<sup>219</sup>

In order for the sponsorship payment to be a qualified sponsorship payment, the charity may not make an impermissible use or acknowledgement of the corporate sponsor. The permitted "uses or acknowledgements" include (i) "logos and slogans that do not contain qualitative or comparative descriptions of the [sponsor's] products, services, facilities or company," (ii) "a list of the [sponsor's] locations, telephone numbers, or Internet address," (iii) "value-neutral descriptions, including displays or visual depictions, of the [sponsor's] product-line or services," and (v) "the [sponsor's] brand or trade names and product or service listings."<sup>220</sup> "Lo-

216. See Treas. Reg. § 1.513-4(c)(1) (2002).

217. *Id.* § 1.513-4(c)(2).

218. *Id.* § 1.513-4(c)(2)(iii).

219. *Id.* § 1.513-4(d).

220. *Id.* § 1.513-4(c)(2)(iv).

gos or slogans that are an established part of [the sponsor's] identity are not considered to contain qualitative or comparative descriptions."<sup>221</sup>

In conjunction with the corporate partner's use of the charity's name or logo, the charity may acknowledge the affiliation on the charity's website or printed materials. Depending on how the charity describes its affiliation with the corporate partner, the "use or acknowledgement" exception may not apply. The display of the logos and/or slogans of the corporate partners are "uses or acknowledgements." The provision of hyperlinks to various sponsors' Internet sites also constitutes merely "uses or acknowledgements," provided the sponsor's Internet site does not contain additional statements indicating that the charity promotes the sponsor or its products or services.<sup>222</sup> However, the provision of the hyperlink to the sponsor's website by the charity may be for the purpose of encouraging consumers to purchase the branded merchandise or promotional merchandise from the sponsor because the proceeds from those sales benefit the charity. Since the corporate sponsorship rules were not designed with cause-related marketing activities in mind, they do not address whether the charity's motivation in providing the link to the partner's website should be taken into account in determining whether the charity is promoting the sponsor's products or services.

In addition, the branded merchandise may contain the corporate sponsor's name or logo, potentially causing confusion as to which entity's product is being sold. For example, the LIVESTRONG brand of merchandise, sold through the Lance Armstrong Foundation website, the Nike LIVESTRONG web store, and in Nike physical stores, prominently displays the Nike "swoosh" symbol in yellow. Similarly, merchandise in the (PRODUCT)<sup>Red</sup> campaign carries both the trademark (PRODUCT)<sup>Red</sup> logo and the sponsoring company's name or logo. In these types of cases, the corporate partner *could* be viewed as receiving the benefit of the inclusion of the corporate partner's logo on the branded merchandise belonging to the charity for free. Thus, the question arises as to whether the inclusion of the corporate partner's logo on the branded merchandise is a mere use or acknowledgement.

The application of the "use or acknowledgement" exception to the inclusion of the corporate partner's logo on the branded merchandise is not

221. *Id.*

222. *Id.* § 1.513-4(f), examples 11 & 12; I.R.S. Priv. Ltr. Rul. 2003-03-062 (Oct. 22, 2002). For an interesting discussion of the effects of Cyberspace on the distinction between a charity's mere use or acknowledgement of a corporate sponsor and advertising, see generally Daryll K. Jones, *Advertisements and Sponsorships in Charitable Cyberspace: Virtual Reality Meets Legal Fiction*, 70 MISS. L.J. 323 (2000).

as clear. The existence of the use or acknowledgment exception reflects the conclusion that mere inclusion of a corporate partner's name or logo on a charity's product is not an implied endorsement of the corporate partner's products or services by the charity. One way to view the inclusion of the corporate partner's logo on the branded merchandise is as an insubstantial benefit to the corporate partner in return for the corporate partner's contribution of a portion of the proceeds from the sale of the branded merchandise to the charity. If so considered, including the corporate partner's logo on the branded merchandise could be considered a mere use or acknowledgement of the corporate partner's sponsorship, and not an endorsement of the corporate partner's product.<sup>223</sup>

However, what if the arrangement is not viewed as the inclusion of the corporate partner's logo on the charity's product, but instead is viewed as the inclusion of the charity's name or logo on the corporate partner's product? The corporate partner's interest in using the charity's name or logo on the corporate partner's product is the desire to portray to consumers a close association with the charity. The association with the charity is expected to improve the corporate partner's image and goodwill among consumers, thus potentially resulting in increased sales for the corporate partner. Thus, an argument could be made that a charity allowing its name or logo to be used on the corporate partner's product is in effect endorsing or advertising the corporate partner's product.

"Advertising" is "any message or other programming material which is broadcast or otherwise transmitted, published, displayed or distributed, and which promotes or markets any trade or business, or any service, facility or product."<sup>224</sup> Advertising includes "messages containing qualitative or comparative language, price information or other indications of savings or value, an endorsement, or an inducement to purchase, sell, or use any company, service, facility or product."<sup>225</sup> For example, the Internal Revenue

223. However, if the charity's website or printed materials contain qualitative or comparative descriptions of the sponsor's product or other endorsements of the sponsor's product, the charity's website or printed material would be considered an advertisement, and thus revenues from the cause-related marketing alliance would be UBTI. See *infra* note 225 and accompanying text.

224. Treas. Reg. § 1.513-4(c)(v) (2002).

225. *Id.* Typically, advertising is considered to be a trade or business that is unrelated to the charity's exempt purposes. Thus, the question remains whether the advertising activity is "regularly carried on." If advertising messages of a corporate sponsor's product are continuously present on the charity's website, such advertising activities would seem to be regularly carried on and the revenues therefrom would thus constitute UBTI. One counter-argument would appear to be that the limited number of advertisements makes the charity's activities dissimilar in extent to comparable commercial activities. See I.R.S. Tech. Adv. Mem. 94-17-003 (Dec. 31, 1993) (stating that an advertising campaign conducted by placing advertisements in programs for an organization's annual ball was not typical of commercial endeavors because solicitations for advertisements were limited in number and consisted of a single form letter). Given the variety and relative novelty of Internet advertisements, it would be unwise for a



Service considers the following messages to consist, at least in part, of advertising: (i) "This program has been brought to you by the Music Shop, located at 123 Main Street. For your music needs, give them a call at 555-1234. This station is proud to have the Music Shop as a sponsor,"<sup>226</sup> and (ii) "Visit the Music Shop today for the finest selection of music CDs and cassette tapes."<sup>227</sup> If a single message contains both advertising and an acknowledgement, the message is an advertisement. Where the Treasury Regulations do not allow one to clearly distinguish between advertisements and permitted uses and acknowledgements, a court may be inclined to take a common-sense approach and consider a message an advertisement if it "looks like" an ad.<sup>228</sup> If the inclusion of the corporate logo on the branded merchandise is considered to be advertising rather than a mere use or acknowledgement, then the income the charity receives from the affiliation is likely subject to tax as UBTI, as more fully discussed below.

*b. Use of the charity's name or logo may not fit within the royalty exception.*

Based on the success of taxpayers in establishing royalty treatment for payments for the use of the charity's name and logo in the affinity card context, it would seem that the payments received by a charity for the licensing of their name, logo, and trademarks in connection with the sale of the branded merchandise and promotional merchandise should also be considered royalties and thus exempt from the charity's UBTI. This result presupposes that the charity is not performing more than an insubstantial amount of services in connection with the licensing of the charity's name, logo, and trademarks. If the charity performs more than insubstantial services, then the income received is considered compensation for personal services, the royalty exception would not apply, and the income would most likely be subject to tax as UBTI.

The determination of the permissible amount of "insubstantial ser-

charity to rely upon such a position. *See generally* I.R.S. Announcement 2000-84, 2000-42 I.R.B. 385 (announcing that the Internal Revenue Service was considering whether clarification was needed as to the application of the "regularly carried on" requirement to business activities conducted on the Internet).

226. *Id.* § 1.513-4(f), example 7.

227. *Id.* at example 8. Where a document can be broken down into segments identified in the Treasury Regulations, a court or the Internal Revenue Service will likely analyze each segment with reference to the rules set out above. *See, e.g.*, I.R.S. Tech. Adv. Mem. 98-05-001 (Oct. 7, 1997) (concluding that an "ad" did not rise to the level of advertising when it consisted of a can of a sponsor's pet food made to look like a trophy and included two slogans that had long been used by the sponsor in its advertising).

228. *See, e.g.*, *State Police Ass'n of Mass. v. Comm'r*, 125 F.3d 1, 6 (1st Cir. 1997).

vices” is uncertain, however, especially in connection with the charitable organization’s exercise of quality control over the use of its name, logo, and trademarks. As is prudent business practice, a charity would want to maintain quality control over the use of its name, logo, and trademark by the corporate partner under the licensing agreement. In some cases, the Internal Revenue Service has determined that “mere” quality control does not constitute more than insubstantial services related to the royalty income.<sup>229</sup> In other cases, a charity’s “quality control” was recharacterized as services, resulting in the income from the arrangement being taxed as compensation from services rather than exempted as royalty income.<sup>230</sup> Therefore, charities are left to struggle with the determination of the permissible types of “quality control” they can include in their licensing agreements without crossing the boundary between *de minimus* and substantial services.

Furthermore, caution should be taken in relying on the royalty exception for income received from the licensing of a charity’s name or logo for placement on a corporate partner’s product. Recently, in evaluating the justification for the continued tax exemption for college athletic programs, the Congressional Budget Office recommended repealing the royalty exception to the extent that it applies to the licensing of a charity’s name or logo:

Some types of royalty income may reasonably be considered more commercial than others. . . . [W]hen colleges and universities license team names, mottoes, and other trademarks to for-profit businesses that supply apparel, accessories, and credit cards to the general public, they approve each product and use of their symbols and, in some cases, exchange information, such as donor lists, with the licensees to aid in their marketing. . . . The manufacture or sale of such items would clearly be commercial—and subject to the UBIT—if undertaken directly by the schools. Schools’ active involvement in generating licensing income

229. See, e.g., Rev. Rul. 81-178, 1981-2 C.B. 135; I.R.S. Priv. Ltr. Rul. 2006-01-033 (Oct. 14, 2005); I.R.S. Priv. Ltr. Rul. 90-29-047 (Apr. 27, 1990). In Private Letter Ruling 2006-01-033, the charity retained the right to review the commercial counterpart’s designs and proposed uses of the charity’s intellectual property, inspect the commercial counterpart’s facilities where the product was manufactured, and inspect the commercial counterpart’s books and records annually. The Internal Revenue Service determined that these services performed by the charity in connection with the licensing arrangement were *de minimus*. I.R.S. Priv. Ltr. Rul. 2006-01-033. Moreover, the Internal Revenue Service concluded the licensing agreement was narrowly tailored to protect the charity’s ownership of its intellectual property by giving the charity absolute discretion to reject proposed uses of the property, providing notice on every unit displaying the charity’s mark that it was used with the charity’s permission, and allowing the charity to approve and limit mass media advertising of the product. *Id.*

230. See, e.g., *NCAA v. Comm’r*, 92 T.C. 456, 468–70 (1989), *rev’d on other grounds*, 914 F.2d 1417 (10th Cir. 1990); *Fraternal Order of Police v. Comm’r*, 87 T.C. 747, 758 (1986), *aff’d*, 833 F.2d 717 (7th Cir. 1987).

could be the basis for considering such income as commercial and therefore subject to the UBTI. . . .

Bringing royalty income that accrues only to athletic departments under the UBIT would be problematic, however . . . . [I]f royalty income from licensing team names to for-profit businesses was truly considered commercial and subject to the UBIT, the same arguments would apply in full force to licensing all other university names and trademarks. A consistent policy would subject all such income to the UBIT because of its commercial nature. Such a change in policy could affect many other nonprofits in addition to colleges and universities . . . .<sup>231</sup>

Even if the royalty exception is not repealed as proposed by the Congressional Budget Office, the law is not clear that the use of the charity's name or logo on the corporate partner's products fits within the royalty exception. If the charity's name or logo is placed on the corporate partner's product (as is the case in promotional merchandising) or is viewed as being placed on the corporate partner's product (as described above for branded merchandise), the payment could instead be viewed as received in connection with the joint advertisement of the product.<sup>232</sup> Especially relevant in this analysis is consumer perception of apparent endorsement of the product by the charity because the charity has allowed its name and logo to be placed on the product without qualification. Although the licensing agreement and official position of the charity may state that the charity does not endorse the product, the charity normally retains the right to approve how its name and logo are used on the product. By approving the placement of its name and logo on the product, the charity should be held to the reasonable impressions such cause-related marketing leaves in the minds of consumers. If the charity's name and logo are used in such a way as to give consumers the impression that the charity endorses the product, the charity

231. CONG. BUDGET OFFICE, PUB. NO. 3005, TAX PREFERENCES FOR COLLEGIATE SPORTS 13 (2009). Previous proposals to modify the royalty exception include repealing the exemption for royalties from the use of property where the charity "either created the property or performed substantial services or incurred substantial costs" in developing or marketing the property. See Pat Jones, *Oversight Subcommittee Makes More Progress on UBIT Package*, 39 TAX NOTES 1022, 1023 (1988); Pat Jones, *Pickle Subcommittee Appears Willing to Modify UBIT Stance*, 39 TAX NOTES 907, 907 (1988). Such proposals would have worked to treat royalty income from the use of a charity's patents or copyrights as UBTI. Pat Jones, *House Oversight Subcommittee UBIT Proposals Stir Cautious Reactions*, 39 TAX NOTES 153, 155 (1988).

232. Whether the placement of a charity's name or logo on a corporate partner's product is a joint advertisement is a fact specific determination. In some cases, the association between the charity's mission and the corporate partner's product is such that it would be clear the charity is not impliedly endorsing the corporate partner's product. In other cases, the charity's mission and the corporate partner's product are so closely aligned that it is unclear whether the charity endorses the corporate partner's product. See *infra* notes 291-300 and accompanying text. The issue is prevalent because the most successful cause-related marketing alliances occur when the charity's mission and corporate partner's products are closely aligned.

should be deemed to have endorsed the product. If the Internal Revenue Service looks beyond the explicit terms of the agreement to the manner in which the agreement is carried out, the payment may be considered advertising income received by the charity and may no longer be excluded from the charity's UBTI.

*c. Is revenue from cause-related marketing advertising revenue?*

If the combined use of the charity's logo and the corporate partner's logo on branded merchandise or the use of the charity's logo on promotional merchandise is considered advertising, the next question is whether such advertising constitutes a regularly carried on trade or business that is not substantially related to the charity's exempt purpose. Advertising activities are routinely considered to constitute a trade or business.<sup>233</sup> Charities in litigation involving advertising typically concede this point.<sup>234</sup>

Since the sponsor's logo is continuously present on branded merchandise, advertising activities involving such merchandise would likely be considered to be "regularly carried on," especially where the merchandise is sold on a year-round basis. For promotional products, the question of whether the inclusion of the charity's logo on the sponsor's product is advertising that is regularly carried on may turn on the length of time of the promotion. For isolated promotions that are conducted on a short-term basis, the advertising may not be "regularly carried on" by the charity.<sup>235</sup> In

233. See *United States v. Am. Coll. of Physicians*, 475 U.S. 834, 839 (1986) ("Congress has declared unambiguously that the publication of paid advertising is a trade or business activity . . ."); *State Police Ass'n of Mass. v. Comm'r*, 125 F.3d 1 (1st Cir. 1997) (holding that an organization's sale of advertising in an annual "yearbook" constituted a trade or business because (i) the yearbook included "display ads (using logos, slogans, and blocking), a directory section, and a message asking readers to patronize the businesses listed therein," (ii) the price of the ad was proportional to its size, and (iii) the organization characterized the disputed activity as advertising); I.R.S. Priv. Ltr. Rul. 2001-28-059 (Apr. 17, 2001) ("[T]he solicitation, selling, and publishing of advertising in connection with [an] annual golf tournament is an unrelated trade or business . . .").

234. See, e.g., *NCAA v. Comm'r*, 914 F.2d 1417, 1421 (10th Cir. 1990); I.R.S. Priv. Ltr. Rul. 2003-03-062 (Oct. 22, 2002) (conceding that displaying banner advertisements on an organization's internet site constituted an unrelated trade or business).

235. Several authorities discuss intermittent sales of advertising; their conclusions often turn upon whether preparatory activities are included in determining the duration of such activities. Although the Internal Revenue Service is more likely than the courts to include the length of preparatory activities in its determinations, the weight of authority holds that preparatory activities do *not* constitute part of a business activity if the preparatory activities are related to an isolated event, such as an entertainment or sporting event, but that preparatory activities *are* included in other circumstances. Compare *Suffolk County Patrolmen's Benevolent Ass'n v. Comm'r*, 77 T.C. 1314 (1981) (determining that advertising sold in a program guide for performances occurring on a single weekend was not "regularly carried on," even though preparation for the performances, including the solicitation of advertising, lasted for eight to sixteen weeks each year; also rejecting the notion that hiring professionals to ensure the success of a fundraiser impacts the analysis of whether an activity is regularly carried on), *acq.*, 1984-2 C.B. 2, and *NCAA*, 914 F.2d 1417 (concluding that the sale of advertising in the program for the Final Four round

contrast, if the charity conducts promotions that allow the use of the charity's name or logo on commercial products with many corporate partners throughout the year, the likelihood increases that a court or the Internal Revenue Service would consider all of the charity's promotional activities to be regularly carried on.

Both the courts and the Internal Revenue Service generally consider the publication and distribution of advertising by a charity to be unrelated to the accomplishment of the charity's exempt purposes. For example, the Treasury Regulations provide that even if an exempt organization formed to advance the interests of a particular profession advertises *only* products "within the general area of professional interest of its members," the advertisements do not bear a substantial relation to the organization's exempt function when "the informational function of the advertising is incidental to the controlling aim of stimulating demand for the advertised products and differs in no essential respect from the informational function of any commercial advertising."<sup>236</sup> Even though one of the purposes of such an exempt organization is to educate its members in matters pertaining to their profession, the Treasury Regulations do not consider "the publication of advertising designed and selected in the manner of ordinary commercial

of the NCAA college basketball tournament was not regularly carried on because (i) the programs were distributed for less than three weeks (even though solicitation and preparation activities took place over a longer period of time), and (ii) the publication of advertising is normally a year-round activity), *action on dec.*, 1991-015 (July 3, 1991), with *State Police Ass'n of Mass. v. Comm'r*, 72 T.C.M. (CCH) 582 (1996) (concluding that the sale of advertising in an annual yearbook was a regularly carried on activity when such advertising was solicited by professional fundraisers working approximately forty-six weeks per year, and distinguishing the foregoing cases on the basis that the publication of this yearbook was not tied to a particular event), *aff'd*, 125 F.3d 1 (1st Cir. 1997). In light of the U.S. Supreme Court's application of fragmentation in *American College of Physicians*, the reasoning behind the exclusion of preparatory activities in advertising sales in these cases seems questionable. See *Am. Coll. of Physicians*, 475 U.S. 834.

As alluded to above, the Internal Revenue Service typically takes the contrary position that preparatory activities constitute part of the business activity for purposes of the regularly carried on requirement. In Revenue Ruling 73-424, for example, the Internal Revenue Service concluded that the annual sale of a yearbook was regularly carried on, where (i) intensive solicitation of advertising space lasted only three months out of the year, (ii) distribution lasted a shorter period, (iii) distribution of the yearbook did not tie into any other organizational activity, (iv) the preparation of the yearbook was carried out as a regular staff duty from year to year, and (v) "no part of the advertising program for which the independent firm had assumed responsibility varied from customary commercial practice in any material respect." Rev. Rul. 73-424, 1973-2 C.B. 190. Similarly, in Private Letter Ruling 2001-28-059, the Internal Revenue Service ruled that income from advertising related to an annual golf tournament constituted UBTI when the entity solicited advertising during a nine-month period before the tournament. I.R.S. Priv. Ltr. Rul. 2001-28-059 (Apr. 17, 2001). In contrast, in Revenue Ruling 75-201, the Internal Revenue Service concluded that the sale of advertising space in an annual concert book was *not* regularly carried on, where (i) the book was distributed at the orchestra's annual charity ball, (ii) a volunteer committee designed each book and solicited advertising for it, and (iii) solicitation activities never continued for "an extended period" of time. Rev. Rul. 75-201, 1975-1 C.B. 164.

236. Treas. Reg. § 1.513-1(d)(iv), example 7 (as amended in 1983).

advertising” to be an “educational activity.”<sup>237</sup>

The United States Supreme Court considered whether advertising could be substantially related to an organization’s exempt purposes in *United States v. American College of Physicians*,<sup>238</sup> the leading case on this topic. There, an exempt physicians’ organization received income from the sale of advertising in its professional journal.<sup>239</sup> The messages in question consisted of advertisements for “pharmaceuticals, medical supplies, and equipment useful in the practice of internal medicine.”<sup>240</sup> The organization “has a long-standing practice of accepting only advertisements containing information about the use of medical products, and screens proffered advertisements for accuracy and relevance to internal medicine.”<sup>241</sup> The organization argued that these advertisements were substantially related to its exempt functions because they contributed to the education of the journal’s readers.<sup>242</sup> At trial, experts testified that “drug advertising performs a valuable function for doctors by disseminating information on recent developments in drug manufacture and use.”<sup>243</sup> Rejecting the organization’s claim and ruling that the advertising income was UBTI, the Supreme Court analyzed this issue as follows:

[A]ll advertisements contain some information, and if a modicum of informative content were enough to supply the important contribution necessary to achieve tax exemption for commercial advertising, it would be the rare advertisement indeed that would fail to meet the test. Yet the statutory and regulatory scheme, even if not creating a *per se* rule *against* tax exemption, is clearly antagonistic to the concept of a *per se* rule *for* exemption . . . . Thus, the Claims Court properly directed its attention to the College’s conduct of its advertising business, and it found the following pertinent facts:

The evidence is clear that plaintiff did not use the advertising to provide its readers a comprehensive or systematic presentation of any aspect of the goods or services publicized. Those companies willing to pay for advertising space got it; others did not. Moreover, some of the advertising was for established drugs or devices and was repeated from one month to another, undermining the suggestion that the advertising was principally designed to alert readers of

237. *Id.*

238. 475 U.S. 834 (1986).

239. *Id.* at 836.

240. *Id.*

241. *Id.*

242. *Id.* at 847.

243. *Id.*

recent developments . . . . Some ads even concerned matters that had no conceivable relationship to the College's tax-exempt purposes.

. . . This is not to say that the College could not control its publication of advertisements in such a way as to reflect an intention to contribute importantly to its educational functions. By coordinating the content of the advertisements with the editorial content of the issue, or by publishing only advertisements reflecting new developments in the pharmaceutical market, for example, perhaps the College could satisfy the stringent standards erected by Congress and the Treasury.<sup>244</sup>

Generally, displaying the charity's name or logo on the advertisement likely would not be sufficient to cause the advertising to be substantially related to the charity's exempt purposes. Although there are no rulings or other primary authorities considering receipts from advertisements bearing an exempt organization's name or logo, the Internal Revenue Service has considered receipts from the direct sale of items bearing an exempt organization's name or logo.<sup>245</sup> If the inclusion of the charity's name or logo on items directly sold by the charity would not prevent receipts from constituting UBTI, then *a fortiori*, there is little reason to suppose that receipts from advertisements of a third party's products or services which contain the charity's name or logo would not constitute UBTI. However, as discussed in detail above, the Internal Revenue Service has on occasion reached a contrary conclusion regarding the sale of t-shirts and similar items bearing an organization's name or symbol, where additional facts demonstrated how the items furthered the organization's exempt function. If such additional facts are present—for example, if the items advertised displayed the charity's message—this would be a positive factor. Note, though, that the positive rulings would still not be directly applicable to receipts obtained from a sponsor for *advertising* a product. One would need to closely examine all of the facts and circumstances to determine the extent to which the advertising activity promoted the charity's message (as opposed to promot-

244. *Id.* at 848–50 (citation omitted). Several cases and rulings follow the reasoning of *American College of Physicians*. See, e.g., *Minn. Holstein-Frisian Breeders Ass'n v. Comm'r*, 64 T.C.M. (CCH) 1319 (1992) (holding that advertisements that may have been of “incidental benefit to breeders in running their day-to-day operations” but that did not “contribute importantly to improving the quality of the breed of Holstein-Friesian cattle” were not substantially related to a cattle breeding organization's exempt purposes); *Fla. Trucking Ass'n v. Comm'r*, 87 T.C. 1039 (1986) (holding that advertisements of products of particular interest to the trucking industry did not bear a substantial relationship to the exempt functions of a trucking trade association); Rev. Rul. 82-139, 1982-2 C.B. 108 (concluding that a bar association's publication of advertisements for products and services used by the legal profession was not substantially related to the association's exempt purposes).

245. See *supra* notes 192-196 and accompanying text.

ing the corporate partner more generally), with unpredictable results.

### 3. UBTI Rules Need to Address Unique Nature of Cause-Related Marketing

The analysis of the application of existing UBTI guidance to cause-related marketing activities reveals that there are many unanswered questions in this area, and the results can be uncertain and unpredictable.<sup>246</sup> Given the prevalence of cause-related marketing and the implications for smaller charities attempting to imitate the success of large charities' cause-related marketing alliances, the Internal Revenue Service should issue guidance on the UBTI treatment of cause-related marketing by charities. A revenue ruling or Treasury regulation setting forth safe harbor provisions for permitted cause-related marketing alliances would be mutually beneficial because it would reduce the administrative burden on the Internal Revenue Service of examining these arrangements on a case by case basis, and it would allow charities to more easily comply with the law. In particular, smaller charities that cannot readily afford legal counsel to assist them in structuring complex licensing transactions would benefit.

Cause-related marketing alliances today are significantly different than the affinity card programs litigated in *Sierra Club* and its progeny. Continued reliance on the royalty exception as described in Revenue Ruling 81-178 and the affinity card cases for the UBTI treatment of royalties from the use of a charity's name, logo, or trademark in cause-related marketing alliances is misguided. First, Revenue Ruling 81-178 is directed not at a charitable organization, but at a tax-exempt labor organization.<sup>247</sup> While both types of organizations are subject to the same UBTI rules, charitable organizations are subject to much more scrutiny in maintaining their tax exemption. This is because charitable organizations are required to operate for public benefit; labor organizations are not. Charities receive additional tax subsidies in the form of deductible charitable contributions; labor organizations do not.

246. A review of the Form 990s filed by several of the charities that engage in the cause-related marketing alliances described in this article reveals that these charities universally treat the income received from the corporate partners in their cause-related marketing alliances as exempt income, but on different claims. See, e.g., American Heart Association, Inc. Form 990, Return of Organization Exempt from Income Tax, for the fiscal year ended June 30, 2009, at p. 9 (available at [www.guidestar.org](http://www.guidestar.org)) (reporting as exempt royalties); Lance Armstrong Foundation Merchandise Form 990, Return of Organization Exempt from Income Tax, for the fiscal year ended December 31, 2008, at p. 9 (available at [www.guidestar.org](http://www.guidestar.org)) (reporting as exempt "licensing fees"); Susan G. Komen Breast Cancer Foundation, Inc. Form 990, Return of Organization Exempt from Income Tax, for the fiscal year ended March 31, 20098, at p. 8 (available at [www.guidestar.org](http://www.guidestar.org)) (reporting as exempt "affiliate payments").

247. See Rev. Rul. 81-178, 1981-2 C.B. 135.



Additionally, charitable organizations may not advocate for political office candidates, may not engage in certain lobbying activities, may not confer any private inurement, and may not confer more than insubstantial private benefit. These restrictions generally do not apply to most other tax-exempt organizations which are subject to the UBTI rules. Essentially, charities are a special subset of tax-exempt organizations warranting different considerations.

Second, the affinity card cases applying the royalty exception contained in Revenue Ruling 81-178 to charitable organizations do not factor in the unique nature of charitable organizations. Accordingly, several commentators have argued that *Sierra Club* and its progeny are wrongly decided.<sup>248</sup> In particular, the courts did not address what impact, if any, private benefit concerns should play in determining whether licensing of a charity's brand to sell commercial products is a passive royalty arrangement. Furthermore, the courts did not consider the argument that the arrangement be viewed as the charity's apparent endorsement of the affinity card by virtue of the charity's name and logo placement on the card; therefore, the argument that the revenue be treated as advertising income was not addressed. While consumer perception of apparent endorsement of the product likely was not evident in the affinity card context, those perceptions can be prevalent in the context of cause-related marketing alliances.

Guidance is sorely needed to set forth a safe harbor under which charities could operate to claim the revenue received from cause-related marketing alliances is exempt from the charity's UBTI. This safe harbor should take into account the unique aspects of cause-related marketing alliances identified above. Failure to meet the safe harbor should not result in automatic treatment of the revenue as UBTI; rather, the arrangement should then be evaluated under the general UBTI principles discussed above, on a case by case basis, to determine whether the revenue should be subject to tax as UBTI.<sup>249</sup>

### III. PRIVATE BENEFIT

Section 501(c)(3) of the Internal Revenue Code provides that to qualify for tax-exempt status, a charitable organization must operate exclu-

248. See, e.g., Lee A. Sheppard, *Aspirin & the Ultimate Tax Shelter*, 64 TAX NOTES 420 (1994).

249. This treatment would be consistent with the way corporate sponsorship arrangements that fail to meet the safe harbor of "qualified sponsorship payments" are treated.

sively for charitable purposes.<sup>250</sup> As part of this operational test, a charitable organization may not confer more than incidental private benefit in conducting its activities. The purpose of the private benefit limitation is to ensure that charitable organizations are operated for public purposes because of their special tax status.<sup>251</sup> Private benefit results when a benefit is conferred upon an individual or entity who is not a member of the charitable class intended to be benefited by the organization;<sup>252</sup> it may or may not include the diversion of charitable assets.<sup>253</sup> If an organization provides more than incidental private benefit, the organization's tax-exempt status may be revoked.<sup>254</sup> The determination of whether the private benefit is more than incidental is based on a "balancing test" set forth in a 1987 General Counsel Memorandum:

A private benefit is considered incidental only if it is incidental in both a qualitative and a quantitative sense. In order to be incidental in a qualitative sense, the benefit must be a necessary concomitant of the activity which benefits the public at large, i.e., the activity can be accomplished only by benefiting certain private individuals. To be incidental in a quantitative sense, the private benefit must not be substantial after considering the overall public benefit conferred by the activity.<sup>255</sup>

There is much confusion and debate about the scope of the private benefit doctrine. In early rulings and cases, the view seemed to be that the private benefit was a restatement of the common law requirement that a charity serve a charitable class of beneficiaries.<sup>256</sup> As long as the charitable class served by the charity was broad enough, any private benefits conferred as a byproduct of the charity's exempt activities was deemed inci-

250. I.R.C. § 501(c)(3) (2006).

251. See Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (as amended in 1990). According to the Treasury Regulations, an organization does not qualify for exemption

unless it serves a public rather than a private interest. Thus . . . it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

*Id.*

252. See Colombo, *supra* note 27, at 681 ("Even trying to summarize the private benefit doctrine is hazardous, but from a variety of IRS rulings and litigated cases, one might conclude that private benefit is a benefit (usually economic) that flows to some person or entity outside the charitable class as a result of serving the charitable class.")

253. I.R.S. Chief Couns. Adv. Mem. 2004-31-023 (July 13, 2004).

254. For example, the Internal Revenue Service ruled that an organization formed to promote interest in classical music was not exempt because its only method of achieving its goal was to support a commercial radio station that was in financial difficulty. Rev. Rul. 76-206, 1976-1 C.B. 154.

255. I.R.S. Gen. Couns. Mem. 39,598 (Jan. 23, 1987) (citations omitted).

256. John D. Colombo, *In Search of Private Benefit*, 58 FLA. L. REV. 1063, 1069 (2006).

dental.<sup>257</sup> Beginning in the second half of the 1970s, the Internal Revenue Service expanded its view of the private benefit doctrine and found impermissible private benefit when the benefits flowing to private individuals were deemed too large, even if such benefits stemmed from the provision of charitable services to the charitable class.<sup>258</sup> Then, after unsuccessfully challenging the exempt status of a theatre company that had formed a partnership with private investors for the production of a play as *per se* private benefit,<sup>259</sup> the Internal Revenue Service announced its balancing test.<sup>260</sup> The Internal Revenue Service's balancing test was adopted by the Tax Court in *American Campaign Academy v. Commissioner*.<sup>261</sup>

Despite the confusion surrounding the scope and application of the private benefit doctrine, two examples addressing whether private inurement (which is similar to private benefit)<sup>262</sup> has occurred are instructive in determining whether the private benefit argument would be applied to cause-related marketing activities. General Counsel Memorandum 37,289 provides the first example; there, the Internal Revenue Service concluded that a joint advertising campaign carried on between a nonprofit organization and a for-profit organization was not indicative of private inurement.<sup>263</sup> Although the circumstances are somewhat unclear, it appears that the for-profit organization conducted all of the advertising while the nonprofit organization paid a sales commission. The Internal Revenue Service reasoned that (i) the for-profit entity *was not capitalizing on the nonprofit's goodwill* (because the nonprofit had only recently been created) and (ii) joint advertising set up a cost-efficient economy with *quid pro quo* benefits to both entities.<sup>264</sup> The Internal Revenue Service distinguished *Restland Memorial Park v. United States*—the second example case—in which a

257. *Id.*

258. *Id.* at 1069–71.

259. See *Plumstead Theatre Soc'y v. Comm'r*, 74 T.C. 1324 (1980), *aff'd*, 675 F.2d 244 (9th Cir. 1982).

260. Colombo, *supra* note 256, at 1071–72.

261. 92 T.C. 1053 (1989).

262. Private inurement involves the use of a charity's income or assets by insiders. In contrast to private benefit, any amount of private inurement could result in the revocation of a charity's tax-exempt status. However, revocation of tax-exempt status is rarely used to address instances of private inurement. In 1996, an intermediate sanction regime was added to impose excise taxes on certain private inurement transactions to give the Internal Revenue Service another enforcement tool to remedy private inurement transactions. See I.R.C. § 4958 (2006). The intermediate sanction regime does not apply to private benefit transactions.

263. I.R.S. Gen. Couns. Mem. 37,289 (Oct. 7, 1977). While the joint advertising campaign itself did not yield private inurement, the General Counsel concluded that the non-profit organization had not proven that it was entitled to tax-exempt status because the overall "intertwining relationship" between the non-profit and for-profit organizations caused prohibited private inurement. *Id.*

264. *Id.*

joint advertising campaign between a nonprofit cemetery company and a for-profit entity did result in private inurement, *because the nonprofit entity's goodwill was used to benefit the for-profit entity*.<sup>265</sup> The purpose of cause-related marketing is to leverage the goodwill of the charity in a joint campaign that provides mutual benefits for the charity (increased donations) and the corporate partner (sale of the promotional or branded merchandise), but this raises concerns about whether cause-related marketing alliances produce impermissible private benefit for the corporate partner.

#### A. Impermissible Private Benefit to the For-Profit Partner

It is undisputed that a cause-related marketing alliance results in some benefit to the corporate partner. Otherwise, the corporate partner would be expected to act under purely altruistic motives, which is not the case.<sup>266</sup> Furthermore, the benefits flowing to the corporate partner from the cause-related marketing alliance are private benefits because they are not benefits that are normally provided by the charity in the conduct of its charitable activities. The question thus remains whether such private benefits flowing to the corporate partner from the cause-related marketing alliance are more than incidental. Before addressing this question, I will expand on the types of benefits the corporate partner may receive from a cause-related marketing alliance.

One author notes that cause-related marketing could result in the following benefits to the corporate partner:

- (1) creation of goodwill with the community, (2) differentiation of the corporate image and its brands from competitors, (3) greater customer acceptance of price increases, (4) increase in employee and channel member morale, (5) recruitment of new employees, (6) use as a shield against public criticism in times of crisis, (7) winning over skeptical public officials (an aid in lobbying), and (8) increased revenues and profits.<sup>267</sup>

265. *Id.*; Restland Mem'l Park v. United States, 371 F. Supp. 164 (N.D. Tex. 1974).

266. See Vicki Thomas, *Cause-Related Marketing: Bringing Together Senior Organizations and Businesses*, 28 GENERATIONS 71, 72 (2004) ("Potential sponsors of cause-related marketing programs look for opportunities that help promote a product or service. It is not about charity. . . . If there is no opportunity to move a product or service, the marketer won't be motivated to make a financial commitment to the cause.").

267. Dean, *supra* note 3, at 92. Specific product-related benefits of cause-related marketing include "breaking through advertising clutter, low cost exposure, the ability to sway selective customers who want to support the cause, and a broader customer base." File & Prince, *supra* note 3, at 1531 (citations omitted).

Importantly, several studies have shown that cause-related marketing increases customer goodwill of the corporate partner<sup>268</sup> and helps to establish brand loyalty.<sup>269</sup> In one study, the author explains how the association between a brand and a social cause could positively affect consumer perception of the brand:

In [cause-related marketing], the association between a brand and a social cause could lead to a similar affect transfer process: consumers' general positive attitudes toward the nonprofit organization could be transferred to the sponsoring brand. In addition, as the brand promises to donate money to the social cause, consumers may perceive the brand to be altruistic, which could result in more favorable brand evaluations. Furthermore, for consumers who themselves are altruistic, perceived altruism of the brand can result in a sense of connectedness or social identification, which is the inference that the sponsoring brand or company has certain desirable traits that resonate with one's sense of self. All these mechanisms suggest that consumers will respond more favorably to a company/brand engaging in [cause-related marketing] versus a similar one that does not engage in this philanthropic activity . . . .<sup>270</sup>

This study concludes that an advertisement for a product containing a cause-related marketing message elicits more favorable consumer responses than a similar advertisement without a cause-related marketing message and that consumers generally have a more favorable attitude towards companies employing cause-related marketing.<sup>271</sup> Furthermore, consumers with high brand consciousness had a more favorable attitude toward the product or brand advertised when there was a high level of brand/cause

268. See, e.g., Xiaoli Nan & Kwangjun Heo, *Consumer Responses to Corporate Social Responsibility (CSR) Initiatives: Examining the Role of Brand-Cause Fit in Cause-Related Marketing*, J. ADVERTISING, Summer 2005, at 63, 64 (noting that previous studies have found that consumer perception is largely favorable of corporations which engage in cause-related marketing); Dean, *supra* note 3, at 101 (demonstrating that a single episode of cause-related marketing led consumers to increase their favorable perception of corporations with a reputation for social irresponsibility and had little to no effect on increased favorable customer perceptions of corporations with scrupulous reputations, but concluding that all firms could realize an increase in customer goodwill by engaging in prolonged cause-related marketing activities that demonstrate a long-term commitment to the cause).

269. See, e.g., Hassay & Pelozo, *supra* note 2. In surveying previous studies, the authors explain: Identification with a cause has even been shown to extend to the type of products that supporters buy. For example, consumers have been shown to actively search for and purchase products that support causes that they identify with. In addition, [one study] found that consumers not only select products based on charity affiliation but that they will even pay more for products affiliated with personally relevant charities.

*Id.* at 37–38 (citations omitted); see also Nan & Heo, *supra* note 268, at 64 (noting that previous studies have found that a corporation's cause-related marketing activities positively influences consumer willingness to purchase the corporation's product or services).

270. Nan & Heo, *supra* note 268, at 66 (citations omitted).

271. *Id.* at 70.

fit in the cause-related marketing program.<sup>272</sup>

Another study revealed that forty-five percent of consumers surveyed said they would switch brands to buy from a company that supported a charitable cause.<sup>273</sup> Yet another study revealed that almost fifty percent of consumers surveyed indicated they had purchased a product primarily because of their desire to support the charitable cause and that most consumers were willing to try a new brand as a result of a cause-related promotion.<sup>274</sup>

A survey conducted by Cone Communications in 2004 lends additional support to these conclusions. The 2004 study reported that eighty-six percent of the 1,033 adults surveyed responded that they would “switch from one brand to another that is about the same in price and quality, if the other brand is associated with a cause.”<sup>275</sup> Additionally, seventy four percent of the respondents reported that a company’s commitment to a social issue would be important in determining which products and services they would recommend to other people.<sup>276</sup>

Anecdotal evidence also suggests the benefits received by the corporate partner from engaging in cause-related marketing activities are real—and substantial. For example, in 1983 when American Express launched its campaign to renovate the Statute of Liberty and Ellis Island, American Express experienced a twenty-eight percent increase in credit card usage over the preceding year.<sup>277</sup> Affinity card programs generated a twenty percent incremental sales growth for U.S. banks in the early 1990s, and for MBNA, the bank with the largest base of affinity card customers, the affinity card programs resulted in customer defections at half the industry

272. *Id.* at 70–71 (“It appears that the addition of a [cause-related marketing] component, whether it involves high or low brand/cause fit, to a regular ad message is beneficial in that it enhances the sponsoring company’s overall image.”); *see also* Grau & Folse, *supra* note 22 (concluding that customers more involved in the cause were more likely to favorably perceive the cause-related marketing alliance which supports that cause).

273. Emily DeNitto, *Marketing with a Conscience*, *MARKETING COMM.*, May 1989, at 42, 43.

274. John K. Ross, Mary Ann Stutts & Larry Patterson, *Tactical Considerations for the Effective Use of Cause-Related Marketing*, 7 *J. APPLIED BUS. RES.* 58, 61–62 (1991).

275. CONE, 2004 CONE CORPORATE CITIZENSHIP STUDY: BUILDING BRAND TRUST 2 (2004), available at <http://www.coneinc.com/research/archive.php> (follow the “2004 Corporate Citizenship Study” hyperlink); *see also* Michal Strahilevitz, *supra* note 53, at 231 (reaching the same conclusion as the Cone study and further concluding that for certain types of products, consumers may be willing to pay a higher price for a charity-linked product that offers a relatively larger contribution than a lower-priced charity-linked product offering a smaller contribution).

276. CONE, *supra* note 275, at 2; *cf.* Andreasen, *supra* note 18, at 169–72 (summarizing numerous studies that have reported (i) positive consumer attitudes towards companies that engage in cause-related marketing, and (ii) increased consumer preferences for products from such companies).

277. Dean, *supra* note 3, at 92.

rate.<sup>278</sup>

A case study of the Sierra Club's alliance with Toyota to promote the sale of Toyota's hybrid cars hypothesizes the monetary values of the first-order and second-order benefits resulting from the partnership as follows:

1. Increased sales of Toyota hybrids resulting in \$6 million more in profits
2. A 10 percent reduction in employee turnover yielding training costs reduced by \$1 million
3. A saving of \$3 million in Toyota's lobbying costs
4. 10,000 new donors joining the Sierra Club as a result of this partnership resulting in \$2 million in new donations
5. 2,500 long-time supporters alienated by the alliance withholding \$1 million in donations
6. Increases in consumers' awareness of environmental issues and the need for more prudent automobile purchases and usage saves the Sierra Club \$1 million in advertising costs

The hypothetical net value of the alliance is therefore \$12 million. But what may be troubling is that 83 percent of this value is captured by Toyota and only 17 percent by the Sierra Club. On the other hand, the calculations do not include the cost of the venture. It is possible that Toyota would bear 83 percent of the cost—but probably not.<sup>279</sup>

Furthermore, companies view cause-related marketing alliances as more business arrangement than philanthropic venture.<sup>280</sup> One study concluded that companies are more concerned with cause-related marketing motivations than philanthropic motivations, with enhancing company image and promoting company products being the central motivations for engaging in cause-related marketing alliances.<sup>281</sup> Nike appears to have reaped the benefits of enhanced company image as a result of its cause-related marketing alliance with the Lance Armstrong Foundation. While the amount of these benefits has not been quantified, it has been reported that the positive association with the LIVESTRONG message has boosted Nike in subtle ways and helped to overcome a negative corporate image developed in the 1990s after allegations of sweatshop conditions in its

278. Andreasen, *supra* note 18, at 171.

279. *Id.* at 183–184.

280. See Byrnes, *supra* note 74 (“Although companies are not handing out much more on the whole—last year’s giving equaled 1.2% of total corporate profits, the average over the past 40 years . . . —they are taking a more businesslike approach to charity. The goal: to get the most out of every philanthropic dollar by tracking giving, measuring its impact, and helping nonprofits work more efficiently.”).

281. File & Prince, *supra* note 3, at 1535.

overseas factories; other social responsibility commitment programs undertaken by Nike did not undercut this negative image.<sup>282</sup>

An evaluation of whether the private benefits received by the corporate partner are more than incidental is difficult at best. To be incidental, the benefit must be both quantitatively and qualitatively incidental.<sup>283</sup> A benefit is quantitatively incidental if, after considering the overall public benefit conferred by the activity, the private benefit is not substantial.<sup>284</sup> This requires a comparison of the value of the private benefit to the value of the public benefit of the cause related-marketing alliance. Neither valuation is easy. Some of the private benefits to the corporate partner may be quantifiable, such as increased sales or revenues, but the value of many of the benefits, such as enhanced corporate goodwill, improved employee morale, and increase in customer esteem, may be difficult to value.

In determining the value of the public benefit, the first question is: what is the public benefit? While raising funds is vital to the existence of every charity, it is not the reason charities are granted a tax exemption.<sup>285</sup> The private benefit doctrine is typically applied to evaluate benefits stemming from the conduct of the organization's core charitable activities. One may argue that the amount paid to a charity as a result of a cause-related marketing alliance that enables the charity to carry out its core charitable activities is the public benefit resulting from the cause-related marketing alliance. If this view is adopted, then a comparison of the value of the private benefit flowing to the corporate partner to the money and other benefits received by the charity should be made to determine if the corporate

282. *Yellow Fever in the U.S. Gives Nike a Boost*, *supra* note 40. ("Something like this creates goodwill. It creates a favorable impression and feeling toward the brand." (quoting Nike spokesman Scott Reames)). Unlike the other LIVESTRONG merchandise, the yellow LIVESTRONG bracelets do not display the Nike "swoosh" symbol. *Id.* "Most consumers don't realize that the bracelet is part-and-parcel of the sneaker giant's branding mechanism—and that's exactly why the concept has been so successful . . ." *Id.* "By not putting a logo on it, they are avoiding the impression of commercialism . . . Once the media picks up on it, suddenly Nike comes off as the good guy without ever having told you "Hey, look at what we're doing."” *Id.* (quoting retired president of the American Academy of Advertising, Joseph Pisani). "What the success of the yellow bracelet teaches us is that subtlety is the best policy—rather than coming out and saying "We're doing all these great things."” *Id.* (quoting Paul Swangard, managing director of the Warsaw Sports Marketing Center at the University of Oregon). "Although the bracelet may be swooshless, some people will eventually make the link—and while that might not sell shoes right away, the positive association will seep into the brand." *Id.* These predictions seem to hold true. Currently, products in the LIVESTRONG collection offered by Nike bear the Nike swoosh symbol. On some items, the only indication that the product is part of the LIVESTRONG collection is the yellow Nike swoosh symbol, and the words LIVESTRONG do not appear on the product.

283. I.R.S. Gen. Couns. Mem. 39,862 (Nov. 22, 1991).

284. *Id.*

285. *Cf.* Treas. Reg. § 1.513-1(d)(2) (as amended in 1983) (providing that production of income for use in an organization's exempt activities is alone not enough to make the conduct of the activity substantially related to the organization's tax-exempt purposes).



benefits are substantially more than the charity's take under the cause-related marketing alliance. If they are, then impermissible private benefit would exist. Another view may be that the public benefit is the use of the charity's goodwill because, as an asset of the charity, it is committed for public purposes. Under this view, as long as the payments received by the charity approximates the value of the nonexclusive license to use the charity's name and logo, the charity is not harmed; therefore, there is no impermissible private benefit. However, this view ignores the amount of benefits flowing to the corporate partner, which is a necessary factor in the balancing test.<sup>286</sup> Therefore, the former view is the more appropriate view under which to evaluate whether the arrangement produces more than incidental private benefit in the quantitative sense.

The benefit is incidental in the qualitative sense if it is "a necessary concomitant of the activity that benefits the public at large."<sup>287</sup> In other words, the activity only can be accomplished by benefiting the private party.<sup>288</sup> Cause-related marketing alliances are viewed by the charity as a means of fundraising. The application of this test to fundraising activities is difficult as the test was designed to be applied to the carrying out of the organization's charitable activities. To be sure, fundraising is a necessary activity of most charities. A literal application of this test would appear to prohibit any private benefit from fundraising activities as long as it is possible to raise funds without conferring any benefit on the donors (i.e., by raising funds only from purely gratuitous donations). Yet, in many fundraising campaigns donors receive some benefit in return, whether it be recognition of their generosity or a trinket item that donors can use or display to show their support.

The end result of the private benefit analysis is to compare the value of the benefits flowing to the corporate partner against the value of the benefits flowing to the charity from the cause-related marketing alliance. In addition to the monetary benefits received from the cause-related marketing alliance, the charity benefits in the form of increased awareness of the charity's message and name recognition because the charity gains publicity from the corporate partner's marketing efforts to promote the alliance. The actual benefit of increased publicity of the charity resulting from a cause-related marketing alliance is hard to quantify, and necessitates a fact specific inquiry that may vary widely from one charity to the next. For example, it may be that a local unfamiliar charity can benefit greatly from the

286. See 1.R.S. Gen. Couns. Mem. 39,862.

287. *Id.*

288. *Id.*

publicity achieved in a cause-related marketing alliance with a well-known corporate partner. Such an alliance could result in the charity becoming a household name, possibly resulting in additional individual donations to the charity. In contrast, a well-established charity may not gain as much additional public goodwill from a cause-related marketing alliance with a well-known corporate partner. Since the charity's name and message are already well-known, increased publicity of the charity's name or message by the corporate partner may not provide much additional benefit to the charity. In this scenario, rather, the corporate partner may benefit more by leveraging the existing public goodwill of the well-known charity to promote increased public goodwill for the corporate partner.

When a comparison of the benefits to both the charity and the corporate partner produces a substantial discrepancy in favor of the corporate partner, the cause-related marketing alliance would result in impermissible private benefit. Yet, cause-related marketing activities on the whole are generally not a significant part of the charity's activities. Therefore, revocation of the charity's tax-exempt status, the only remedy currently available for violation of the private benefit doctrine, is harsh and likely unwarranted. Rather, concerns about impermissible private benefit should be factored into a safe harbor guidance that identifies specific cause-related marketing activities which would not jeopardize a charity's tax-exempt status.

#### *B. Deceptive Information to the Consumer Enhances Private Benefit*

Although cause-related marketing alliances may be a win-win situation for the charity and the corporate partner, the impact of cause-related marketing alliances on an important third party, the consumer, needs to be evaluated.<sup>289</sup> The manner in which a cause-related marketing alliance is conducted and communicated to consumers may have a significant impact on consumers' willingness to purchase the product, and thus, participate in the campaign. Collectively, these attributes may cause consumers to purchase products that are part of the campaign over competing products, thus enhancing the private benefit realized by the corporate partner.

Specifically, the prevalence of web-based platforms to promote cause-related marketing alliances adds confusion to the amount of benefits the charity receives from the campaign and possibly increases sales for the

289. See Pracejus, Olsen, & Brown, *supra* note 66, at 27. ("It is important to remember, however, that [cause-related marketing] is not a dyadic exchange; it is a triadic one. It involves a third player: the consumer.").

corporate partner. For example, The Global Fund's website contains links to websites of its corporate partners which sell (PRODUCT)<sup>Red</sup> merchandise. A consumer who visits The Global Fund's website can click on the link to The Gap's website to purchase a (PRODUCT)<sup>Red</sup> t-shirt. The consumer is then redirected to The Gap's website where the consumer would select the t-shirt and add it to his shopping cart. In this transaction, no disclosure is made to the consumer about being redirected to The Gap's website. Because The Gap is a supporter of The Global Fund and the consumer linked through to The Gap's web store from The Global Fund site, the consumer may believe that a portion of the proceeds from *any* purchase made in that transaction (whether they be (PRODUCT)<sup>Red</sup> merchandise or other Gap products) will benefit The Global Fund. There is no disclosure to tell them differently. Even if the consumer does not hold that belief, The Gap could benefit in another way from the increased traffic to its web store. The consumer could also want a new pair of jeans. Instead of going through the hassle of another web transaction with a different merchant, or simply because the consumer now has a more positive image of The Gap generally from its affiliation with The Global Fund, the consumer chooses to add some jeans from The Gap's web store to his shopping cart at the time he purchases the (PRODUCT)<sup>Red</sup> t-shirt. Studies support increased sales of other products as a benefit to the corporate partner from cause-related marketing alliances.<sup>290</sup> The prevalence of web-based platforms makes the realization of this benefit that much easier.

Furthermore, the inclusion of the charity's name and logo on the product may cause consumers to believe that the charity is endorsing the particular product, possibly motivating consumers to purchase the product.<sup>291</sup> The consumer's perception of product endorsement by a charity can become further blurred the more the attributes of the product relate to a vital message of the charity. For example, the March of Dimes wanted to promote a message to make pregnant women aware of their need for folic acid, a B vitamin that can help prevent birth defects of the spine and brain.<sup>292</sup> At the same time, Kellogg was interested in increasing the sale of

290. See *supra* notes 269-276 and accompanying text.

291. See Bennett & DiLorenzo, *supra* note 7, at 10 ("The marketing arrangements, as typically set up, are inescapably misleading to the buying public. . . . [T]he essential problem is the implied endorsement from association with a charity, even when it is at pains to hold these relationships at arm's length."). Bennet & DiLorenzo quote an executive of the American Lung Association acknowledging consumer perception of a charity's apparent endorsement of a product by the inclusion of the charity's logo on the product package: "If you're standing there looking at the shelf, you might say, 'Hmm, maybe I'll buy the product with the logo as opposed to the one that doesn't have any.' That's a reality." *Id.* at 13.

292. Alan R. Andreasen, *Profits for Nonprofits: Find a Corporate Partner*, HARV. BUS. REV.,

Product 19, a breakfast cereal rich in folic acid.<sup>293</sup> In exchange for \$100,000 from Kellogg, the March of Dimes agreed to the use of its name on Product 19 packages in association with a message about folic acid.<sup>294</sup> To the end consumer, Product 19 could appear to be superior to other breakfast cereals rich in folic acid in helping to prevent birth defects because the packaging contains the March of Dimes logo. Thus, consumers concerned about doing all they can to consume foods that will aid in the prevention of birth defects may be motivated to purchase Product 19 over its competitors.

Similarly, Bristol-Myers Squibb Company partnered with the American Heart Association in a cause-related marketing alliance concerning Pravachol, a cholesterol-lowering drug. In exchange for \$600,000, American Heart Association allowed Bristol-Myers Squibb to use its name and logo on a full page advertisement for Pravachol. Since the mission of the American Heart Association is the education on heart health and promotion of a heart-healthy lifestyle, a consumer could easily perceive the inclusion of the American Heart Association's name and logo on the advertisement as the charity's endorsement of Pravachol as the cholesterol-lowering drug of choice.<sup>295</sup>

Finally, in 1994, the Arthritis Foundation partnered with Johnson and Johnson for a specially marked line of acetaminophen, coated aspirin and ibuprofen, which bore the Arthritis Foundation name and logo as the product's brand name.<sup>296</sup> Not readily evident from the packaging was that the products were manufactured and marketed by Johnson & Johnson:

The "Arthritis Foundation" line was no different in formulation from competing brands. All that was "new" was the marketing arrangement and the cooperative exposure each organization brought to the other. The mutually beneficial partnership was widely considered to be the first in which a charity's name was featured as the product's brand name. Nevertheless, it blurred the line between nonprofit and for-profit enterprise to such an extent that law enforcement officials cried foul. The relationship was so vague that 19 state Attorneys General charged [Johnson & Johnson] with deceptive advertising, alleging that consumers were misled to believe the drugs were new medications created by the Foun-

Nov.-Dec. 1996, at 47, 56.

293. *Id.* at 57.

294. *Id.*; see also Cordes & Weisbrod, *supra* note 28, at 6.

295. See Bennett & DiLorenzo, *supra* note 7, at 12 ("In the ad, the drug maker surrounds its pitch for Pravachol with eye-catching messages about cholesterol and heart disease from the [American Heart Association].").

296. *Id.* at 10. The Arthritis Foundation licensed the use of its name and logo to Johnson & Johnson in exchange for royalty payments exceeding \$1 million annually. *Id.*

dition . . . . It simply wasn't clear, the Attorneys General argued, as to who was behind the product, what was inside the package, or where the money was going.<sup>297</sup>

Without careful and prominent explanation of the relationship between the charity and the company on the product or advertisement for the product, a consumer's misconception of what it means to have the charity's logo on the product could lead the consumer to conclude that the charity is endorsing the product. State regulators share these concerns. For many years, the American Cancer Society partnered with Nicoderm in the campaign to promote cessation of smoking. As part of this alliance, the American Cancer Society allowed Nicoderm to feature the American Cancer Society's logo on Nicoderm's packaging "as an additional motivation to purchase the product and quit smoking" in exchange for fees in excess of \$1 million.<sup>298</sup> The campaign caught the eye of several state attorneys general who alleged that the product packaging falsely implied that the American Cancer Society endorsed Nicoderm.<sup>299</sup> The manufacturer of Nicoderm, SmithKline Beecham, eventually paid \$2.5 million in a settlement with twelve state attorneys general over the allegations of deceptive advertising.<sup>300</sup>

In addition to concerns of apparent product endorsement, the lack of uniform disclosure regarding the benefits received by the charity from the cause-related marketing alliance may cause consumers to form false impressions of the philanthropic benefits being conveyed by the alliance. For example, in Minneapolis, Barnes & Noble ran ads asking customers to donate books for a literacy program. Barnes & Noble did not inform customers that the company donated nothing to the program; the customers made all the donations. Barnes & Noble kept all the profits from the in-

297. *Id.*

298. See Andreasen, *supra* note 18, at 161; Young, *supra* note 3, at 202.

299. The American Cancer Society viewed the program not as a product endorsement but as an alliance to create a national awareness program on the benefits of cessation of smoking. Young, *supra* note 3, at 202; but see Bennett & DiLorenzo, *supra* note 7, at 13 ("Is there an implied endorsement? The answer to that has to be "yes." There is no way around it.") (quoting a vice president of the American Cancer Society)). The American Cancer Society recognizes the marketing value of its brand:

Research shows us that the public trusts and respects the American Cancer Society beyond virtually any other American institution. We know that the power of that public recognition adds valuable credibility to the companies and products with which we partner. It is for this reason that we will chose to partner only with those products and companies which can further the mission of the [American Cancer Society].

*Id.* (quoting an ACS position statement) (internal quotation marks omitted).

300. Edward P. Jones, *Sales Pitches Tied to Charities Draw States' Scrutiny*, 24 EXEMPT ORG. TAX REV. 613, 613 (1999). In addition, SmithKline Beecham agreed to disclose in its advertisements that the campaign was as much as business deal as an effort to encourage cessation of smoking. *Id.*

creased sale of books during the campaign period.<sup>301</sup>

When the promotion states that a percentage of the proceeds or profits from the sale of the merchandise are donated to charity, consumers may underestimate the amount of the sale that is actually donated to charity. During October (national breast cancer awareness month) each year, a proliferation of pink products inundates store shelves.<sup>302</sup> Often times, the product merely states that a portion of the proceeds from the sale of the product will be used to benefit breast cancer research. Consumer perception of the amount donated for breast cancer research from their purchases may far exceed the amount actually donated for the cause:

Barbara Brenner, executive director of Breast Cancer Action, noted “When companies put pink ribbons on their products, they’re no longer selling a sweater or a watch—they’re selling the expectation that buying their products is going to make a difference in the fight against breast cancer. Pink ribbon marketing efforts make a significant difference in corporate bottom lines. But the ‘portion of the proceeds’ that goes to breast cancer is all too often minuscule in comparison.”<sup>303</sup>

Anecdotal evidence of consumer misperceptions of cause-related product promotions is supported by studies which evaluate the effect of disclosure in promotional merchandising on consumer estimates of philanthropic benefits going to charity.<sup>304</sup> Of particular concern in these studies was the use of “vague” qualifiers, such as a “portion of the proceeds” from the sale of this product will benefit charity, in advertisements for the product.<sup>305</sup> Neither the word “portion” nor the word “proceeds”<sup>306</sup> have a standard quantifiable meaning. Almost seventy percent of the advertisements studied employed vague references to the amount that would be donated to charity.<sup>307</sup> Consumers who viewed advertisements containing vague refer-

301. Andreasen, *supra* note 18, at 173–74.

302. *See, e.g.*, Cardona, *supra* note 59.

303. Andreasen, *supra* note 18, at 182.

304. *See generally* Pracejus, Olsen, & Brown, *supra* note 66.

305. *See id.* at 22.

306. “Proceeds” could mean either the gross amount of revenues realized from the sale of the product or the net amount of revenues from the sale after taking into account expenses (i.e., profits).

307. Pracejus, Olsen, & Brown, *supra* note 66, at 22. Other advertisements employed calculable or estimable formats:

Calculable formats . . . refer to descriptions of the donation amount that would allow consumers to calculate the actual amount being donated. For example, a common calculable format is “X% of the sales.” Estimable formats . . . provide consumers with only some of the information needed to calculate the donation amount. A common estimable format is “X% of profits.”

*Id.* at 21. Of the thirty percent of advertisements that did not use vague references to the donation amount, companies used estimable formats substantially more often than calculable formats. *See id.* at

ences varied widely in their estimation of the amount donated to charity,<sup>308</sup> and consumer estimates of donation amounts almost doubled when the advertisement disclosed that a “substantial portion” (rather than a “portion”) of the proceeds would benefit charity.<sup>309</sup> Consumer misperception of the actual amount donated to charity is important because consumers preferred brands which they viewed as making a larger donation to charity over brands which did not contribute as much in the consumers’ view.<sup>310</sup>

The impact on the consumer from the use of vague references to the philanthropic benefits going to charity gives cause for concern. One study found that the vast majority of descriptions of cause-related marketing campaigns gave absolutely “no hint to consumers as to the actual amount being donated.”<sup>311</sup> The authors surmise that in some cases, adequate disclosure would be difficult because the amount donated to charity may be based on a complex formula, but caution that vague descriptions are nonetheless deceptive:<sup>312</sup>

Simply saying in an advertisement “something will be given” eliminates the need for such complex, potentially confusing disclosures. However, even where the [disclosure] is technically correct, if such offers result in overestimation of the donation amount by the consumer and this, in turn, results in differential purchase behavior because of the overestimation, there is reason for concern from a policy perspective.

. . . .

. . . [T]he results of the present set of studies suggest that the particular abstract ad copy used to describe a [cause-related marketing] offer does influence perceived donation magnitude. Second, the variance associated with these estimates is extremely large, suggesting that consumers differ widely with respect to what a given term means (e.g., there is not a universal understanding in the minds of individuals with respect to what a “portion” means). Third, given that the level of donation impacts

23. Thus, the substantial majority of companies prefer to use disclosures in promotional merchandising that do not allow consumers to calculate the amount donated to charity resulting from their purchase. The authors posited one possible motivation for companies to use vague references rather than more concrete references, such as a fixed dollar amount or percentage of sales price: “[I]t is not inconceivable that firms donating smaller percentages are more likely to choose [vague] formats. In other words, firms that are donating large percentages may be more likely to make their donation amounts explicit in their advertising.” *Id.* at 24.

308. *See id.* at 24 (noting that estimations of the percentage of purchase-price donated to charity varied from zero percent to sixty percent).

309. *Id.* at 23–24. The author notes, “[w]hat an individual advertiser considers substantial is quite subjective . . . [I]t may be substantial relative to industry norms, relative to previous giving, or relative to what the advertiser would normally consider fair.” *Id.* at 24.

310. *Id.* at 26.

311. *Id.*

312. *Id.*

choice, the ability of an offer to be estimated with reasonable accuracy may be of concern to advertisers and regulators.

... [F]rom a policy perspective, it is suggested that when at all possible, enterprises identify [cause-related marketing] offers either in the form of a dollar value per unit, or as a percentage of the sales price. Such a policy would reduce the variance in estimates, and therefore diminish the potential for confusion caused by abstract formats.<sup>313</sup>

The impact cause-related marketing alliances have on consumer perception is an important element of the overall private benefit analysis. Consumers may reasonably form misperceptions about the amount of philanthropic benefit to the charity from the alliance because of the manner in which the alliance is conducted, the way in which the packaging or advertising for the product is presented, or the way in which the alliance is described to the consumer. When these misperceptions motivate the consumer to purchase the branded or promotional merchandise or other products or services offered by the corporate partner, the private benefit realized by the corporate partner is enhanced. The charity is in a position to minimize consumer misperception by the control the charity may exercise over the way the alliance is conducted and described to the consumer and over the use of its name or logo on the product packaging or advertisement. Therefore, in formulating the appropriate tax treatment of these transactions for the charity, it is appropriate to consider ways to mitigate consumer misperception as well as ways to mitigate private benefit from cause-related marketing alliances in general.

### C. *Reform Through the Federal Tax Laws*

Regulation of vague references in disclosures made to consumers is necessary to mitigate some of the risk of enhanced private benefit to the corporate partner. The overwhelming majority of cause-related marketing disclosures to consumers contain vague references to the philanthropic benefit.<sup>314</sup> Vague references are troubling because they may cause consumers to form misperceptions about the amount of philanthropic benefit flowing to the charity from the cause-related marketing campaign;<sup>315</sup> consumer misperceptions then may alter the consumers' buying behavior and motivate consumers to purchase the promotional product over a competing

313. *Id.* at 26–27 (citation omitted).

314. See Pracejus, Olsen, & Brown, *supra* note 66, at 22 (seven out of ten disclosures surveyed contained vague references).

315. *See id.* at 27.



product.<sup>316</sup> Increased sales of the promotional product enhance the private benefit realized by the corporate partner from the cause-related marketing alliance.<sup>317</sup> Requiring more concrete disclosure of the philanthropic benefit would mitigate this risk of enhanced private benefit because the consumer would be less likely to form misperceptions about the amount of the philanthropic benefit.<sup>318</sup>

Regulation of charitable solicitation typically falls within the province of the state attorney general.<sup>319</sup> Concerns of federalism give rise to consideration of whether state laws are more appropriately suited to mitigate the consumer misperception concerns I have raised. Many states require charities to register with the state prior to soliciting funds from residents of that state;<sup>320</sup> some do not.<sup>321</sup> Oftentimes, professional fundraisers hired by the charity to solicit donations on the charity's behalf are also required to register.<sup>322</sup> However, a corporate partner in a cause-related marketing alliance is not hired as a professional fundraiser (i.e., an agent of the charity). Therefore, the charitable solicitation laws applicable to professional fundraisers would not apply to cause-related marketing alliances.

Since the corporate partner may maintain control over the manner in which the cause-related marketing alliance is communicated to consumers, the state would need to adopt a separate set of rules that apply to the corporate partner to effectively regulate cause-related marketing alliances. In fact, several states impose requirements on commercial coventurers<sup>323</sup> un-

316. *See id.*

317. *See supra* Part III.A.

318. *See* Pracejus, Olsen, & Brown, *supra* note 66, at 27.

319. *See* MARION R. FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION 53–55 (2004).

320. *See id.* at 317 (noting that thirty-nine states regulate the solicitation of charitable funds). Even among the states that regulate charitable solicitation, the extent and nature of the regulation varies greatly from one jurisdiction to the next. For example, Texas only regulates charitable solicitation activities of veterans organizations and public safety organizations, and telephone solicitations by charities related to law enforcement. *See* TEX. BUS. & COM. CODE ANN. §§ 303.001–303.154 (Vernon 2009) (law enforcement-related charities); TEX. OCC. CODE ANN. §§ 1803.001–1803.155 (Vernon 2004) (public safety organizations); TEX. OCC. CODE ANN. §§ 1804.001–1804.206 (Vernon 2004) (veterans organizations).

321. *See generally* FREMONT-SMITH, *supra* note 303, app. at 496–511 (summarizing charitable regulation laws of all the states and the District of Columbia and indicating that twelve jurisdictions do not have charitable solicitation statutes).

322. *See id.* at 317.

323. The Model Act Concerning the Solicitation of Funds for Charitable Purposes drafted by the National Association of Attorneys General (“Model Act”) defines “commercial coventurer” as “a person who for profit is regularly and primarily engaged in trade or commerce other than in connection with soliciting for charitable organizations or purposes and who conducts a charitable sales promotion.” A MODEL ACT CONCERNING THE SOLICITATION OF FUNDS FOR CHARITABLE PURPOSES § 1(h) (1986) [hereinafter MODEL ACT]. States vary in how they define commercial coventurer. *See, e.g.*, CAL. GOV'T CODE § 12599.2(a) (West 2005) (“[A]ny person who, for profit, is regularly and primarily engaged in

der their state charitable solicitation statutes.<sup>324</sup> Generally, these commercial coventurer statutes do not require the corporate partner to register with the state in order to advertise that a portion of the proceeds from the sale of the branded products will benefit a charity.<sup>325</sup> Although these statutes may require certain provisions to be included in the agreement between the charity and the corporate partner prior to the charitable sales promotion,<sup>326</sup>

trade or commerce other than in connection with the raising of funds, assets, or property for charitable organizations or charitable purposes, and who represents to the public that the purchase or use of any goods, services, entertainment, or any other thing of value will benefit a charitable organization or will be used for a charitable purpose.”); COLO. REV. STAT. ANN. § 6-16-103(4) (West 2002) (Same as Model Act); FLA. STAT. ANN. § 496.404(4) (West 2006) (“[A]ny person who, for profit, regularly and primarily is engaged in trade or commerce other than in connection with solicitation of contributions and who conducts a charitable sales promotion or a sponsor sales promotion.”); N.Y. EXEC. LAW § 171-a(6) (McKinney 2002) (same as California).

324. These requirements are generally imposed on a “charitable sales promotion,” which typically includes an “advertising or sales campaign conducted by a commercial co-venturer which represents that the purchase or use of goods or services offered by the commercial co-venturer are to benefit a charitable organization.” FLA. STAT. ANN. § 496.404(3); *see also, e.g.*, COLO. REV. STAT. ANN. § 6-16-103(3). A statement by the corporate partner that a portion of the proceeds from the sale of the branded merchandise benefit the charity would be a charitable sales promotion and therefore would cause the corporate partner to be a commercial coventurer.

325. California does not require commercial coventurers to register or file periodic reports with the California Attorney General provided that the commercial coventurer (i) has a written contract with the charity, signed by two officers of the charity, prior to the representation to the public of the benefit to the charity; (ii) within ninety days after the representations to the public, and at the end of each successive 90 day period during which representations are made, “transfers to [the charity] all funds, assets, or property received as a result of the representations”; and (iii) provides in conjunction with each such transfer a written accounting to the charity of all funds, assets, or property received “sufficient to enable [the charity] to determine that representations made to the public on its behalf have been adhered to accurately and completely,” and to enable the charity to prepare its periodic report filed with the California Attorney General. CAL. GOV’T CODE § 12599.2(b). A commercial coventurer that does not meet these requirements must register with the California Attorney General each year and pay an annual fee of \$200. *Id.* § 12599.2(c).

Similarly, New York does not require a commercial coventurer to register or file periodic reports with the New York Attorney General. Rather, a charity that enters into a contract with a commercial coventurer must file with the New York Attorney General along with its financial report certain information including a list of the commercial coventurers authorized by the charity to use its name, a statement of the financial terms and conditions of the coventurer contract, and a statement whether the commercial coventurer has provided the charity with the required accounting. N.Y. EXEC. LAW § 173-a(4). Florida does not require the commercial coventurer to register but does require that the commercial coventurer file a final accounting of the sales promotion with the Department of Agriculture and Consumer Services upon request. FLA. STAT. ANN. § 496.414(3).

326. The Model Act requires the agreement between the charity and the commercial coventurer to be in writing and include the following information:

- (1) The goods or services to be offered to the public;
- (2) The geographic area where, and the starting and final date when, the offering will be made;
- (3) The manner in which the charitable organization’s name will be used, including the representation to be made to the public as to the actual or estimated dollar amount or percent per unit of goods or services purchased or used that will benefit the charitable organization;
- (4) If applicable, the maximum dollar amount that will benefit the charitable organization;
- (5) The estimated number of units of goods or services to be sold or used;
- (6) A provision for a final accounting on a per unit basis to be given by the commercial coventurer to the charity and the date by which it will be made;

the corporate partner is not required to disclose to the consumer the amount benefitting the charity from the sales promotion except in limited circumstances.<sup>327</sup> Thus, even in states which attempt to regulate cause-related marketing alliances, there is typically no regulation of vague references to the philanthropic benefit to charity in the disclosures made to consumers.

Even if states were inclined to require more concrete disclosure to consumers of the philanthropic benefits resulting from the cause-related marketing alliance, direct regulation of the disclosure made to consumers by the states may be vulnerable to attack on First Amendment grounds. Concerned about the large percentage of solicited funds which end up in the pockets of professional fundraisers, state regulators have made several attempts to require that professional fundraisers disclose to potential donors the amount or percentage of the solicited donation that would actually go to charity. The U.S. Supreme Court has routinely thwarted these attempts by state regulators as unduly infringing on the professional fundraisers' and the charities' constitutionally protected right to free speech.<sup>328</sup> Similar con-

(7) A statement that the charitable sales promotion is subject to the requirements of this act; and

(8) The date by when and the manner in which the benefit will be conferred on the charitable organization.

MODEL ACT § 7(b). Most states do not elaborate in this amount of detail the requirements for the written contract. For example, under New York law, a commercial coventurer is simply required to have a written contract with the charity benefiting from its services. Additionally, within ninety days after the termination of a sales promotion advertised to benefit a charity, a commercial coventurer must provide the charity with an accounting stating the number of sold items, the dollar amount of each sale and the amount paid or to be paid to the charitable organization. N.Y. EXEC. LAW § 173-a(3). If the sales promotion lasts over a year, an interim report must be provided to the charity at least annually. *Id.*

327. Under the Model Act, the commercial coventurer is required to "disclose in each advertisement for the charitable sales promotion the dollar amount or percent per unit of goods or services purchased or used that will benefit the charitable organization or purpose." MODEL ACT § 7(d). Most states do not adopt this requirement. For example, under Colorado's charitable solicitation statute, a commercial coventurer is required to make certain disclosures in its advertisements only when "the commercial coventurer reasonably expects that more than one-half of all proceeds of a solicitation campaign will be derived from transactions within the state of Colorado." COLO. REV. STAT. ANN. § 6-16-110(1). New York, California and Florida have no disclosure requirement for consumers.

328. *See, e.g.,* *Riley v. Nat'l Fed'n of the Blind of N.C., Inc.*, 487 U.S. 781 (1988); *Sec'y of State of Md. v. Joseph H. Munson Co.*, 467 U.S. 947 (1984); *Vill. Of Schaumburg v. Citizens for a Better Env't*, 444 U.S. 620 (1980). The solicitation of charitable funds is protected speech. Direct regulation of the content of the solicitation must satisfy a strict scrutiny standard under the First Amendment: (1) the regulation must promote a substantial state interest; and (2) the regulation must be narrowly tailored to promote that interest. While the state's interest in protecting charities and the public from fraud is a sufficiently substantial state interest to justify narrowly tailored regulation of speech, the requirement that a professional fundraiser disclose to potential donors the percentage of the donation actually contributed to the charity is not narrowly tailored to promote the state's interest in preventing fraud. *See Riley*, 487 U.S. at 799-800. The Supreme Court reasoned that there is no nexus between the percentage of funds retained by the professional fundraiser and incidence of fraud. *Munson*, 467 U.S. at 966-67. The Court explained that

a charity might choose a particular type of fundraising drive, or a particular solicitor, expecting to receive a large sum as measured by total dollars rather than the percentage of dollars remitted. Or, a solicitation may be designed to sacrifice short-term gains in order to achieve

stitutional challenges may be encountered if state regulators attempt to require that the content of the disclosure made to consumers by cause-related marketing alliances specify in concrete terms the amount of philanthropic benefit flowing to charity in the form of a dollar value per unit or a specified percentage of the sales price.<sup>329</sup>

In contrast to state regulation of disclosures made to consumers under state charitable solicitation laws, considerably more flexibility exists for

long-term, collateral, or noncash benefits. To illustrate, a charity may choose to engage in the advocacy or dissemination of information during a solicitation . . . . Consequently, even if the State had a valid interest in protecting charities from their own naiveté or economic weakness, the [regulation] would not be narrowly tailored to achieve it.

*Riley*, 487 U.S. at 791–92.

329. Since the regulation would be aimed at the content of the disclosure, a court may apply a strict scrutiny standard to evaluate whether the requirement that disclosure of the specific dollar amount or percentage contributed to charity is narrowly tailored to promote a substantial state interest—the protection of the consumer against fraud. Based on the Supreme Court’s opinions in the professional fundraising cases, it may be difficult for the state to establish the requisite nexus between the content of the disclosure and the protection against fraud.

Nonetheless, there are two significant differences between cause-related marketing alliances and professional fundraiser relationships that may impact a court’s analysis. First, since the disclosure sought to be regulated typically is on the product packaging or an advertisement for the product, a court may view the speech being regulated as commercial speech rather than fully protected speech. Commercial speech is protected by the First Amendment, but court review of regulation of commercial speech is subject to a more deferential standard than other forms of protected speech. See generally *Zauderer v. Office of Disciplinary Council of Supreme Court of Ohio*, 471 U.S. 626 (1985); *Va. Pharmacy Bd. v. Va. Citizens Consumer Council, Inc.*, 425 U.S. 748 (1976). However, in the professional fundraising context, the Supreme Court rejected the argument that a more deferential commercial speech standard should apply to professional fundraising solicitation because the commercial portions of the solicitation were “inextricably intertwined” with the other protected portions—the charity’s dissemination of its message. *Riley*, 487 U.S. at 795–96. Often times the product packaging or advertisement for the promotional or branded merchandise contains a statement of the charity’s cause or mission. The product may include an insert which describes in more detail the mission and programs of the charity. Charities certainly view cause-related marketing alliances as fundraising relationships. Taken together, these elements may lead a court to conclude that the product packaging or advertisement is not “mere commercial speech” but in part “fundraising speech” and thus entitled to greater protection under the First Amendment. Accordingly, it is unclear what standard a court would apply to evaluate the state’s direct regulation of the content of the disclosure to consumers of the philanthropic benefit flowing to the charity from the cause-related marketing alliance.

A second distinguishing factor of cause-related marketing alliances is that the corporate partner is not typically an agent of the charity. In fact, the licensing agreement between the charity and the corporate partner may take great pains to establish that neither party is acting as an agent for the other. In the professional fundraising context, the contract is clear that the professional fundraiser is acting as an agent of the charity in soliciting funds for the charity. Speech made by the professional fundraiser in the solicitation campaign thus can be attributed to the charity as communication of the charity’s message and more readily determined to be fundraising speech. In the cause-related marketing context, it is not as clear whose speech is being regulated—the corporate partner’s or the charity’s. If the court determines that the speech was not made by the charity, this may impact a court’s analysis of whether fundraising speech is really involved. Typically, however, a charity would retain the right to approve the use of its name or logo on the product package or in an advertisement for the product and would also supply any statement of the charity’s cause or mission included in the product package or advertisement. The charity’s involvement in reviewing and approving the disclosure would indicate that the speech is at least in part made by the charity, and thus at least a portion of the speech could be determined to be fundraising speech. It is unclear how a court would decide this issue.

incorporating specific requirements for consumer disclosures under the federal tax laws. The U.S. Supreme Court has stated that tax exemption is a matter of legislative grace.<sup>330</sup> Accordingly, conditions to receive tax exemption which may restrict a charity's fundamental right to free speech are not subject to strict scrutiny because Congress may validly decide not to use public tax dollars to subsidize certain speech.<sup>331</sup> For example, the Supreme Court has held that restrictions imposed on charities' ability to engage in lobbying activities do not infringe charities' First Amendment rights.<sup>332</sup> Similarly, federal appellate courts have ruled that the prohibition on charities' ability to engage in political campaign advocacy do not violate a charity's First Amendment rights.<sup>333</sup> Charities have a choice: comply with the conditions to receive tax exemption or engage in the prohibited activities and pay tax on its revenues.<sup>334</sup> Therefore, imposing a condition that restricts the content of consumer disclosures made in cause-related marketing campaigns, but also creates a safe harbor that exempts the revenue received from taxation as UBTI, arguably would not infringe on charities' free speech rights.

More importantly, because the disclosures made to consumers implicate the private benefit realized by the corporate partner, federal tax laws are appropriately used to impose conditions on consumer disclosures that would minimize private benefit. As explained previously, the effect that cause-related marketing alliances have on consumer perception is an important element of the overall private benefit analysis. When consumers form misperceptions about the amount of philanthropic benefit flowing to the charity, these misperceptions may cause the consumer to purchase the branded or promotional merchandise or other products or services offered by the corporate partner; thus the private benefit realized by the corporate partner is enhanced. Because the charity is in a position to minimize consumer misperception by controlling the way the alliance is conducted and described to the consumer and by controlling the use of its name or logo on the product packaging or advertisement, it is appropriate to consider ways in which the charity can mitigate consumer misperception as part of the overall federal tax treatment of charities' cause-related marketing activities.

For example, to address the concern that a consumer may be unaware of which purchases made online will benefit the charity, the charity could

330. See *Comm'r v. Sullivan*, 356 U.S. 27 (1958).

331. See *Regan v. Taxation With Representation of Wash.*, 461 U.S. 540 (1983).

332. See *id.*

333. See *Branch Ministries v. Comm'r*, 211 F.3d 137 (D.C. Cir. 2000); *Christian Echoes Nat'l Ministry, Inc. v. U.S.* 470 F.2d 879 (10th Cir. 1972).

334. See *Regan*, 461 U.S. at 545; *Cammarano v. United States*, 358 U.S. 498 (1959).

be required to include a pop up message that is displayed when the consumer clicks on the link from the charity's website to the corporate partner's website to purchase the branded or promotional merchandise. The pop up message would inform the consumer that he is being redirected to a site which is not maintained by the charity, that not all purchases made on the corporate partner's website will benefit the charity, and that the charity will receive a portion of the sales from only the products which are clearly marked as benefiting the charity on the corporate partner's website.

To minimize consumer misperceptions about the philanthropic benefit of the cause-related marketing alliance, the charity could be required to ensure that the packaging or advertisement for the promotional merchandise or branded merchandise clearly state the dollar amount per unit or the specific percentage of the sales price that will be donated to the charity from the sale of the product. The alliance of the Yoplait yogurt "Save Lids to Save Lives" campaign with the Susan G. Komen Foundation is an example of disclosure made to consumers which would meet this requirement.<sup>335</sup> As discussed above, in its communications made to consumers, General Mills clearly specifies that ten cents from the sale of every container of Yoplait yogurt with a pink lid will be donated to the Susan G. Komen Foundation, provided the consumer mails the lids to General Mills. Additionally, General Mills specifies that it will make a minimum donation of \$500,000 and a maximum donation of \$1,500,000. This type of disclosure leaves no doubt in the consumers' minds about the amount of philanthropic benefit flowing to the Susan G. Komen Foundation. Therefore, consumers make the decision whether to purchase Yoplait yogurt with pink lids with clear knowledge of how their purchase will benefit charity. A charity could ensure that the corporate partner makes more concrete disclosure of the amount donated to charity by including a provision in the licensing agreement which requires the corporate partner to do so. Additionally, as part of the charity's quality control over the corporate partner's use of the charity's name or logo on the product packaging or advertisement, the charity can maintain approval rights over the manner in which the philanthropic benefit is disclosed to consumers.

#### IV. FRAMEWORK FOR SAFE HARBOR GUIDANCE

Given the prevalence of cause-related marketing and the uncertain and unpredictable tax results identified in this article, I advocate the establishment of Internal Revenue Service guidance that sets forth a dual safe har-

335. For a more detailed discussion of this campaign, see *supra* Part I.B.

bor under which charities could operate to claim that revenue they receive from cause-related marketing alliances is exempt from the unrelated business income tax and that the cause-related marketing alliance does not result in impermissible private benefit. The safe harbor should specifically take into account the unique nature of cause-related marketing activities identified in this Article.

As envisioned, the safe harbor would provide that if certain conditions are satisfied, the charity could treat the revenue received from the corporate partner as royalty income, thereby excluding the revenue from the charity's UBTI. Failure to meet the safe harbor should not result in automatic treatment of the revenue as UBTI; rather, the arrangement should then be evaluated on a case by case basis under the general UBTI principles discussed above to determine whether the revenue should be subject to tax as UBTI. Further study needs to be done to determine the specific conditions that should be contained in a safe harbor for treatment of cause-related marketing revenues as royalties. The considerations I describe below, however, are essential for determining that the cause-related marketing alliance is passive in nature, thus justifying the exclusion of the revenues from the charity's UBTI as passive royalties.

One of the central concerns about distinguishing royalty income from compensation for personal services is the amount of services provided by the charity. Under existing guidance, the determination of the permissible amount of "insubstantial services" a charity may provide and still qualify for royalty treatment is uncertain, especially in connection with the charitable organization's exercise of quality control over the use of its name, logo, and trademarks. As is prudent business practice, a charity would want to maintain quality control over the use of its name, logo, and trademark by the corporate partner under the licensing agreement. Therefore, the safe harbor guidance should include specific examples of permissible and impermissible "quality control" services by the charity based on typical licensing arrangements used in cause-related marketing alliances. The safe harbor guidance should also identify other typical "services" a charity may perform to protect its financial interests, such as periodic inspection of its corporate partner's books and records.

Another central concern about the appropriate UBTI treatment of revenues from cause-related marketing alliances is distinguishing royalty income from advertising income. Especially relevant in this analysis is consumer perception of apparent endorsement of the product by the charity by virtue of allowing its name and logo to be placed on the product without qualification. By approving the placement of its name and logo on the

product, the charity should be held to the reasonable impressions such cause-related marketing leaves in the minds of consumers. If the charity's name and logo are used in such a way as to give consumers the impression that the charity endorses the product, the charity should be deemed to have endorsed the product; thus, the payment should be considered advertising income received by the charity and could no longer be excluded from the charity's UBTI. Accordingly, the safe harbor guidance should incorporate principles for minimizing consumer perception of apparent product endorsement; the charity must follow these principles for the marketing arrangement to qualify for the safe harbor. For example, to qualify for the safe harbor, the charity may be required to ensure that the product packaging or advertisement for promotional products contains an express statement that the charity does not endorse the product. Additionally, if a charity's website includes links to the corporate partner's website which would enable consumers to purchase products from the corporate partner's web store, the charity could be required to include an express statement on its website that the charity does not endorse the corporate partner's products.<sup>336</sup>

Private benefit concerns also should be factored into the design of the safe harbor addressing cause-related marketing alliances. Cause-related marketing alliances allow a charity's most valuable assets, its brand and goodwill, to be used to benefit private entities. While the charity indeed benefits in return, the central concern needs to be whether the corporate partner is improperly benefiting from the use of the charity's brand or goodwill. Thus, to qualify for the safe harbor, a charity should be required to satisfy certain conditions designed to minimize the private benefit to the corporate partner from the cause-related marketing alliance. Similar to the safe harbor for UBTI treatment, failure to meet the safe harbor related to private benefit should not result in automatic revocation of a charity's tax exemption; rather, the arrangement should then be evaluated on a case by case basis under general private benefit principles.

Adequately addressing private benefit concerns would entail ensuring that the private benefit to the corporate partner is not substantial in comparison to the benefit the charity receives from the cause-related marketing

336. I would like to emphasize that the foregoing safeguards would only be conditions the charity must satisfy to qualify for the safe harbor; charities would be free to structure the financial terms of their cause-related marketing alliances as they see fit. Only charities seeking the protection of the safe harbor would need to incorporate the required safeguards in their licensing agreements. Of course, charities not seeking the safe harbor may still believe they have incorporated adequate safeguards in their licensing agreements, and thus, they would be able to argue that the revenues received from the licensing agreement are royalties on a case by case basis.



alliance. Determining the safeguards necessary for achieving this result will require further study of how to quantify the private benefits corporate partners receive from cause-related marketing alliances. Some potential safeguards may include specifying a minimum percentage of the revenues from the sales of the branded or promotional merchandise that must be donated to the charity, eliminating financial caps on the amount donated to charity, specifying that any formula to determine the amount donated to charity be based on gross revenues instead of profits, or otherwise ensuring that the amount donated to the charity is not limited to an insubstantial amount as compared to the benefits received by the corporate partner.

Adequately addressing private benefit concerns also would require mitigation of consumer misperceptions about the amount of philanthropic benefit to the charity from the alliance. Such misperceptions can arise because of the manner in which the alliance is conducted, the way in which the packaging or advertising for the product is presented, or the way in which the alliance is described to the consumer. As discussed previously, mitigating consumer misperception may entail requiring the charity to display a pop-up message when consumers link from the charity's website to a corporate partner's web store to purchase branded merchandise. The pop-up message would clarify that the charity only benefits from the sale of the branded merchandise and not from the sale of other products found in the corporate partner's web store. This also may entail requiring the charity to ensure that vague references to the philanthropic benefit flowing to the charity are not used in communications to the consumer about the cause-related marketing alliance. The charity could be required to include a provision in the licensing agreement which requires the corporate partner to clearly state on the packaging or advertisement for the promotional merchandise or branded merchandise the dollar amount per unit or specific percentage of the sales price that will be donated to the charity from the sale of the product. Additionally, as part of the charity's quality control over the corporate partner's use of the charity's name or logo on the product packaging or advertisement for the product, the charity can be required to maintain approval rights over the manner in which the philanthropic benefit is disclosed to consumers in the licensing agreement.

Overall, the conditions under which revenues from cause-related marketing alliances would qualify for safe harbor classification should be designed to ensure that the charity's involvement is passive, that there is no apparent endorsement of the product by the charity, and that private benefit to the corporate partner is insubstantial. Further study of existing cause-related marketing licensing arrangements should be conducted to discern

commonalities among the arrangements, to determine typical provisions that satisfy the criteria discussed in this article, and to identify provisions that give cause for concern that the revenues from the arrangements might not be exempt from taxation. With additional study, conditions for safe harbor treatment could be established that reflect reasonable provisions in licensing arrangements; thus, charities would have a realistic expectation of structuring their cause-related marketing alliances to fit within the safe harbor.

#### CONCLUSION

Cause-related marketing is a booming industry; countless charities and for-profit companies are engaged in cause-related marketing alliances. Despite the widespread success of cause-related marketing, the Internal Revenue Service has issued little guidance on acceptable practices by charities engaged in cause-related marketing. A revenue ruling or Treasury regulations setting forth safe harbor provisions for permitted cause-related marketing alliances would be mutually beneficial for charities and the Internal Revenue Service. It would reduce the administrative burden on the Internal Revenue Service, which now must examine these arrangements on a case by case basis, and it would allow charities to more easily comply with the law. In particular, smaller charities that cannot readily afford legal counsel to assist them in structuring complex licensing transactions would benefit. Safe harbor guidance in the area of cause-related marketing taxation would thus be a “win-win” situation for charities and the Internal Revenue Service.

