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Joint Ventures of Nonprofits and For-Profits

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I. Introduction.[1] This article summarizes special tax considerations that should be taken into account when for-profit parties seek to engage in joint ventures with charitable organizations. In particular, there are two areas of concern unique to charitable organizations with respect to joint ventures with for-profit parties. First, certain rules restrict or prohibit a charitable organization's ability to enter into transactions with its insiders. Second, a charitable organization's participation in a joint venture with a taxable party may cause the charitable organization to incur unrelated business taxable income or lose its tax-exempt status. Underlying both of these areas of concern is the overriding concern that a charitable organization be organized primarily for the conduct of its charitable purposes and not engage in any activity that results in private inurement or private benefit.

A. Private Inurement. Section 501(c)(3) of the Code[2] provides that no part of the net earnings of an organization described therein may inure to the benefit of any private shareholder or individual. The Internal Revenue Service ("IRS") takes the position that any element of private inurement can cause an organization to lose or be deprived of tax exemption, and that there is no de minimis exception.[3] The private inurement prohibition contemplates a transaction between a charitable organization and an individual in the nature of an "insider," who is able to cause application of the organization's assets for private purposes because of his or her position.[4] In general, an organization's directors, officers, members, founders and substantial contributors are insiders. The meaning of the term "net earnings" in the private inurement context has been largely framed by the courts. Most decisions reflect a pragmatic approach, rather than a literal construction of the phrase "net earnings."[5] Common transactions that may involve private inurement include (i) excessive compensation for services; (ii) inflated or unreasonable rental prices; (iii) certain loan arrangements involving the assets of a charitable organization; (iv) purchases of assets for more than fair market value; and (v) certain joint ventures with commercial entities.

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1 As required by United States Treasury Regulations, this article is not intended or written to be used, and cannot be used, by any person for the purpose of avoiding penalties that may be imposed under the United States federal tax laws.

2 All references to the "Code" are to the Internal Revenue Code of 1986, as amended.

3 Gen. Couns. Mem. 35855 (June 17, 1974). The U.S. Tax Court has also adopted this approach. McGahen v. Comm'r, 76 T.C. 468, 482 (1981), *aff'd*, 720 F.2d 664 (3d Cir. 1983); Unitary Mission Church of Long Island v. Comm'r, 74 T.C. 507 (1980), *aff'd*, 647 F.2d 163 (2d Cir. 1981).

4 *See* Treas. Reg. § 1.501(a)-1(c); *see, e.g,* South Health Ass'n v. Comm'r, 71 T.C. 158, 188 (1978) (stating that the private inurement prohibition has generally been applied to an organization's founders or those in control of the organization).

5 *See, e.g.*, Texas Trade Sch. v. Comm'r, 30 T.C. 642 (1958) (holding that net earnings inured to insiders' benefit when the insiders leased property to an organization and caused it to make expensive improvements that would remain after the lease expired); Rev. Rul. 67-4, 1967-1 C.B. 123 (holding that an organization did not qualify for tax exemption because private inurement occurred when (i) the organization's principal asset was stock in the insiders' family-owned corporation, and (ii) the organization's trustees failed to vote against the corporation's issuance of a new class of preferred stock, diluting the organization's holdings); Tech. Adv. Mem. 9130002 (Mar. 19, 1991) (concluding that private inurement occurred when a hospital sold a facility to a private entity controlled by insiders for less than the fair market value).

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B. Private Benefit. A charitable organization may not confer a "private benefit" on persons who are not within the charitable class of persons who are intended to benefit from the organization's operations, unless the private benefit is purely incidental. The purpose of the private benefit limitation is to ensure that charitable organizations are operated for public purposes because of their special tax status.[6] 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.[7]

If an organization provides more than incidental private benefit, the organization's tax-exempt status may be revoked.[8]

The "private benefit doctrine" subsumes, and is technically distinct from, the private inurement doctrine, and is not limited to situations where benefits accrue to an organization's insiders.[9] The IRS has been more willing to accept the contention that incidental private benefit, as opposed to incidental private inurement, will not preclude or defeat tax exemption.[10]

II. *Joint Ventures with Insiders.*

A. Private Foundations. In general, a "private foundation" is a charitable organization that is funded by contributions from only a few sources (usually a single family or company) and that typically accomplishes its charitable purposes by making grants to other charitable organizations. Section 4941 of the Code imposes a tax on "disqualified persons" who participate in acts of self-dealing with a private foundation. In particular, Section 4941 of the Code prohibits direct or indirect acts of "self dealing" between a private foundation and those individuals or entities who are "disqualified persons" with respect to the foundation. For this purpose, the term "disqualified person" includes:

(1) a substantial contributor (one who contributes more than $5,000 to the foundation, if such contribution is more than 2% of the total contributions received before the end of the foundation's taxable year);
(2) a foundation manager;
(3) the owner of more than 20% of a business or trust which is a substantial contributor;

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6 *See* Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii). 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.

7 I.R.S. Gen. Couns. Mem. 39,598 (Jan. 23, 1987) (citations omitted). The Internal Revenue Service's balancing test was adopted by the Tax Court in *American Campaign Academy v. Commissioner*, 92 T.C. 1053 (1989).

8 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.

9 *See* Gen. Couns. Mem. 39876 (Aug. 10, 1992).

10 *See, e.g.,* Priv. Ltr. Rul. 200044039 (Nov. 6, 2000) (ruling that a contract would not defeat an organization's tax-exempt status because it resulted in no private inurement and no more than incidental private benefit).

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(4) a member of the family of any of the preceding;

(5) a corporation, trust, estate, or partnership more than 35% of which is owned or held by any of the preceding; or

(6) a government official.[11]

A "foundation manager" includes officers and directors of a private foundation and any employee who has the authority or responsibility with respect to an act that constitutes self-dealing.[12] A person is considered a "member of the family" if such person is the spouse, ancestor, child, grandchild or great grandchild of the individual who is a disqualified person.[13]

The prohibited acts of self-dealing, direct or indirect, between a disqualified person and a private foundation include the following:

(1) The sale, exchange or lease (other than a rent-free lease to a private foundation) of property between a private foundation and a disqualified person.

(2) The lending of money or other extension of credit between a private foundation and a disqualified person. An interest-free loan by a disqualified person to a private foundation is excepted from this prohibition, provided that the loan proceeds are used exclusively for exempt purposes.

(3) The furnishing of goods, services or facilities between a private foundation and a disqualified person (other than those furnished by a disqualified person to a private foundation without charge and for use exclusively for exempt purposes).

(4) The payment of compensation to a disqualified person for services unrelated to carrying out the foundation' s exempt purposes and the payment of excessive compensation (or payment or reimbursement of excessive expenses) by a private foundation to a disqualified person, except a government official, to whom the payment of compensation is even more severely proscribed.

(5) The transfer to or use by a disqualified person of the income or assets of a private foundation.

(6) The agreement by a private foundation to make any payment of money or other property to a government official, other than an agreement to employ such official for a period after termination from government employment and certain other limited types of payments.[14]

In considering whether a transaction between a private foundation and a disqualified person is an act of self-dealing, it is immaterial whether the transaction results in a benefit or detriment to the foundation.[15]

The initial tax on a disqualified person who participates in self-dealing is 10% of the amount involved.[16] In addition, the initial excise tax on a foundation manager who knowingly participates in an act of self-dealing between a disqualified person and a private foundation is 5% of the amount involved, unless such participation is not willful and is due to reasonable cause.[17] The initial excise tax on foundation managers is capped at $20,000.[18] If a disqualified person engages in an act of self-dealing with a private foundation, corrective action must be

11 I.R.C. § 4946(a)(1). The term "government official" is defined in Code Section 4946(c).

12 I.R.C. § 4946(b).

13 I.R.C. § 4946(d).

14 I.R.C. § 4941(d)(1), (2).

15 Treas. Reg. § 53.4941(d)-1(a).

16 I.R.C. § 4941(a)(1). The "amount involved" means the greater of the amount of money or fair market value of other property given by the private foundation or the amount of money or fair market value of other property received by the private foundation. I.R.C. § 4941(e)(2).

17 I.R.C. § 4941(a)(2).

18 *Id*.

taken to essentially undo the act of self-dealing to the extent possible and put the private foundation in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards.[19] The self-dealing excise tax is imposed each calendar year until the act of self-dealing is corrected.[20]

B. Public Charities. In general, a charitable organization is presumed to be a private foundation unless it can establish that it qualifies as a public charity under Sections 509(a)(1)–(3) of the Code. Types of public charities described under Section 509(a)(1) of the Code include churches, schools, hospitals, government entities and university endowment funds.[21] In addition, an organization which normally receives more than one-third of its total support from contributions from the general public is considered a public charity under Section 509(a)(1) of the Code.[22] An organization which receives more than one-third of its total support from exempt function revenues, such as admission fees to a museum or patient revenues for a hospital, is considered a public charity under Section 509(a)(2) of the Code, provided the organization does not normally receive more than one-third of its support from gross investment income. An organization which does not meet either of these tests may still qualify as a public charity under Section 509(a)(3) of the Code as a "supporting organization" of another public charity by virtue of the relationship between the first organization and the second public charity.

Section 4958 of the Code imposes an excise tax on disqualified persons who engage in excess benefit transactions with public charities. An "excess benefit transaction" is any transaction in which an economic benefit is provided by the public charity directly or indirectly to or for the use of any disqualified person, if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received in exchange for such benefit.[23] The term "transaction" is used very generally and includes a disqualified person's use of a charitable organization's property and services provided to a disqualified person without adequate payment. Prototypical examples of excess benefit transactions include paying excessive compensation to a director or officer or overpaying a director or officer for property the director or officer sells to the charitable organization. However, any direct or indirect benefit to a disqualified person may result in a violation of Section 4958 if the disqualified person does not provide adequate consideration for the benefit.

The term "disqualified person" includes any person who was, at any time during the 5-year period ending on the date of the transaction, in a position to exercise substantial influence over the affairs of the organization.[24] Some persons, including (but not limited to) board members, the president or chief executive officer, the treasurer or chief financial officer, family members of such individuals, and entities in which such individuals own 35% of the interests, are automatically considered "disqualified."[25] Where a person is not automatically disqualified, all of the facts and circumstances will generally be considered to determine if the person has substantial influence over the affairs of the organization.[26] Being a substantial contributor to the organization is a fact tending to show that the person has

[19] I.R.C. § 4941(e)(3). The Treasury Regulations contain specific procedures to correct certain acts of self-dealing between a private foundation and a disqualified person. *See* Treas. Reg. § 53.4941(e)-1(c).

[20] I.R.C. § 4941(a), (e)(1).

[21] I.R.C. §§ 509(a)(1), 170(b)(1)(A)(i)-(v).

[22] I.R.C. §§ 509(a)(1), 170(b)(1)(A)(vi); Treas. Reg. § 1.170A-9(e)(2).

[23] I.R.C. § 4958(c)(1).

[24] I.R.C. § 4958(f)(1).

[25] Treas. Reg. § 53.4958-3(c).

[26] Treas. Reg. § 53.4958-3(e).

substantial influence and is therefore disqualified.[27]

When it applies, Section 4958 imposes an initial tax equal to 25% of the excess benefit on any disqualified person. [28] A tax of 10% of the excess benefit is imposed on any organization manager, i.e., any officer, director, or trustee of the organization, who knowingly participates in the transaction.[29] The initial excise tax on organization managers is capped at $20,000.[30] If a disqualified person engages in an excess benefit transaction with a public charity, corrective action must be taken to essentially undo the excess benefit to the extent possible and to take any additional measures to put the public charity in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards.[31]

The Treasury regulations provide for a procedure, which if followed, creates a rebuttable presumption that a transaction between a public charity and a disqualified person will not constitute an excess benefit transaction within the meaning of Section 4958 of the Code. These procedures apply to fixed payments and, with minor additional requirements, to non-fixed payments subject to a cap.[32] Legislative history indicates that compensation arrangement or other financial transactions will be presumed to be reasonable if the transaction arrangement was approved in advance by an independent board (or an independent committee of the board) that (1) was composed entirely of individuals unrelated to and not subject to the control of the disqualified person, (2) obtained and relied upon appropriate data as to comparability, and (3) adequately documented the basis for its determination.[33] The Treasury Regulations read into the legislative history three distinct requirements: (1) approval by an authorized body, (2) the appropriate data as to comparability, and (3) the documentation.[34]

1. Approval by an Authorized Body. The authorized body may be the Board of Directors or a committee duly authorized under state law to act on behalf of the Board of Directors.[35] A person is not considered part of the authorized body if he merely meets to provide information to the board and then recuses himself.[36] No person voting on the matter may have a conflict of interest with respect to the transaction.[37] A member of the authorized body does not have a conflict of interest if the member:

i. is not the disqualified person or related to any disqualified person who benefits from the transaction;
ii. is not employed by or controlled by any disqualified person benefiting from the transaction;
iii. is not receiving compensation or other payments from a disqualified person benefiting from the transaction;
iv. has no material financial interest affected by the compensation arrangement or transaction; and
v. does not approve a transaction providing economic benefits to any disqualified person participating in the compensation arrangement or transaction, who in turn has approved or will approve a transaction providing economic benefits to the member.[38]

27 Treas. Reg. § 53.4958-3(e)(2).
28 I.R.C. § 4958(f)(1).
29 I.R.C. § 4958(a)(2).
30 I.R.C. § 4958 (d)(2).
31 I.R.C. § 4958(f)(6). The Treasury Regulations contain specific procedures to correct certain excess benefit transactions between a public charity and a disqualified person. See Treas. Reg. § 53.4958-7.
32 Non-fixed payments to a disqualified person not subject to a cap are generally not advisable.
33 H.R. Rep. No. 104-506, at 56-57.
34 Treas. Reg. § 53.4958-6(a)(1)-(3).
35 Treas. Reg. § 53.4958-6(c)(1)(i)(A)-(C).
36 Treas. Reg. § 53.4958-6(c)(1)(ii).
37 Treas. Reg. § 53.4958-6(a)(1).
38 Treas. Reg. § 53.4958-6(c)(1)(iii)(A)-(E).

2. Appropriate Data as to Comparability. The authorized body must have sufficient information to determine whether a compensation arrangement or other transaction will result in the payment of reasonable compensation or a transaction for fair value. Relevant information includes, but is not limited to:

i. compensation levels paid by other similarly-situated organizations (taxable or tax-exempt);
ii. availability of similar services in the applicable geographic area;
iii. independent compensation surveys;
iv. written offers from similar institutions competing for the services of the person;
v. independent appraisals of all property to be transferred; or
vi. offers for property received as part of an open and competitive bidding process.[39]

3. Documentation. For the decision to be adequately documented, the records of the authorized body must note:

i. the terms of the transaction and the date it was approved;
ii. the members of the authorized body who were present during the debate on the transaction or arrangement and those who voted on it;
iii. the comparability data obtained and relied upon and how the data was obtained;
iv. the actions taken with respect to consideration of the transaction by anyone who is otherwise a member of the authorized body but who had a conflict of interest with respect to the transaction; and
v. the basis for any deviation from the range of comparable data obtained.[40]

III. Joint Ventures with Third Parties. Participation in joint ventures affords charitable organizations with numerous opportunities, such as to (1) further their exempt purposes, (2) diversify their revenue source, and (3) obtain needed capital or expertise in an increasingly competitive economic environment.[41] While these types of business arrangements can be highly profitable and truly beneficial to both the charitable and for-profit organizations involved, there is a serious risk for the participating charitable organization. The failure of the charitable organization to protect its charitable assets can lead the loss its federal tax exemption.

Prior to 1982, a charitable organization automatically ceased to qualify as tax exempt under Code Section 501(c)(3) when it served as a general partner in a partnership that included private investors as limited partners. The IRS's reasoning was that the obligations of the charitable general partner to its for-profit limited partners were incompatible with its requirement to operate exclusively for charitable purposes. The IRS's per se opposition to charitable organizations' involvement in joint ventures with for-profit investors was abandoned, however, in 1982, with the issuance of the *Plumstead Theatre Society* decision.

A. Plumstead Theatre Society v. Commissioner. In *Plumstead*, the Ninth Circuit Court of Appeals held that a charitable organization's participation as a general partner in a limited partnership involving private investors did not

[39] Treas. Reg. § 53.4958-6(c)(2)(i).

[40] Treas. Reg. § 53.4958-6(c)(3)(i)(A)-(D), (ii). Moreover, such records must be prepared by the next meeting of the authorized body (or within 60 days after the final action of the authorized body, if later than the next meeting) and must be reviewed and approved as reasonable, accurate and complete within a reasonable time period thereafter. Treas. Reg. § 53.4958-6(c)(3)(ii).

[41] *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).

jeopardize its tax exempt status.[42] The theatre company at question co-produced a play as one of its charitable activities. Prior to the opening of the play, the theatre company encountered financial difficulties in raising its share of costs.[43] In order to meet its funding obligations, the theatre company formed a limited partnership in which it served as general partner, and two individuals and a for-profit corporation were the limited partners. The IRS denied tax-exempt status to the theatre company on the grounds that it was not operated exclusively for charitable purposes. Based on the safeguards contained in the limited partnership agreement, which served to insulate the theatre company from potential conflicts with its exempt purposes, the Ninth Circuit Court of Appeals disagreed with the IRS, holding that the theatre company *was* operated exclusively for charitable (and educational) purposes, and therefore was entitled to tax exemption. One of the significant factors supporting the court's holding was its finding that the limited partners had no control over the theatre company's operations or over the management of the partnership.[44] Another significant factor was that the theatre company was not obligated for the return of any capital contribution made by the limited partners from the theatre company's own funds.[45]

Following its defeat in this landmark court decision, the IRS abandoned its prior per se opposition and formulated the basis on which charitable organizations could become general partners in joint ventures without violating the terms of their exemption.

B. <u>The IRS's Two-Part Test for Joint Ventures</u>. Soon after *Plumstead*, the IRS issued General Counsel Memoranda 39005 in which it set forth the required analysis in testing a charitable organization's participation as a general partner in a limited partnership involving private investors. The IRS used a two-prong "close scrutiny" test to determine the permissibility of joint venture arrangements between charitable and for-profit organizations. The IRS reiterated that participation by a charitable organization as a general partner in a limited partnership with private investors would not per se endanger its tax exempt status.[46] However, close scrutiny would be necessary to ensure that the obligations of the charitable organization as general partner do not conflict with its ability to pursue exclusively charitable goals.[47]

> Thus, in all partnership cases, the initial focus should be on whether the joint venture organization furthers a charitable purpose. Once charitability is established, the partnership agreement itself should be examined to see whether the arrangement permits the exempt party to act exclusively in furtherance of the purposes for which exemption is granted, and not for the benefit of the limited partners.[48]

The foregoing required a finding that the benefits received by the limited partners are incidental to the public purposes served by the partnership.[49]

In other words, the two-pronged "close scrutiny" test requires that: (1) the activities of the joint venture further the charitable purposes of the charitable organization; and (2) the structure of the venture insulate the charitable organization from potential conflicts between its charitable purposes and its joint venture obligations, and minimizes the likelihood that the arrangement will generate private benefit. If the charitable organization fails to satisfy either test and the activities of the joint venture are

[42] Plumstead Theatre Society v. Comm'r, 675 F.2d 244 (9th Cir. 1982) *aff'g* 74 T.C. 1324 (1980).
[43] *Id*.
[44] Priv. Ltr. Rul. 200502046 (Oct. 18, 2004).
[45] *Id*.

[46] Gen. Couns. Mem. 39005 (June 28, 1983).
[47] *Id*.
[48] *Id*.
[49] *Id*.

substantial, the IRS may seek to revoke the charitable organization's tax exemption.

C. Control by the Charitable Organization is a Key Factor. In evaluating joint ventures between charitable organizations and for-profit organizations, the focus of the IRS in applying the two-pronged close scrutiny test eventually evolved into a "facts-and-circumstances" determination. This determination focused on whether the charitable organization retained sufficient control over the joint venture activities, thereby ensuring that the organization's own charitable purposes were furthered or accomplished through its participation in the joint venture and no more than incidental benefit, financial or otherwise, was conferred on the for-profit participants.

1. Revenue Ruling 98-15. Revenue Ruling 98-15 was the first guidance with precedential value promulgated by the IRS with respect to joint ventures between charitable organizations and for-profit entities.[50] The ruling incorporates the two-part close scrutiny test set forth in General Counsel Memorandum 39005 with a focus on whether charitable organizations "control" the ventures in which they participate.[51] The IRS saw the charitable organization's control of the venture as crucial because it provided the charitable organization with an ability to ensure that the venture's activities were exclusively in furtherance of the charitable organization's exempt purposes and served as a safeguard against too much benefit, financial or otherwise, being conferred on the for-profit participants.

Revenue Ruling 98-15 describes two scenarios: one "good" and one "bad" joint venture involving nonprofit and for-profit healthcare organizations.[52] The IRS scrutinizes a variety of factors that determine whether the nonprofit has sufficient control over the venture.[53] Although Revenue Ruling 98-15 lists a number of relevant factors, four factors appear to be most significant: (1) governance control of the joint venture; (2) control of day-to-day operations of the joint venture; (3) management of conflicts of interest between the tax-exempt and for-profit participants; and (4) priority of charitable purposes over profit motives in the joint venture operations.

Based on substantial scrutiny of Revenue Ruling 98-15 after its release, several conclusions can be drawn. First, charitable organizations may participate in a joint venture with private investors and not automatically jeopardize their tax-exempt status. Second, in such situations, the joint venture agreement should clearly provide that the charitable partner's charitable purposes supersede any financial or private concerns in the event of a conflict between those goals. In addition, all contracts and agreements between the joint venture and another for-profit entity, such as a management agreement, must be entered into at arm's length and reflect commercially reasonable terms. Finally, Revenue Ruling 98-15 clearly favors the control of the joint venture's governing body by the charitable organization and elevates this component to unprecedented importance.[54]

2. Redlands Surgical Services v. Commissioner. In *Redlands*, the Tax Court upheld the IRS's denial of tax exempt status to a charitable organization which formed a joint venture with for-profit organizations.[55] In arriving at its decision that private, rather than charitable, interests were being served, the court examined various factors similar to the factors the IRS enunciated in Revenue Ruling 98-15.[56] The court noted, most

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50 Rev. Rul. 98-15, 1998-1 C.B. 17.
51 *Id*.
52 Rev. Rul. 98-15, 1998-1 C.B. 17.

53 *Id*.
54 *See generally* Mirkay, *supra* note 41.
55 Redlands Surgical Services v. Comm'r, 113 T.C. 47 (1999), *aff'd*, 242 F.3d 904 (9th Cir. 2001).
56 *Id*.

significantly, that there was a lack of any express or implied obligation of the for-profit parties to place charitable objectives ahead of for-profit objectives.[57] Moreover, the relevant organizational documents did not include an overriding charitable purpose.[58] The Tax Court held that the requirement that a charitable organization operate exclusively for charitable purposes is not satisfied merely by establishing "whatever charitable benefits [the partnership] may produce," finding that the charitable partner lacked "formal or informal control sufficient to ensure furtherance of charitable purposes."[59] Affirming the Tax Court, the Ninth Circuit Court of Appeals held that ceding "effective control" of partnership activities impermissibly serves private interests.[60] *Redlands* provides that a charitable organization may form partnerships, or enter into contracts, with private parties to further its charitable purposes on mutually beneficial terms, "so long as the charitable organization does not thereby impermissibly serve private interests."[61]

3. <u>St. David's Health Care System v. United States</u>. The issue of whether a charitable organization's participation in a joint venture with for-profit participants would cause loss of the charitable organization's tax exempt status was revisited in *St. David's*, a case tried right here in Austin. Relying on Revenue Ruling 98-15 and *Redlands*, the Fifth Circuit Court of Appeals focused on the issue of the charitable organization's control over the joint venture, ultimately concluding that genuine issues of material fact existed with respect to whether the charitable organization "ceded control" of its tax-exempt hospital.[62] The court held that the determination of whether a charitable organization that enters into a partnership with for-profit partners operates exclusively for exempt purposes is not limited to "whether the partnership provides some (or even an extensive amount of) charitable services."[63] The charitable partner also must have the "capacity to ensure that the partnership's operations further charitable purposes."[64] Thus, "the [charity] should lose its tax-exempt status if it cedes control to the for-profit entity."[65] The Fifth Circuit ultimately wanted to see majority control by the charitable organization. The IRS continues to view its position on control of the joint venture by the charitable organization, as supported by the *St. David's* decision, as the "proper framework" for analyzing joint ventures between charitable organizations and for-profit entities.[66]

4. <u>Revenue Ruling 2004-51</u>. Revenue Ruling 2004-51 is the first instance in which the IRS acknowledges and supports equal ownership by charitable and for-profit participants in a joint venture, provided some protections are in place to ensure the furtherance of the charitable organization's exempt purposes.[67] The ruling pointedly looks at which partner controls the exempt activities. If the charitable partner controls the exempt activities, the joint venture presumably will not endanger the tax exemption of the charitable organization. Specifically, Revenue Ruling 2004-51 involved an exempt university that formed a limited liability company with a for-profit entity to provide distance learning via interactive video. Ownership of the joint venture was split equally between the university and the for-profit partner, but the university controlled the academic portion

[57] *Id*.
[58] *Id*.
[59] *Id*.
[60] 242 F.3d 904 (9th Cir. 2001).
[61] Rev. Rul. 2004-51, 2004-1 C.B. 974 (quoting Redlands Surgical Services v. Comm'r, 113 T.C. 47 (1999))
[62] St. David's Health Care System v. United States, 349 F.3d 232 (5th Cir. 2003).
[63] *Id*. at 243.
[64] *Id*.
[65] *Id*. at 239.
[66] *Id*.
[67] Rev. Rul. 2004-51, 2004-1 C.B. 974.

of the joint venture's activities, while the for-profit partner provided and controlled production expertise. The ruling concluded that the university's exempt status was not affected by the joint venture because the activities constituted an insubstantial part of the university's activities.[68] The ruling also implies that fifty-fifty control of the joint venture is acceptable as long as the charitable partner controls the charitable aspects of the joint venture.[69]

Even though Revenue Ruling 2004-51 marks an indisputable movement forward in the IRS's stance regarding the proper federal income tax treatment of joint ventures between charitable organizations and for-profit organizations, the ruling stops short of answering all of the questions and issues raised by venturers. In particular, Revenue Ruling 2004-51 does not modify Revenue Ruling 98-15. Therefore, the control requirement set forth in Revenue Ruling 98-15 is still viewed as essential by the IRS, continuing to raise questions as to how and when it may be applied.

IV. Unrelated Business Income Tax ("UBIT"): General Rules.[70]

A. Definition of Unrelated Business. Since the 1950s, 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. 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.[71] Organizations described in Section 501(c)(3) of the Code are generally subject to income tax on the net income produced from engaging in an unrelated trade or business activity.[72] The term "unrelated trade or business" means an activity conducted by a tax-exempt organization which is regularly carried on[73] for the production of income from the sale of goods or performance of services[74] and which is not substantially related to the performance of the organization's charitable, educational or other exempt functions.[75]

1. Activity is a "Trade or Business." For purposes of the unrelated business income tax regime, "the term 'trade or business' has the same meaning it has in Section 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of services."[76] Section 162 of the 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

[68] *Id*.
[69] *Id*. Revenue Ruling 2004-51 further stated that the limited liability company's activities would not generate unrelated business income for the university because (1) the university had exclusive control over the educational content, (2) all contracts entered into by the limited liability company were at arms length and for fair market value, (3) allocations and distributions were proportional to each member's ownership interest, (4) the video courses covered the same content as the university's traditional classes, and (5) the video courses increased access to the university's educational programs. *Id*.
[70] Portions of this discussion on unrelated business income are extracted from the author's previously published article, *The Taxation of Cause-Related Marketing*, 85 CHI-KENT L. REV. 883 (2010).

[71] *See* Treas. Reg. § 1.513-1(b) ("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.").

[72] *See* I.R.C. § 511.

[73] Treas. Reg. § 1.513-1(a).

[74] I.R.C. § 513(c); Treas. Reg. § 1.513-1(b).

[75] I.R.C. § 513(a).
[76] Treas. Reg. § 1.513-1(b).

the activity with continuity and regularity and . . . the taxpayer's primary purpose for engaging in the activity must be for income or profit."[77] When applying this test, the IRS 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."[78]

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.'"[79] Significant weight is given to objective factors such as whether the activity is similar to profit-making activities conducted by commercial enterprises.[80] When the activity involved is highly profitable and involves little risk, courts generally infer the presence of a profit motive.[81] 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 business.[82]

2. Regularly Carried On Requirement. In general, in determining whether a trade or business is "regularly carried on," one must consider the frequency and continuity with which the activities productive of income are conducted, and the manner in which they are pursued. Business activities are deemed to be "'regularly carried on' if they manifest a frequency and continuity, and are pursued in a manner, generally similar to comparable commercial activities of nonexempt organizations."[83] 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 *[sic]*."[84] 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."[85] However, "[w]here income producing activities are of a kind normally undertaken by nonexempt

[77] Comm'r v. Groetzinger, 480 U.S. 23, 35 (1987).

[78] Treas. Reg. § 1.513-1(b). *But see* La. Credit Union League v. United States, 693 F.2d 525, 542 (5th Cir. 1982) ("[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.").

[79] 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).

[80] Ill. Ass'n of Prof'l Ins. Agents v. Comm'r, 801 F.2d 987, 992 (7th Cir. 1986).

[81] *See, e.g.*, Carolinas Farm & Power Equip. Dealers Ass'n, Inc. 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 Ill. State Troopers Lodge No. 41 v. Comm'r, 87 T.C. 747, 756 (1986), *aff'd*, 833 F.2d 717 (7th Cir. 1987) (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).

[82] *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").

[83] Treas. Reg. § 1.513-1(c)(1).

[84] Treas. Reg. § 1.513-1(c)(2)(i).

[85] Treas. Reg. § 1.513-1(c)(2)(iii).

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."[86]

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.[87] 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.[88]

Furthermore, in determining whether an exempt organization's business activities are "regularly carried on," the activities of the organization's agents may be taken into account.[89] Courts disagree as to whether an exempt organization's preparation time in organizing and developing an income-producing activity may be taken into account.[90]

3. Unrelated to the Charity's Exempt Purpose. In the event the charity's activities are determined to be regularly carried on, the next inquiry is whether such activities are related to the charity's purposes which constitute the basis for its exemption.[91] This in an inherently factual determination. To determine whether the business activity is "related," the relationship between the conduct of the business activities that generate the income and the accomplishment of the organization's exempt purposes must be examined to determine whether a causal relationship exists.[92] The activity will not be substantially related merely because the income produced from the activity is used to further the organization's exempt purposes.[93] Rather, the inquiry focuses on the manner in which the income is earned. Thus, a substantial causal relationship exists

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[86] Treas. Reg. § 1.513-1(c)(2)(i).

[87] Veterans of Foreign Wars, Dept. of Mich. v. Comm'r, 89 T.C. 7, 32-37 (1987).

[88] *See* Treas. Reg. § 1.513-1(c)(2)(iii) (stating 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, Inc. 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.")

[89] 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).

[90] *See* Nat'l Collegiate Athletic Ass'n 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); A.O.D. 1991-015 (indicating that the IRS will continue to litigate the issue).

[91] *See* Treas. Reg. § 1.513-1(d)(1).

[92] Treas. Reg. § 1.513-1(d)(1).

[93] I.R.C. § 513(a); Treas. Reg. § 1.513-1(d)(1).

if the distribution of the goods from which the income is derived contributes importantly to the accomplishment of the organization's exempt purposes.[94] In each case, the determination of whether this relationship exists depends on the facts and circumstances involved. In making this determination, the size and extent of the activities involved are considered in relation to the nature and extent of the exempt functions they are serving.[95] If the activities are conducted on a scale larger than is reasonably necessary to accomplish the exempt purposes, the income attributed to the excess activities constitutes unrelated business income.[96]

B. Exceptions and Modifications. The term "unrelated trade or business" is subject to several exceptions under which certain businesses that may otherwise constitute unrelated businesses are removed from the scope of the tax. In particular, the term "unrelated trade or business" does not include a trade or business in which substantially all the work in carrying on the trade or business is performed for an organization without compensation.[97] Unlike the other exceptions, the "volunteer exception" is not restricted as to the nature of the businesses to which it pertains. In addition, the term "unrelated trade or business" does not include the trade or business of selling merchandise, substantially all of which has been received by the organization as gifts or contributions.[98] Finally, an exception from the unrelated business income tax is also provided for income derived from the distribution of low cost articles incident to the solicitation of charitable contributions.[99]

1. Passive Activities Generally. The purpose of the unrelated business income tax is to eliminate the conduct of unrelated businesses by tax exempt organizations as a source of unfair competition with for-profit companies. To the extent that income of a tax exempt organization is derived from investment and other passive activities, the taxation of such income is not necessary to accomplish this goal. Accordingly, the modifications to the unrelated business income tax exclude most passive income, as well as the deductions associated with such passive income, from the scope of the tax.[100] In particular, the following types of passive income are excluded from unrelated business taxable income:

i. dividends;[101]
ii. interest;[102]
iii. annuities;[103]
iv. payments with respect to securities loans;[104]
v. amounts received or accrued as consideration for entering into agreements to make loans;[105]
vi. royalties;[106]

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[94] Treas. Reg. § 1.513-1(d)(2).

[95] *See* I.R.C. § 511.

[96] *Id*.

[97] I.R.C. § 513(a)(1).

[98] I.R.C. § 513(a)(3).

[99] I.R.C. § 513(h). For tax years beginning in 2012, a low-cost article is one which has a cost to the organization of $9.90 or less. Rev. Proc. 2011-52, 2011-45 I.R.B.

[100] *See generally* Trinidad v. Sagrada Orden de Predicadores, 263 U.S. 578 (1924).

[101] I.R.C. § 512(b)(1).

[102] I.R.C. § 512(b)(1).

[103] I.R.C. § 512(b)(1).

[104] I.R.C. § 512(b)(1). The term "payments with respect to securities loans," refers to income derived from a securities lending transaction in which an exempt organization loans securities from its portfolio to a broker in exchange for collateral. I.R.C. § 512(a)(5). Payments derived from a securities lending transaction typically include interest earned on the collateral and dividends or interest paid on the loaned securities while in the possession of the broker.

[105] I.R.C. § 512(b)(1).

[106] I.R.C. § 512(b)(2). 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. Rev. Rul. 81-178, 1981-2 C.B. 135. By contrast, the payment for personal services does not constitute a royalty. *Id.*

vii. gains or losses from the sale, exchange, or other disposition of property other than inventory;[107] and

viii. gains or losses recognized in connection with a charitable organization's investment activities from the lapse or termination of options to buy or sell securities or real property.[108]

2. Rents. In addition, certain rents are excluded from unrelated business taxable income.[109] The exclusion applies to rents from real property and rents from personal property leased with such real property, provided that the rents attributable to the personal property are an incidental amount of the total rents received or accrued under the lease.[110] Three principal exceptions limit the ability of a charitable organization to exclude the eligible rents described above from unrelated business taxable income. The exceptions apply when there are excessive personal property rents, when rent is determined by net profits from the property, and when certain services are rendered to the lessee. Under the first exception, the rental exclusion does not apply if more than 50% of the total rent received or accrued under the lease is attributable to personal property, determined at the time the personal property is first placed in service.[111] Under the second exception, the rental exclusion is not available if the determination of the amount of rent depends in whole or in part on the income or profits derived by any person from the leased property, other than an amount based on a fixed percentage or percentages of receipts or sales.[112] Under the third exception, payments for the use or occupancy of rooms or other space where services are also rendered to the occupant do not constitute rent from real property.[113] As a general rule, services are considered to be rendered to the occupant if the services are (a) primarily for the convenience of the occupant, and (2) other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only.[114]

3. Royalties. 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.[115] Accordingly, section 512 of the Code provides that a charity's UBTI generally does not include royalties.[116] 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.[117] 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.

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 minimis* services in connection with the arrangement.[118] 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

[107] I.R.C. § 512(b)(5).
[108] I.R.C. § 512(b)(5).
[109] I.R.C. § 512(b)(3).
[110] I.R.C. § 512(b)(3)(A).
[111] I.R.C. § 512(b)(3)(B)(i).
[112] I.R.C. § 512(b)(3)(B)(ii).
[113] Treas. Reg. § 1.512(b)-1(c)(5).
[114] *Id.*
[115] *See* Sierra Club Inc. v. Comm'r, 86 F.3d 1526, 1533 (9th Cir. 1996).
[116] I.R.C. § 512(b)(2); Treas. Reg. § 1.512(b)-1(b). A charity's UBTI would include royalties derived from debt-financed property. Treas. Reg. § 1.512(b)-1(b).
[117] Rev. Rul. 81-178, 1981-2 C.B. 135.
[118] *Sierra Club*, 86 F.3d at 1533–35.

the income would most likely be subject to tax as UBTI.[119]

For example, 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.[120] 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. The Internal Revenue Service determined that these services performed by the charity in connection with the licensing arrangement were *de minimis*. 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. The Internal Revenue Service concluded that the income that the charity would receive from the arrangement was "vastly out of proportion with the time and effort" the charity would expend. Therefore, it could only be compensation for the use of the charity's intellectual property.

The determination of the permissible amount of "insubstantial services" 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.[121] 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.[122] 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 minimis* 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 sponsor's product. 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 could be the basis for considering such income as

119 *See* Rev. Rul. 81-178.

120 Priv. Ltr. Rul. 200601033 (Oct. 14, 2005).

121 *See, e.g.*, Rev. Rul. 81-178, 1981-2 C.B. 135; Priv. Ltr. Rul. 200601033 (Oct. 14, 2005); Priv. Ltr. Rul. 9029047 (Apr. 27, 1990)

122 *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).

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 . . . .[123]

4. Corporate Sponsorships. 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.[124] A "qualified sponsorship payment" is "any payment[125] 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."[126] A "substantial return benefit" is any benefit other than a "use or acknowledgement"[127] of the corporate sponsor and certain disregarded benefits.[128] Substantial benefits include the charitable organization's provision of facilities, services, or other privileges to the sponsor; exclusive provider relationships;[129]

[123] CONG. BUDGET OFFICE, PUB. NO. 3005, TAX PREFERENCES FOR COLLEGIATE SPORTS 13 (2009).

[124] I.R.C. § 513(i); Treas. Reg. § 1.513-4(a). 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.

[125] "Payment" means "the payment of money, transfer of property, or performance of services." *Id.* § 1.513-4(c)(1).

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

[127] 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.*

[128] *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.*

[129] 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

and any license to use intangible assets of the charitable organization.[130] "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."[131] The exempt organization has the burden of establishing the fair market value of the substantial return benefit. If the organization fails to do so, "no portion of the payment constitutes a qualified sponsorship payment."[132]

The tax treatment of any payment that does not represent income from a qualified sponsorship payment is governed by general UBIT principles.[133] 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.[134] 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. 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. 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 total payment attributable to the value of the license would be excluded from the university's UBTI as a royalty payment.

If the corporate sponsorship involves the charity's endorsement of the corporate sponsor's product or services, then the income from the corporate sponsorship will likely be included in the charity's UBTI as advertising income. "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."[135] 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."[136] For example, the Internal

connection with an activity, the payor has received a substantial return benefit." *Id.*

130 *Id.* § 1.513-4(c)(2)(iii)(D).

131 *Id.* § 1.513-4(d).

132 *Id.*

133 *Id.* § 1.513-4(f).

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

135 Treas. Reg. § 1.513-4(c)(v).

136 *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* Tech. Adv. Mem. 9417003 (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 charity to rely upon such a position. *See generally* I.R.S. Announcement 2000-84, 2000-42 I.R.B. 385

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Revenue 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,"[137] and (ii) "Visit the Music Shop today for the finest selection of music CDs and cassette tapes."[138] 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.[139]

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*,[140] the leading case on this topic. There, an exempt physicians' organization received income from the sale of advertising in its professional journal. The messages in question consisted of advertisements for "pharmaceuticals, medical supplies, and equipment useful in the practice of internal medicine." 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." The organization argued that these advertisements were substantially related to its exempt functions because they contributed to the education of the journal's readers. At trial, experts testified that "drug advertising performs a valuable function for doctors by disseminating information on recent developments in drug manufacture and use."[141] 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 recent developments . . . . Some ads

(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).

137 *Id.* § 1.513-4(f), example 7.

138 *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.*, Tech. Adv. Mem. 9805001 (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).

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

140 475 U.S. 834 (1986).

141 *Id.* at 847.

> 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.[142]

C. Payments Between Controlled Groups. When a charitable organization receives a "specified payment" from another entity which it controls, the payment is treated as unrelated business income to the extent the payment reduces the trade or business income of the controlled entity.[143] The term "specified payment" means any interest, annuity, royalty, or rent paid to the controlling organization.[144] For purposes of this rule, the term control means (1) in the case of a corporation, ownership (by vote or value) of more than 50% of the stock in a corporation,[145] or (2) in the case of a partnership, ownership of more than 50% of the profits interest or capital interest in a partnership.[146] In determining control, the constructive ownership rules of Code section 318 apply.[147] If a partnership owns stock in a corporation, ownership of the corporation will be attributed to the partners in the same proportion in which the partners hold their interests in the partnership.[148] In addition, if a shareholder owns 50% or more of the value of the stock in a corporation, stock in another entity owned by the corporation is considered as owned by its shareholder in proportion to the shareholder's ownership interest in the corporation.[149]

Code Section 318 is silent with respect to applying attribution rules among tax exempt organizations. On its face, Code Section 318 does not seem to attribute ownership in an entity from one nonstock

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[142] *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).

[143] I.R.C. § 512(b)(13)(A). A modification to this rule applies to "qualifying specified payments" (i.e., specified payments made pursuant to a binding written contract in effect on Aug. 17, 2006) received or accrued after Dec. 31, 2005 and before Jan. 1, 2010. Under the modified rule, only the excess payments – the portion of the "qualifying specified payment" received or accrued by the controlling organization that exceeds the amount which would have been paid or accrued if such payment met the requirements prescribed under Code section 482 – is included in the controlling organization's UBTI, and only to the extent such excess payment reduces the trade or business income of the controlled entity. I.R.C. § 512(b)(13)(E).

[144] I.R.C. § 512(b)(13)(C).

[145] I.R.C. § 512(b)(13)(D)(i)(I).

[146] I.R.C. § 512(b)(13)(D)(i)(II).

[147] I.R.C. § 512(b)(13)(D)(ii).

[148] I.R.C. § 318(a)(2)(A).

[149] I.R.C. § 318(a)(2)(C).

tax exempt organization to another because the attribution rules focus on one's ownership interest in an organization. Ownership is not an appropriate criterion for tax exempt organizations because no one has an ownership interest in a nonstock tax exempt organization. For example, if two tax exempt organizations, which have identical boards of directors, each own a 50% interest in a for-profit corporation, the constructive ownership rules of Code Section 318 would not seem to attribute the ownership of the corporation's stock from one of the tax exempt organizations to the other.[150] Thus, since both tax exempt entities would own only 50% of the corporation's stock, the corporation would not be controlled by either tax exempt organization.[151] As a result, interest paid from the for-profit corporation to the tax exempt shareholders would not be considered unrelated business income.

However, by analogizing the principles of former Code Section 512(b)(13), ownership in an entity by one tax-exempt organization may be attributed to another tax-exempt organization if there is a common degree of management between the two tax-exempt organizations.[152] Former Code Section 512(b)(13) defined control by reference to Code Section 368(c) which provides that ownership of at least 80% of the corporation's stock effectuated control.[153] In applying the principles of Section 368(c), Treasury Regulation Section 1.512(b)-1(l)(4)(i)(b) states that in the context of nonstock tax-exempt organizations, control exists between two or more tax-exempt organizations in which more than 50% of the governing boards overlap.[154]

D. Unrelated Debt Financed Income. Property acquired by an exempt organization with borrowed funds may be considered debt-financed property.[155] Debt-financed property is property held by a charitable organization to produce income that is encumbered by acquisition indebtedness at any time during the taxable year.[156] The term "acquisition indebtedness" refers to acquisition or indebtedness incurred in connection with the acquisition or improvement of property, whether the debt is incurred before, after, or at the time of acquisition.[157] There are several exceptions to the term acquisition indebtedness, including exceptions for property acquired by gift, bequest, or devise, indebtedness incurred in performing the organization's exempt function, and certain real property acquired by educational organizations, qualified plans, and multiple-parent title holding organizations.[158] Exceptions under which property acquired with financing escapes classification as debt-financed property include property used by an organization in performing its exempt function, property used in an unrelated trade or business, and property acquired for prospective exempt use.[159]

A certain portion of income derived from debt-financed property must be included in unrelated business taxable income as an item of gross income derived from an unrelated trade or business.[160] Similarly, a certain portion of the deductions

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[150] Robert A. Wexler & Lisa R. Appleberry, *TRA '97 Brings Charities a Little Relief . . . and Maybe a Lot of Grief*, 87 J. TAX'N 360, 363 (1997).

[151] *See* I.R.C. § 512(b)(13)(D).

[152] *See* Wexler & Appleberry, *supra* note 150 at 363; *see also* Priv. Ltr. Rul. 199941048 (Oct. 18, 1999).

[153] Former I.R.C. § 512(b)(13) (repealed by P.L. 105-34 § 1041(a)) (effective for tax years beginning before August 6, 1997).

[154] Wexler & Appleberry, *supra* note 150 at 363.

[155] I.R.C. § 514(b).

[156] I.R.C. § 514(b)(1).

[157] I.R.C. § 514(c)(1).

[158] I.R.C. § 514(c).

[159] I.R.C. § 514(b)(1), (3).

[160] I.R.C. § 514(a)(1).

directly connected with debt-financed property are allowed as deductions in computing unrelated business taxable income.[161] The portion of income and deduction that must be taken into account is determined by applying a debt/basis percentage, which is equal to the ratio of the average acquisition indebtedness for the taxable year with respect to the property over the average amount of the adjusted basis of the property during the period it is held by the organization during the taxable year.[162]

The treatment of income and deductions from debt-financed property described above overrides the modifications from unrelated business taxable income otherwise provided for dividends, interest, payments with respect to securities loans, annuities, loan commitment fees, royalties, rents, and gains and losses from the sale, exchange, or other disposition of property.[163] In other words, the amount ascertained under the debt-financed property rules is expressly required to be included as an item of gross income derived from an unrelated trade or business despite the fact that the source of such income is passive in nature.

E. Partnerships. Section 702(b) of the Code provides that the character in the hands of a partner of an item of partnership income is determined as if the item were realized directed from the source from which realized by the partnership. For example, if an entity's share of partnership income is derived from debt-financed property, the income from the property is generally taxable as debt-financed income.[164]

Technical Advice Memorandum 9651001 indicates that the use of multiple pass-through entities does not change this result.[165] There, an exempt organization ("X") held an interest in a limited partnership ("Z"). Z in turn owned an interest in a joint venture ("Venture"). Venture owned property that was collateral for a mortgage note. X eventually sold its interest in Z. The issue in the Technical Advice Memorandum was whether this sale was subject to unrelated business income tax under Section 511 of the Code because Z owned debt-financed property. The IRS concluded that it was, explaining, "[a]n interest in a partnership that holds debt-financed property is effectively an interest in the underlying assets and liabilities of the partnership. An anomalous result would occur if ownership of debt-financed property through a partnership would result in one tax treatment when direct ownership would result in another." Under this reasoning, the same result follows if the income in question was derived from debt-financed property other than through a sale of the exempt entity's interest in a pass-through entity. Regardless of how many layers of pass-through entities are imposed, the "lowest level" entity's property would effectively be owned by each entity up the line, and would ultimately effectively be owned by the tax exempt entity.

To avoid the realization of debt-financed income through an investment in a limited partnership or hedge fund, charitable organizations often use "blocker" entities to acquire these investments. A "blocker" entity is a corporate entity that is interposed between the investment and the charitable organization. The corporation "blocks" the attribution of any debt in the investment partnership to the charitable organization, and thus enables the charitable organization to avoid the application of the debt-financed

161 I.R.C. § 514(a)(2).

162 I.R.C. § 514(a)(1).

163 I.R.C. § 512(b)(4).

164 *See, e.g.,* Rev. Rul. 74-197, 1974-1 C.B. 143. Example 4 in Treasury Regulation Section 1.514(c)-1(a)(2) specifically demonstrates that this is so. Treas. Reg. § 1.514(c)-1(a)(2), example 4. Relying upon Section 702(b), Example 4 explains that if an entity ("X") is a limited partner in a partnership that borrows money to purchase an office building for lease to the general public, X's share of the income from the building is debt-financed income. *Id.*

165 Tech. Adv. Mem. 9651001 (Dec. 20, 1996).

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income rules with respect to the investment income generated by the investment partnership. Rather, the partnership income is taxed to the corporate blocker entity. Often, the blocker entity is a foreign corporation formed in a low tax jurisdiction. As a result, the blocker entity pays little or no tax on the income from the investment partnership or hedge fund. The blocker entity in turn distributes the income received from the investment partnership to the charitable organization in the form of dividends, which is excluded from the charitable organization's unrelated business taxable income.[166] The IRS has issued a private letter ruling determining that dividends received by a charitable organization from a foreign corporation used as a blocker entity is not subject to the unrelated business income tax.[167] Although the use of blocker entities may appear to be a "loophole," blocker entities are often used to avoid the application of the unrelated debt-financed income rules to passive investments that were never intended to be within the scope of the rules.

F. S Corporations. Charities are able to hold S corporation shares without breaking the S election.[168] However, all income distributable to a charitable S corporation shareholder will be treated as unrelated business taxable income from an asset deemed in its entirety to be an interest in unrelated trade or business.[169] Consequently, "(i) all items of income, loss, or deduction taken into account under Section 1366(a), and (ii) any gain or loss on the disposition of the stock in the S corporation shall be taken into account in computing the unrelated business taxable income of such organization."[170] In addition, the basis of any S corporation stock acquired by purchase is reduced by the amount of dividends received by the charitable organization with respect to the stock.[171]

G. Public Disclosure of Information Relating to the Unrelated Business Income Tax. Charitable organizations are required to make their annual Form 990/Form 990PF information returns and exemption materials available for public inspection.[172] Organizations that have unrelated business income also have to file a Form 990-T return. Charitable organizations described in Section 501(c)(3)[173] are required to make their Form 990-T returns[174] available for public inspection.[175] Certain information may be withheld by the charitable organization from public disclosure and inspection (e.g., information relating to a trade secret, patent, process, style of work, or apparatus of the charitable organization) *if* the Secretary determines that public disclosure of such information would adversely affect the charitable organization.[176] Under the commensurate in scope test, an exempt organization may generate a significant amount of UBTI so long as it performs charitable programs that are commensurate in scope with its financial resources.[177] However, if a substantial portion of the charity's income is from

[166] *See* I.R.C. § 512(b)(1).
[167] Priv. Ltr. Rul. 199952086 (Sept. 30, 1999).
[168] *See* I.R.C. § 1361(c)(6).
[169] I.R.C. § 512(e).
[170] *Id.*

[171] I.R.C. § 512(e)(2).
[172] I.R.C. § 6104(d)(1)(A).
[173] This requirement applies to all charitable organizations which file Form 990-T returns, regardless of whether such organizations are also required to file annual Form 990/Form 990PF information returns. However, state colleges and universities which are exempt from income tax solely under Section 115 of the Code are not required to make their Form 990-T returns available for public inspection. Notice 2007-45, 2007-22 I.R.B. 1320.
[174] An exact copy of the Form 990-T return, including all schedules, attachments and supporting documents must be disclosed. Notice 2007-45, 2007-22 I.R.B. 1320.
[175] I.R.C. § 6104(d)(1)(A)(ii).
[176] Staff of the Joint Comm. on Tax'n, 109th Cong., Technical Explanation of H.R. 4, The "Pension Protection Act of 2006," JCX-38-06 (Aug. 3, 2006) at 330.
[177] Rev. Rul. 64-182, 1964-1 C.B. 186.

unrelated activities, the organization fails to qualify for exemption.[178]

H. Effect of Unrelated Business Activities on the Charity's Tax-Exempt Status. In order to obtain and maintain tax-exempt status, a charity must be operated primarily for the purposes described in Section 501(c)(3) of the Code. Accordingly, if a charity engages in too much unrelated business activity, it risks the loss of its tax-exempt status as no longer satisfying this operational test. There is no bright line rule with respect to how much unrelated business income a charity may receive without jeopardizing its tax-exempt status.[179] Whether an organization has a substantial non-exempt purpose is a question of fact.[180]

I. Use of Taxable Subsidiaries. If a charity engages in an activity that may produce substantial unrelated business income, the charity should consider conducting the activity through a taxable corporate subsidiary wholly owned by the charity. The taxable subsidiary will be responsible for paying income tax on the net taxable income from the activity. The net income may then be distributed to the charity in the form of dividends which generally are excluded from a charity's UBTI.

One advantage of this structure is that the activities of the taxable subsidiary normally will not be attributed to the charity. This is especially important if the conduct of the activity is so substantial that it may jeopardize the charity's tax-exemption. Second, the charity will not be required to file a Form 990-T related to the activity, which is available for public inspection. Although the taxable subsidiary will file a Form 1120, such form is not required to be made publicly available. Third, use of a taxable subsidiary can protect the charity's assets from liabilities arising from the conduct of the unrelated business activity and isolate those liabilities to the taxable subsidiary. Finally, a taxable subsidiary can provide greater flexibility in structuring the unrelated business activity.

However, use of a taxable subsidiary may increase administrative burdens and costs of the charity. Additionally, the dividends from the taxable subsidiary may no longer be exempt from UBIT if the charity transfers debt-financed property to the taxable subsidiary.[181] If the charity provides administrative services to its taxable subsidiary for a fee, the IRS may reallocate income between the charity and the taxable subsidiary under Code section 482. Finally, as discussed above, if the charity receives interest, rent, annuity payments or royalties from its controlled taxable subsidiary, such payment may be treated as unrelated business income to the charity to the extent the payment reduces the trade or business income of the taxable subsidiary.[182]

V. Cause-Related Marketing.[183] Cause-related marketing involves a charity forming

[178] Treas. Reg. § 1.501(c)(3)-1(c)(1).

[179] In making this determination, courts may examine the amount of time or money spent on carrying out an unrelated trade or business. *See* Orange County Agricultural Society v. Comm'r, 893 F.2d 529 (2d Cir. 1990), *aff'g* 55 T.C.M. 1602 (1988) (denying exempt status where an organization received approximately one-third of its gross income from unrelated business activities).

[180] *See* Better Business Bureau of Washington, D.C., Inc. v. United States, 326 U.S. 279 (1945) (holding that the presence of a single, non-exempt purpose, if substantial in nature, will destroy exemption regardless of the number of importance of truly exempt purposes); B.S.W. Group v. Commissioner, 70 T.C. 352 (1978); Nationalist Movement v. Comm'r, 102 T.C. 558, 559 (1994), *aff'd*, 37 F.3d 216 (5th Cir. 1994).

[181] I.R.C. § 357(c); Rev. Rul. 77-71, 1977-1 C.B. 155.

[182] I.R.C. § 512(b)(13).

[183] Portions of this discussion on cause-related marketing are extracted from the author's previously published article, *The Taxation of Cause-Related Marketing*, 85 CHI-KENT L. REV. 883 (2010).

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.[184] Such alliances may include selling merchandise which prominently displays the charity's name, logo, or trademark message in conjunction with a corporate partner or allowing the charity's name or logo to be displayed on promotional products of the corporate partner, with a portion of the sales proceeds of those promotional products donated to the charity. 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.[185] 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.[186] When a charity engages in a cause-related marketing alliance, the charity must carefully structure the alliance or the income the charity receives from the alliance may be treated as unrelated business income.

A. Sale of Merchandise Directly by 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. The sale of the merchandise typically is an activity carried on for the production of income from the sale of goods. Additionally, a charity would normally engage in the sales of the merchandise continuously throughout the year. Accordingly, the sale of the merchandise would be considered a regularly carried on trade or business. Whether the receipts from the sale of the 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.[187] 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.[188] In contrast, if the 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.[189] 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.[190] 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

[184] *See, e.g.* 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)).

[185] *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.

[186] *Id.*

[187] *See e.g.*, Tech. Adv. Mem. 9720002 (Nov. 26, 1996).

[188] *See, e.g.*, Priv. Ltr. Rul. 200222030 (Mar. 4, 2002); Tech. Adv. Mem. 8024111 (Jan. 3, 1980).

[189] *See* Tech. Adv. Mem. 8605002 (Sept. 4, 1985); Tech. Adv. Mem. 832-009 (Mar. 30, 1983).

[190] *See, e.g.*, Tech. Adv. Mem. 8326003 (Nov. 17, 1982).

organization's name or symbol when additional facts indicated that the sales furthered the organization's exempt purpose.[191]

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.[192] Thus, the proceeds from the sale of the breast cancer awareness merchandise were excluded from the charity's UBTI. The branded merchandise described in the ruling included pins, apparel, home and office products, jewelry, and special gifts. 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. 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. The Internal Revenue Service concluded that the sale of the 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."

Even though this type of merchandise sold by a charity typically has some utilitarian value, such as a t-shirt, hat, wristband, or pin, it appears that if the charity carefully links the sale of the merchandise to the spreading of the charity's message, the sale of the merchandise may be considered substantially related to the charity's exempt purpose.[193] The charity's position would be significantly weakened if the charity's primary purpose in selling the merchandise is to generate income.[194] 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."[195] 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.[196]

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.

B. Sale of Merchandise by Corporate Partner. For sales of merchandise directly by the corporate partner containing the charity's name or logo, different considerations apply in determining whether the income received by the charity from the arrangement is excluded from the charity's UBTI. Many cause-related marketing

[191] *See, e.g.*, Priv. Ltr. Rul. 8633034 (May 20, 1986); Tech. Adv. Mem. 9436001 (Sept. 24, 1993).

[192] Priv. Ltr. Rul. 200722028 (Mar. 9, 2007).

[193] 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. *See* Tech. Adv. Mem. 9550003 (Sept. 18, 1995).

[194] *See, e.g.*, Disabled Am. Veterans v. Comm'r, 650 F.2d 1178, 1183 (Ct. Cl. 1981)

[195] Treas. Reg. § 1.513-1(d)(3).

[196] *Id.*

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.

1. 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.[197] 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.[198] 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.[199]

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.[200] 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 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.

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[197] *See* Treas. Reg. § 1.513-4(c)(1).

[198] A "substantial return benefit" is any benefit other than a "use or acknowledgement" of the corporate sponsor. Treas. Reg. § 1.513-4(c)(2). Importantly, substantial benefits include any license to use intangible assets of the charitable organization. Treas. Reg. § 1.513-4(c)(2)(iii).

[199] Treas. Reg. § 1.513-4(c)(2)(iv).

[200] Treas. Reg. § 1.513-4(f), examples 11 & 12; Priv. Ltr. Rul. 200303062 (Oct. 22, 2002).

2. Use of the charity's name or logo may (or 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,[201] 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 merchandise by the corporate partner 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.[202]

However, 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, the payment could instead be viewed as received in connection with the joint advertisement of the product.[203] 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 may 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 may 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.

3. Revenue from cause-related marketing may be advertising. 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

[201] *See, e.g.*, Or. State Univ. Alumni Ass'n v. Comm'r, 193 F.3d 1098 (9th Cir. 1999); 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). 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. 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. *See* I.R.S., INTERNAL REVENUE MANUAL § 7.27.6.7.3 (CCH 1999).

[202] *See* Sierra Club Inc. v. Comm'r, 86 F.3d 1526, 1532 (9th Cir. 1996).

[203] 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. 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.

purposes.[204] If the charity conducts advertising activities on a regular basis, then the advertising income generally is taxable as unrelated business income.

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

C. <u>Private Benefit Concerns of Cause-Related Marketing</u>. 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 merchandise), but this raises concerns about whether cause-related marketing alliances produce impermissible private benefit for the corporate partner. Two examples addressing whether private inurement (which is similar to private benefit) 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. 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. The Internal Revenue Service distinguished Restland Memorial Park v. United States—the second example case—in which a 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.

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. A benefit is quantitatively incidental if, after considering the overall public benefit conferred by the activity, the private benefit is not substantial. 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

[204] *See, e.g.*, Treas. Reg. § 1.513-1(d)(iv), example 7; United States v. Am. College of Physicians , 475 U.S. 834 (1986).

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.

The benefit is incidental in the qualitative sense if it is "a necessary concomitant of the activity that benefits the public at large." In other words, the activity only can be accomplished by benefiting the private party. 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 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 is 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.

VI. Investment in Social Enterprises. Social enterprises are businesses whose primary purpose is the common good. Social enterprises "use the methods and disciplines of business and the power of the marketplace to advance their social, environmental and human justice agendas."[205] Key distinctions between a

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[205] Social Enterprise Alliance, What's a Social Enterprise, at https://www.se-alliance.org/what-is-social-enterprise; *cf.* Cassady V. ("Cass")

social enterprise and a charitable organization include: (i) a social enterprise may have individual owners who receive periodic distributions of net earnings of the social enterprise; (ii) a social enterprise generally does not qualify for tax-exemption as a charitable organization; and (iii) a social enterprise is more flexible in its ability to access capital markets and conduct its activities to accomplish its purposes because the social enterprise is not subject to the restrictions imposed on charitable organizations under the Code.

Currently, researchers believe that over 50% of nonprofits have at least one or more social enterprises,[206] which makes UBIT an important issue within many of them. In addition, in the past few years, there has been growth in social enterprise in the nonprofit sector in the United States spurred by a number of factors: reductions in government funding, increased client need, and interest in diversifying funding sources. The social needs addressed by social enterprises are widely diverse as well as the business models employed by social enterprises to accomplish their purposes.

Many states have created new organizational forms for social enterprises, including the low-profit limited liability company ("L3C").[207] The L3C starts with the traditional limited liability company form and adds features that evidence the L3C promotion of common good over profit-maximization for its members.[208] The L3C is distinguished from a traditional limited liability company by four core elements: (i) the L3C must operate to significantly further the accomplishment of charitable or educational purposes; (ii) the L3C would not have been formed but for its relationship to the accomplishment of these purposes; (iii) income production or capital appreciation may not be a significant purpose of the L3C; and (iv) the L3C may not pursue purposes that would disqualify a charity from exemption under the limitations on lobbying activities and political campaign activities imposed by the Code.[209] The L3C statutes were designed to allow private foundations to invest in properly formed L3Cs as qualifying program-related investments.[210] Accordingly, the four core elements distinguishing L3Cs from traditional limited liability companies were derived primarily with this narrow focus in mind.[211]

Another new state business form for social enterprises gaining popularity is the

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Brewer, *A Novel Approach to Using LLCs for Quasi-Charitable Endeavors*, 38 WM. MITCHELL L. REV. 678, 679 (2012) (noting that "there is no universally accepted legal meaning of the term 'social enterprise.'").

[206] Social Enterprise Alliance, *Social Enterprises: A Snapshot* (Apr. 2009), available at https://www.se-alliance.org/resources. Most organizations operate social enterprises as a division of the parent organization. *Id.*

[207] *See* Dana Brakman Reiser, *Governing and Financing Blended Enterprise*, 85 CHI-KENT L. REV. 619, 620 (2010). Legislation authorizing the L3C form has been enacted in 9 states: Illinois, Louisiana, Maine, Michigan, North Carolina, Rhode Island, Utah, Vermont, and Wyoming. See Americans for Community Redevelopment, Legislation, Laws at http://americansforcommunitydevelopment.org/laws.php for links to the legislation in those states adopting the L3C form.

[208] *See* Reiser, *supra* note 207 at 621.

[209] *Id.*

[210] *Id.* at 622. A program-related investment ("PRI") must have as its primary purpose the accomplishment of one or more charitable purposes and no significant purpose may be the production or income or capital appreciation. I.R.C. § 4944(c). PRIs have a couple of distinct advantages for private foundations. First, a PRI is considered a qualifying distribution for purposes of meeting the private foundation's minimum payout requirement to avoid the excise tax on failure to distribute income. *See* I.R.C. § 4942. Second., a PRI is not subject to the excise tax on jeopardizing investments applicable to private foundations. *See* I.R.C. § 4944. The IRS recently issued proposed regulations on PRIs which contain new examples of permissible PRIs, including investment in social enterprise. *See* Prop. Treas. Reg. § 53.4944-3, example 11 and example 12.

[211] *See* Reiser, *supra* note 207 at 623.

benefit corporation.[212] A benefit corporation begins with the traditional state law corporate form and makes modifications to accomplish the following distinguishing characteristics of a benefit corporation: (i) a corporate purpose to create a material positive impact on society and the environment; (ii) expansion of the fiduciary duties of directors to require consideration of non-financial stakeholders as well as the financial interests of its shareholders; and (iii) an obligation to report on its overall social and environmental performance using a comprehensive, credible, independent and transparent third-party standard.[213]

In contrast to the legislatively-approved L3C and benefit corporation, the B Corporation is a business form used for social enterprises which is self-imposed and privately regulated.[214] A B Corporation (also called a "for-benefit" corporation) uses the existing state-law corporate form and incorporates into its governing documents a commitment to "uses the power of business to solve social and environmental problems."[215] B Lab, a private, nonprofit organization reviews the company's structure and operations as part of its certification process, and if the company is certified by B Lab, the company may license the "certified B Corporation" trademark from B Lab.[216] Often, benefit corporations are referred to as "B Corporations;" however, the benefit corporation is a legislatively-approved business form while the B Corporation is privately regulated.

A. <u>UBIT Treatment for a Charity Investing in a Social Enterprise</u>. When a charity invests in a social enterprise, the potential UBIT treatment of the investment to the charity will depend on the form of the investment. For example, if the investment is structured as a loan from the charity to the social enterprise, then the interest that the charity receives on the loan generally will be excluded from the charity's unrelated business income as passive interest income.[217] Similarly, if the social enterprise is formed as a corporation,[218] such as a benefit corporation or a B Corporation, and the charity's investment in the social enterprise is structured as the acquisition of shares of stock in the social enterprise, then the dividend distributions the charity receives from the corporation generally will be excluded from the charity's unrelated business income as passive dividend income.[219] These interest and dividend exclusions may not apply, however, to the extent the interest or dividend income is treated as unrelated debt-financed income.[220]

L3Cs generally are treated as a partnership for federal income tax purposes.[221] Accordingly, the L3C does not pay income tax on its net earnings. Rather, the profits and losses of the L3C are

[212] Legislation authorizing the benefit corporation form has been enacted in 9 states: California, Hawaii, Maryland, Louisiana, New Jersey, New York, South Carolina, Vermont, and Virginia. See Benefit Corp Information Center, State by State Legislative Status at <u>http://www.benefitcorp.net/state-by-state-legislative-status</u> for links to the legislation in those states adopting the benefit corporation form.

[213] William H. Clark, Jr. & Larry Vranka, *The Need and Rationale for the Benefit Corporation: Why it is the Legal Form That Best Addresses the Needs of Social Entrepreneurs, Investors, and, Ultimately, the Public* (Jan. 26, 2012), at 15, at <u>http://www.benefitcorp.net/for-attorneys/benefit-corp-white-paper</u>.

[214] Reiser, *supra* note 207 at 637.

[215] B Lab, What is a B Corp? at <u>http://www.bcorporation.net/about</u>.

[216] *See* B Lab, Why Become a B Corp? at <u>http://www.bcorporation.net/become-a-b-Corp</u>.

[217] *See* I.R.C. § 512(b)(1); *but see* I.R.C. § 512(b)(13)(A)for an exception for certain interest payments received from a controlled subsidiary.

[218] The result is different if the corporation is treated as an S corporation for federal income tax purposes. All income distributable to a charitable S corporation shareholder is treated as unrelated business taxable income from an asset deemed in its entirety to be an interest in unrelated trade or business. I.R.C. § 512(e).

[219] *See* I.R.C. § 512(b)(1).

[220] *See generally* I.R.C. § 514.

[221] *See* Reiser, *supra* note 207 at 623-24.

allocated to its members, each of whom report and pay tax on the allocated profits and losses in accordance with such member's own tax status.[222] For example, if a charity invests in a social enterprise that is formed as a L3C, the charity would be required to report its allocated items of profit and loss from the L3C on the charity's Form 990.

To the extent the reported items of income do not qualify for the passive exclusions from the unrelated business income tax (e.g., interest, dividends, rents, and capital gains),[223] then the charity typically must apply the general three-prong test to determine whether the income from the business operated by the L3C is unrelated business income for the charity.[224] Usually, investment in the L3C will easily meet the first two prongs: the activity conducted by the L3C typically is a trade or business and normally the activity is regularly carried on. Thus, the key determinant is whether the activity conducted by the L3C substantially furthers the charitable purposes for which the charitable investor was granted tax-exemption. This is a case by case determination. Thus, even though a L3C may operate to substantially further a charitable purpose, if the L3C's charitable purpose is unrelated to the charitable investor's tax-exempt purpose, then the income allocated to the charitable investor from the L3C may not be exempt from that charity's UBTI.[225] Accordingly, a charity desiring to invest in a social enterprise that is treated as a partnership for tax purposes must be careful to select a social enterprise that conducts activities which are closely aligned with the charity's own mission.

B. Effect of Joint Venture Rules on a Charity's Investment in Social Enterprise. Because a social enterprise generally includes for-profit parties as owners, a charity must be mindful of the IRS's stance on joint ventures between charities and for-profit parties when deciding to invest in a social enterprise. In particular, if the investment is a significant activity of the charity, the charity must be careful to structure its investment in the social enterprise so as to not jeopardize the charity's tax-exempt status. The case law and IRS rulings on joint ventures between charities and for-profit parties focus on the charity's ability to ensure that the joint venture is operated to further charitable purposes.[226] As applied to social enterprises, it is not clear how these rulings would impact the amount of control that a charitable investor should maintain over the operations of the social enterprise. In particular, the nature of a social enterprise dictates that the social enterprise already elevates the accomplishment of charitable purposes over the maximization of profits for its owners. This is especially true in the case of the L3C which is required to operate significantly to accomplish charitable or educational purposes and not significantly for income production or capital appreciation.[227] Accordingly, it may not be as important for a charitable investor in a joint venture formed as a L3C to ensure that the social enterprise is operated to further charitable purposes as it is when the joint venture is formed using traditional business models. However, whether the IRS and the courts will adopt this view is uncertain.

[222] *See id.* at 624.

[223] *See* I.R.C. § 512(b). If the L3C derives the passive income from debt-financed property, then such income may be included in the charitable investor's unrelated business income as debt-financed income. *See* Part IV.E. of this outline.

[224] *See* I.R.C. § 513; *see also* Part IV.A. of this outline.

[225] *See* Treas. Reg. § 1.513-1(d).

[226] *See e.g.*, St. David's Health Care System v. United States, 349 F.3d 232 (5th Cir. 2003); Redlands Surgical Services v. Comm'r, 113 T.C. 47 (1999), *aff'd*, 242 F.3d 904 (9th Cir. 2001); Rev. Rul. 2004-51, 2004-1 C.B. 974.; Rev. Rul. 98-15, 1998-1 C.B. 17; s*ee also* Part III. of this outline.

[227] *See* Reiser, *supra* note 207 at 622.