Commercializing and Protecting Intellectual Property in an Increasingly Open and Fluid World

Terri Lynn Helge
Texas A&M University School of Law, thelge@law.tamu.edu

Deborah L. Lively
Thompson and Knight, LLP, deborah.lively@tklaw.com

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Commercializing and Protecting Intellectual Property in an Increasingly Open and Fluid World
by Terri Lynn Helge and Deborah L. Lively

I. Intellectual Property Introduction. Intellectual property ("IP") generally describes the intangible property created by human intellect, and may include inventions, literary works, artistic works, logos, and designs, any of which may be used commercially by the owner. Federal law and many state laws grant certain exclusive rights in intellectual property and enforcement rights against those who use the IP without consent of the owner. The four major areas of IP discussed in this paper are copyrights, trademarks, patents, and trade secrets.

A. Copyrights. Protection of original works of authorship is provided under the Copyright Act, which protects any such works that are "fixed in any tangible medium of expression."1 Examples of original works include the text of literary works such as articles, essays and books, paintings and illustrations, music and lyrics, photographs, choreography, and computer programs.2 This federal copyright protection is provided immediately once the original work is "fixed" and does not require a federal registration with the Copyright Office.3 Copyright protection confers the owner with the exclusive right to use, copy and distribute the original work in any medium and the right to make derivative works thereof along with the right to license any of these rights to a third party. The duration of protection and exclusive rights granted under the Copyright Act is limited to a finite period of time, and for an organization responsible for creating original works, the duration of the copyright protection is the earlier of 120 years from creation or 95 years from publication.4

B. Trademarks. Trademarks and service marks are words, designs, colors, symbols, sounds, or a combination of these used in association with goods or services and that identify a company or entity.5 In the United States, common law rights in a trademark are usually obtained by the first party to use a mark for specific goods or services in a specific geographic area. This use provides the owner with the exclusive right to use the mark in that geographic region and can be perpetual there as long as the mark is in use and not abandoned. Trademark rights may be protected under both state and federal registrations; however, a registration with the U.S. Patent and Trademark Office generally provides the owner with exclusive rights to use the mark nationwide; whereas, state registrations are limited to exclusive rights and protection within a

2 Id.
3 Id. § 304 (for works created on or after January 1, 1978).
4 Id. § 302(a),(c).
5 Id. § 1127.
state. In fact, the state registrations may also be preempted by a federal registration, and thus, may provide no more than common law rights established where the mark has been in use.6

If the mark is federally registered, in addition to use requirement to avoid abandonment of the mark, the owner must also make the requisite maintenance filings with the U.S. Patent and Trademark Office to preserve the registration. For example, after the fifth and no later than the sixth year of registration, the trademark owner must file a declaration of continued use along with a sample specimen of use.7 In addition, a renewal application and specimen of use must be filed every ten years, beginning with the tenth year from the registration date.8

In addition to continued use of the mark, the owner has a duty to police the use of its mark by unauthorized parties to avoid a claim that the owner has abandoned rights in its mark. Even for authorized users who have been granted a license to use the owner’s mark, the trademark owner must exercise some degree of control over the licensee so that the goods/services provided by the licensee under the mark meet the standards required by the trademark owner. By exercising the quality control standards for the licensee’s goods and services, the trademark owner helps maintain the value and goodwill associated with its mark.

C. Patents. A patent is a right that is granted by the federal government for an invention that provides the inventor or owner of the patent with the right to exclude others from making, using, or selling the invention for a specific period of time in exchange for the public disclosure of the invention when the patent is granted as well as the right to license such rights during the period of patent protection.9 Typically, inventions that are subject to patent protection are useful machines, processes, compositions (collectively “Utility Patents”), or ornamental designs (“Design Patents”) or even new varieties of plants.10 For patent applications filed since 1995, the term of a Utility Patent is twenty years from the application filing date. For design patents filed on or after December 18, 2013, the term is fifteen years from the date of issuance; for those filed before December 18, 2013, the term is fourteen years from issuance.11

D. Trade secrets. A trade secret is type of intellectual property that is comprised typically of any information, data, device, process, formula, or technique that is of economic value to a company or entity, that is not readily ascertainable by the public, and that the owner has undergone reasonable efforts to maintain its secrecy (including limiting the number of employees provided access to such).12 The protection afforded trade secrets is governed by state law, but most states, including Texas, have adopted to the Uniform Trade Secrets Act to harmonize the standards governing the protection and remedies for misappropriation.13 Examples of things that

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6 See e.g., Minute Man of Am., Inc. v. Coastal Rests., Inc., 391 F. Supp. 197, 198 (N.D. Tex. 1975) (noting that the Texas registration was limited to the area of use as against a federal registrant regardless when the federal registration occurs); HERBERT J. HAMMOND, TEXAS INTELLECTUAL PROPERTY LAW HANDBOOK 149-50 (2d ed. 2011).
8 Id. §§ 1058, 1059.
10 Id. §§ 101, 161, 171.
12 See TEX. CIV. PRAC. & REM. CODE ANN. § 134A.002(6); see also Unif. Trade Secrets Act § 1.
13 See, e.g., TEX. CIV. PRAC. & REM. CODE ANN. § 134A.002(6); see also Unif. Trade Secrets Act § 1.
might be considered a trade secret for a non-profit organization include donor lists, financial
data, and fundraising strategies.

II. How is intellectual property important to nonprofits? For all non-profit organizations,
intellectual property is important whether it is intellectual property created by the organization or
instead is intellectual property used by the organization in the operation of its business. The
following are examples of areas in which intellectual property rights can be critical to a nonprofit
entity:

• Branding and marketing
• Educational materials
• Brochures
• Discoveries/inventions made by the non-profit
• Fundraising and development activities
• Website content
• Social Media
• Software
• Vendors

III. Intellectual Property owned by the Nonprofit.

A. Marks and Branding. One of the most important forms of intellectual property of a non-
profit organization may be its trade name. Along with the name, the organization may utilize a
unique design and/or tag lines, all of which consumers would associate with the organization.
Such name and/or logo would be considered a mark because it serves as a source identifier of the
organization.

If the nonprofit organization provides services that reach beyond one state or to the extent
that such would be considered use in interstate commerce, the organization should consider
obtaining federal trademark protection for its brand and tag lines. The benefits of a federal
trademark registration include the following: the presumption of nationwide exclusive rights to
the use mark; the right to use the symbol ®; the right to sue for infringement in federal court; a
presumption of validity of the mark; potentially enhanced remedies; constructive notice of a
claim of ownership, and the right to keep other confusingly similar marks off of the federal
trademark registry and even some state registries.14 Even if the mark is not federally registered,

14 15 U.S.C. §§ 1111, 1115(a); Xtreme Lashes, LLC v. Xtended Beauty, Inc. 576 F.3d 221, 232 (5th Cir. 2009);
Pebble Beach Co. v. Tour 18 I, Ltd., 155 F.3d 526, 533 n.4 (5th Cir. 1998).
B. Original Works of Authorship. Essential to a nonprofit organization is its original works of authorship, whether they are development materials, educational materials, videos, website content, or other original works. As noted above, any original work of authorship fixed in a tangible medium is afforded copyright protection under the copyright Act. Typically, an organization or company will own any such original work of authorship as a “work made for hire” if an employee of the organization has developed or created the work as a part of the scope of his or her employment. The “work made for hire” doctrine applies to any work created by the employee in the scope of his or her employment. Many companies and organizations include the concept of “work made for hire” in their employment policies to educate their employees on this issue even though it is not necessary for title to the copyright to vest in the name of the organization or company.

The more complicated issue arises when an employee creates a work that could be outside the scope of his or her employment. A few examples could include the following:

- A photograph taken by employee at a company picnic and published on the company website (when photography is not a component of the employee’s job responsibilities);
- A company logo designed by an employee in a company contest allowing employees to submit a proposed logo to be voted on by all employees;
- Website content created by an employee whose normal job duties are related to finance and accounting; and
- An article written for a company newsletter by an employee as a contributor and not a part of the newsletter staff at the company.

If any of the above are activities outside of the employee’s typical duties, it is possible that these works may not be owned by the organization as works made for hire, and instead may be works whose copyrights are owned by the employee (i.e., the original creator). In such cases, to avoid any uncertainty regarding the copyright ownership of these works, the organization could have the employee assign to the organization any and all rights that he or she “has” or “may have” in the work. One way for obtaining such assignment would be to include a present assignment provision in the employment agreement, which would cause the assignment to be effective upon the creation of any work. Alternatively, the employment agreement could

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17 Id. § 101.
18 Id. § 101; see also Cmty. for Creative Non-Violence v. Reid, 490 U.S. 730, 751-52 (1989) (noting that the following would be considered in determining whether the creator of the work is an employee: tax treatment; provision of benefits; work location; resources provided by employer; payment method; the hiring party’s right to control the manner and means by which the work is accomplished; and the duration of the relationship between the parties).
require that the employee assign his or her rights in the work upon the employee’s submission of any work to the organization.

Due to the potential volume of original works of authorship that could be owned by an non-profit organization or any company, it is likely unrealistic to assume that an entity would register all of its original works with the Copyright Office; however, all organizations should consider registering works that are vital or that add substantial value to the organization. The following may be examples of such works:

- Videos
- Development and fundraising strategies
- Books
- Promotional materials
- Educational materials, booklets
- Testing materials
- Workshop/seminar materials
- Music (original to the organization)
- Computer programs
- Collections of images

19 See U.S. Auto Parts Network, Inc. v. Parts Geek, LLC 692 F.3d 1009, 1015 (9th Cir. 2012) (noting that “courts have accordingly adopted [the Restatement (2d) of Agency] section 228’s three-prong test for determining when a work is made by an employee ‘within the scope’ of employment: ‘(a) it is of the kind [the employee] is employed to perform; (b) it occurs substantially within the authorized time and space limits; [and] (c) it is actuated, at least in part, by a purpose to serve the [employer]’”).
Registration is not required for copyright protection; however, a copyright registration prior to the infringement of a work will provide the copyright owner with a broader remedy—specifically, the copyright owner would have a right to choose statutory damages imposed by the court instead of relying on actual damages, which might be difficult for the court to calculate.\(^{20}\)

As a deterrent to unauthorized copying as well as basis for claiming willful infringement, an entity should include a copyright notice on all materials. Such notice typically identifies the year of first publication and copyright owner, as shown below:

© 2015 ABC Foundation

No registration is required for the inclusion of the © notice symbol. In the copyright notice, an organization may also identify what rights, if any, a third party may have to use or reproduce the work. Such language could be added to the notice provision, as follows:

- © 2015 ABC Foundation. All rights reserved. No copies, reprints, or reproductions may be made without the express authorization of ABC Foundation.

or

- © 2015 ABC Foundation. All rights reserved. Reproductions and copies may be made for personal use only.

or

- © 2015 ABC Foundation. All rights reserved. Copies, reprints, or reproductions may be made by [insert limitations/ restrictions].

C. Inventions and Discoveries. In the event that a non-profit entity is directly involved in scientific research, technological developments, and the like, patent protection may be available for such intellectual property.\(^{21}\) As noted above, patent protection provides the patent owner with exclusive rights to prevent third parties from making, using or selling the patented invention but only for a limited period of time. In order for an inventor or owner of an invention to obtain an issued utility patent, the inventor is required to file the patent application within one year of the first public use of the invention.\(^{22}\) Unlike the ownership of original works created by employees within the scope of their employment, which are considered works made for hire under the Copyright Act, inventions created by employees within the scope of employment are not solely owned by the employer. In fact, prior to the amendment of U.S. patent law by the America Invents Act of 2013, employee inventors were the owners of the inventions identified in patent applications. For such an organization to own the patent for an invention created by the organization’s employee, regardless of whether the invention was made within the scope of the employee’s job, the employee had to assign the ownership of the patent to his or her employer despite the fact that the invention was developed within the scope of employment. The America Invents Act has made it easier for employers/companies to own the patents for inventions developed by their employees by having the inventor-employee submit a declaration stating

\(^{20}\) 17 U.S.C. § 412(1); see also 17 U.S.C. § 504.


\(^{22}\) Id. § 102(b).
whether the inventor is under an obligation to assign the invention. To the extent that the organization expects to own all rights in a patent, it should have the employee assign its rights to the organization, which assignment shall be filed with the U.S. patent and Trademark office.

IV. Special Issues.

A. Works created by independent contractors, consultants, and developers. A common misperception is that any work product created by a third-party on behalf of a company is owned by the company. Such third-party work product consists of website pages, custom software applications, photographs, training materials, architectural drawings, and the like. What is likely owned by the company is a copy of the work product provided to the organization but not the copyright for that work product. For example, an organization may hire a photographer to take photographs of images to be used on the organization’s website as well as in marketing materials. The organization may be given the right to make unlimited copies of the photographs or it may have an implied right to use the photographs in any medium; however, the actual copyright ownership still remains with the photographer. In another example, the organization may have hired a software developer to create a custom program to be used in operation of the organization’s business. The organization would not be able to make enhancements or other modifications to the program (i.e., derivative works) without assignment of all rights or without, a license granting the organization such specific rights.

The organization may not really care whether it has a perpetual license or full ownership in the copyright of any work product created on its behalf as long as it has a perpetual right to use and modify the work product. If it has invested huge sums in the development of the work product, the organization is more likely to seek full title to the copyright. If ownership in all intellectual property rights of such work product is desired, then the organization may want to consider including assignment clause in the services contract, transferring ownership either upon creation of the work product or upon payment in full for the services to develop the work product.

B. Affiliated organizations or local chapters. For an organization who has local chapters or affiliated organizations authorized to use the organization’s intellectual property, such organization should consider having its local groups and affiliates enter into a license agreement to spell out the specific terms of use. With respect to the trademarks and logos, it is particularly important to include standards of use to avoid a claim of abandonment and also to help avoid damage to the organization’s reputation by the affiliated party’s use. In the event that the organization has many chapters or other potential sublicensees, having trademark use guidelines available online and easily accessible is a convenient way to provide use standards. Such guidelines could also specify how copyright-protected materials may be used.

C. Volunteers. Many nonprofit organizations engage the assistance of volunteers, especially in fundraising events and educational programs. It is not uncommon for a volunteer to create materials on behalf of the organization; however, it is likely that the intellectual property rights of such materials would be owned by the volunteer—not the organization. Arguably, without any agreement to the contrary, the organization likely has an implied license to use the materials

23 Id. §§ 115, 118.
created on behalf of the organization for at least as long as the volunteer is involved with the organization, but such license could easily be revoked. To avoid the uncertainty associated with the organization’s ability to use or continue use of the volunteer’s materials, the organization should consider having all volunteers either assign his or her rights to the organization or grant a perpetual, irrevocable license to the organization. This could easily be accomplished by having the volunteer sign a simple release, which would include a disclaimer of any ownership rights in any materials created by the volunteer on behalf of the organization as well as a present assignment clause assigning to the organization ownership to the IP rights in the materials upon their creation. Alternatively, the volunteer could execute a simple license agreement granting a perpetual, royalty-free, irrevocable license to the organization.

- Example of a present assignment provision: “Volunteer acknowledges and agrees that all right, title and interest in and to original works of authorship created by Volunteer on behalf of Organization, including without limitation all copyrights thereof, shall be owned by Organization and upon creation of any such materials, Volunteer hereby assigns all right, title and interest that he/she has or may have in such materials to Organization.”

- Example of a perpetual license provision: “Organization acknowledges that Volunteer owns all right, title and interest in and to original works created by Volunteer on behalf of Organization, including without limitation all copyrights thereof; however, Volunteer hereby grants to Organization a perpetual, irrevocable, royalty-free, nonexclusive, worldwide, license to use such materials and to make copies and derivative works thereof.”

D. Domain names. It is common for entities, including nonprofit organizations, to own numerous domain names that ultimately resolve to the same website address for the entity. For example, ABC Foundation may acquire the following domain names <abcfoundation.org>, <abcfoundation.com>, <abcfoundation.net>, and <abcfoundationdallas.org> and have them all resolve to the same website. There is little policing performed by domain name registrars to prevent unauthorized parties from acquiring domain names that incorporate another party’s trademark even though in their terms of use, most registrars require that the party obtaining a domain name represent and warrant that its registration will not directly or indirectly infringe the legal rights of a third party. This unauthorized use of an organization’s mark may be an unintentional infringement and may occur, for example, when an affiliated entity of the nonprofit organization or a local chapter registers a domain name that incorporates the entity’s mark or trade name without that party having authorization to do so. Any rights granted to the affiliate or chapter related to the use of the parent organization’s mark or trade name within a domain name should be addressed in the trademark use guidelines and/or license agreement with such third party.

A potentially more serious problem is the use of the organization’s mark or trade name in a domain name by an unauthorized and unrelated party. Such use may constitute infringement if the domain name leads to an active website that either serves as a pay-per-click website with links to other commercial websites or serves as the website for a specific commercial
The Anti-Cybersquatting Consumer Protection Act (“ACPA”) may provide a claim under which the organization can stop this unauthorized use of its mark in a domain name; however, instead of filing a lawsuit under the ACPA, another option for the organization would be to initiate a domain name dispute resolution proceeding. Typically, these proceedings are trademark-owner friendly, provided that the trademark owner is able to show that the use and registration of the its mark the infringer is in bad faith. A dispute resolution proceeding generally involves the filing of a complaint with an arbitration body authorized for such proceedings, such as the National Arbitration Forum, and the submission of a response by the allegedly-infringing domain-name owner. Depending upon the arbitration entity, a supplemental submission may be allowed, but no discovery or other filings are required. A decision usually follows within two to three months of the infringer’s response.

One “allowable” use of an organization’s mark that can be particularly frustrating may occur when a third party incorporates into its domain name the organization’s mark along additional words and together the mark and words are construed as free speech under the First Amendment. The following provides an example of the differences between an infringing use and a first amendment use:

Example: In this example, ABC Foundation and XYZ are unrelated entities, and ABC Foundation is a well-known entity. XYZ’s registration and use of the domain name <abcfoundation.org> that resolves to a website of XYZ Company may be infringement if there is no legitimate basis for XYZ Company’s registration or use of the domain name incorporating the ABC Foundation name; however, a third party’s registration and use of the domain name <abcfoundationsucks.com> that resolves to a website devoted to editorials about ABC Foundation may be protected as free speech.

E. Website Issues. In addition to content, which would be considered intellectual property protected under the Copyright Act, there are other issues that organizations should address with respect to their websites.

1. Privacy Policy. Many nonprofit organizations collect information online, whether it be information from its members, donors, or other website users interacting with the website and regardless of whether such information is personally-identifiable information or nonpersonally identifiable, such as a cookie. Any business or entity that collects information through an online website should have a privacy policy, with a conspicuous link at least on the page in which

24 See, e.g., E. & J. Gallo Winery v. Spider Webs Ltd., 286 F.3d 270, 272-77 (5th Cir. 2002) (finding that the Anti-Cybersquatting statute directs a reviewing court to consider whether a defendant’s bad faith intent to profit from the use of a mark held by another party in its domain name).
27 See, e.g., Taubman Co. v. Webfeats, 319 F.3d 770, 778 (6th Cir. 2003) (“We find that Mishkoff's use of Taubman's mark in the domain name "taubmansucks.com" is purely an exhibition of Free Speech, and the Lanham Act is not invoked. And although economic damage might be an intended effect of Mishkoff's expression, the First Amendment protects critical commentary when there is no confusion as to source, even when it involves the criticism of a business. Such use is not subject to scrutiny under the Lanham Act.”) Note, however, that this decision does not take in to account a situation where factually untrue statements are made by the “sucks” site, which could be actionable.
information is collected. Typically, state law governs the specific requirements for website privacy policies so these may vary from state to state; however, most require that the following be included:

- What information is collected;
- How the information is used;
- Whether the information is shared with third parties and if so, what is shared;
- An Internet user opt-out policy; and
- How the information is deleted.

Failing to implement a privacy policy could subject the organization to penalties by the state attorneys general; however, an organization’s failure to follow its own written policy may subject the organization to steep fines issued by the Federal Trade Commission as a breach of the Federal Trade Commission Act.29

2. Children’s Online Privacy Protection Act (“COPPA”). For any organizations whose websites are directed at or may be directed at children and that collect information from children, the organization should comply with the regulations of COPPA. Generally, COPPA requires prior parental consent for the collection of identifiable information by a website directed at children if the children are under age thirteen. There are various methods of obtaining such consent, but there are also some actions that can be taken that help the website owner avoid liability. One common way for a website to avoid having to meet the COPPA regulations is to have an online pre-registration procedure that prevents children under age thirteen from proceeding with registration. Such pre-registration procedure might include requiring the Internet user to enter his or her birthdate, both the birthdate and current school grade, or some other age-identifying questions provided that the questions do not suggest the age threshold for being able to register with the site. Organizations who have websites that are or that might be directed at children but also who want to avoid issues with having to obtain parental consent will typically have pre-registration procedures to block children under age thirteen from registering.

3. Terms of Use.

a. Click-wrap vs. Browse-wrap. All websites, especially those that allow users to upload or submit content, should have terms of use. Websites should have a conspicuous link to the terms of use on the home page and also on the registration page, if applicable. For the websites that do not require the user to agree to the terms of use by clicking “I Agree” or “Yes”
or some other form of active assent, such “browse wrap” agreements, the terms of use are typically not enforceable because the user has not had to affirmatively assent—i.e., has not had to click “I agree”—to the terms. In contrast, however, “click wrap” agreements are typically enforceable because the user has affirmatively agreed to the terms of use after having had the opportunity to review them.

b. **Digital Millennium Copyright Act Take-Down Provision.** For any website that allows a third party to upload or submit content, the website owner/service provider should comply with the Digital Millennium Copyright Act (“DMCA”) take-down provisions in order to avoid liability for copyright-infringement claims based on the content uploaded by a third party to the organization’s website. The DMCA take-down provision provides a safe harbor provided that the service provider:

- does not have actual knowledge that the material or an activity using the material on the system or network is infringing;
- in the absence of such actual knowledge, is not aware of facts or circumstances from which infringing activity is apparent;
- upon obtaining such knowledge or awareness, acts expeditiously to remove, or disable access to, the material;
- does not receive a financial benefit directly attributable to the infringing activity, in a case in which the service provider has the right and ability to control such activity;
- upon notification of claimed infringement as described in paragraph (3), responds expeditiously to remove, or disable access to, the material that is claimed to be infringing or to be the subject of infringing activity; and
- has designated an agent to receive notifications of claimed infringement by making available through its service, including on its website in a location accessible to the public, and by providing to the Copyright Office

The Register of Copyrights maintains a current directory of agents available to the public for inspection.

In the event that an organization receives a DMCA notice of alleged copyright infringement on its website, the organization should immediately remove the allegedly infringing work, but the organization must also notify the party who posted or uploaded the content to that website and must allow that party to respond. The failure of an organization to respond to a DMCA notice by refusing to take down the allegedly infringing content could make the organization liable for at contributory or induced infringement and liable potentially for direct infringement. The DMCA further limits the liability of nonprofit educational institutions when

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34 See, e.g generally, Nguyen v. Barnes & Noble Inc., 763 F.3d 1171 (9th Cir. 2014) (affirming the district court’s denial of Barnes & Noble’s motion to compel arbitration, finding that Barnes & Noble’s browse-wrap terms were unenforceable).

an employee (faculty member or graduate student) uses the institutions’ resources to obtain copyrighted material in performing a teaching or research function. 39 The institutions’ liability is limited so long as:

- The employee’s infringing activities do not involve providing online access to course materials that were required or recommended during the past three years;
- The institution has not received more than two notifications regarding the copyright infringement of that employee within the past three-year period; and
- The institution distributes information to all users regarding its compliance with all copyright laws.40

Even though take down notices may not be required for other forms of intellectual property infringement claims, many website owners have incorporated similar take down provisions for claims of trademark infringement and the infringement of other proprietary rights.

c. Representations and Warranties. Terms of use should also identify (i) prohibited uses of the website, (ii) representations and warranties of users, and (iii) indemnification provisions for a user’s breach. Included in the representations and warranties should be those provisions in which the user represents and warrants that the copyright in any content submitted or uploaded by the user is owned by the user, or alternatively, that the user obtained a license or authorization to post or upload the content on the website. In addition, the user should represent and warrant that such content will not infringe the intellectual property of any third parties. A breach of either of these provisions could provide the organization with breach of contract rights, including the right to recover attorneys’ fees. As additional protection, however, the website owner would likely want to include an indemnification clause to cover third-party claims that the uploaded content has infringed the intellectual property rights of a third party. In the event that the Internet user has no substantial assets, however, the organization may be at risk because the user may be considered “judgment proof” and may not be able to pay damages for a breach of warranty or to indemnify the organization.

F. Vendor agreements. Some nonprofit organizations may provide vendors or suppliers with the right to use the organization’s name and/or logos on certain types of promotional materials, such as t-shirts, buttons, accessories, and materials used by chapters, affiliates, or other entities. Vendors should have a trademark license incorporated into the vendor agreements, and this license should be limited in time and to use on certain products. As noted above in Section I.B., it is important that the license have quality control provisions requiring the vendor to meet certain standards for the products manufactured and sold under the organization’s marks. This license should also include provisions providing the organization with the right to inspect the products and pre-approve all uses of the mark. Failure to incorporate the quality control provisions into a vendor agreement could make it difficult for the organization to claim that it

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36 Id. § 512(c).
37 Id. § 512 (c),(g).
38 See, e.g., Metro-Goldwyn Mayer Studios, Inc. v. Grokster, 545 U.S. 913, 935-37 (2005) (Grokster P2P service found liable for inducing copyright infringement for operating file sharing service.).
40 Id.
exercised the requisite control over the mark to avoid abandonment. Finally, the term of use of the organization’s mark should be limited and may actually terminate upon the sell of all inventory bearing the licensed mark.

V. Unrelated Business Income Tax (“UBIT”): General Rules.\textsuperscript{41} To the extent a nonprofit sells or licenses its IP to others, the nonprofit needs to consider whether the proceeds from the sale or license results in unrelated business income for the nonprofit.

A. Definition of Unrelated Business. Organizations described in Section 501(c)(3) of the Code\textsuperscript{42} are generally subject to income tax on the net income produced from engaging in an unrelated trade or business activity.\textsuperscript{43} The term “unrelated trade or business” means an activity conducted by a tax-exempt organization which is regularly carried on for the production of income from the sale of goods or performance of services\textsuperscript{44} and which is not substantially related to the performance of the organization’s charitable, educational or other exempt functions.\textsuperscript{45}

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.”\textsuperscript{47} 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 the activity with continuity and regularity and . . . the taxpayer’s primary purpose for engaging in the activity must be for income or profit.”\textsuperscript{48} 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.”\textsuperscript{49}

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

\textsuperscript{41} Portions of this discussion on unrelated business income are extracted from the author’s previously published article, \textit{The Taxation of Cause-Related Marketing}, 85 CHI-KENT L. REV. 883 (2010).

\textsuperscript{42} All references to the “Code” are to the Internal Revenue Code of 1986, as amended.

\textsuperscript{43} \textit{I.R.C. § 511.}

\textsuperscript{44} \textit{Treas. Reg. § 1.513-1(a).}

\textsuperscript{45} \textit{I.R.C. § 513(c); Treas. Reg. § 1.513-1(b).}

\textsuperscript{46} \textit{I.R.C. § 513(a).}

\textsuperscript{47} \textit{Treas. Reg. § 1.513-1(b).}

\textsuperscript{48} \textit{Comm’r v. Groetzinger, 480 U.S. 23, 35 (1987).}

\textsuperscript{49} \textit{Treas. Reg. § 1.513-1(b).} \textit{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.”).
hope and intent of realizing a profit.’”50 Significant weight is given to objective factors such as
whether the activity is similar to profit-making activities conducted by commercial enterprises.51
When the activity involved is highly profitable and involves little risk, courts generally infer the
presence of a profit motive.52 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.53

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.”54 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].”55 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.”56 However, “[w]here
income producing activities are of a kind normally undertaken by nonexempt commercial
organizations only on a seasonal basis, the conduct of such activities by an exempt organization
during a significant portion of the season ordinarily constitutes the regular conduct of trade or
business.”57

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

695, 704 (11th Cir. 1984).
51 Ill. Ass’n of Prof’l Ins. Agents v. Comm’r, 801 F.2d 987, 992 (7th Cir. 1986).
52 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).
53 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”).
54 Treas. Reg. § 1.513-1(c)(1).
55 Treas. Reg. § 1.513-1(c)(2)(i).
56 Treas. Reg. § 1.513-1(c)(2)(ii).
57 Treas. Reg. § 1.513-1(c)(2)(i).
conducted over the same seasonal period.\textsuperscript{58} 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.\textsuperscript{59}

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.\textsuperscript{60} Courts disagree as to whether an exempt organization’s preparation time in organizing and developing an income-producing activity may be taken into account.\textsuperscript{61}

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.\textsuperscript{62} 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.\textsuperscript{63} The activity will not be substantially related merely because the income produced from the activity is used to further the organization’s exempt purposes.\textsuperscript{64} Rather, the inquiry focuses on the manner in which the income is earned. Thus, a substantial causal relationship exists if the distribution of the goods from which the income is derived contributes importantly to the accomplishment of the organization’s exempt purposes.\textsuperscript{65} 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.\textsuperscript{66} If the activities are conducted on a


\textsuperscript{59} 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.”)

\textsuperscript{60} 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).

\textsuperscript{61} 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).

\textsuperscript{62} See Treas. Reg. § 1.513-1(d)(1).

\textsuperscript{63} Treas. Reg. § 1.513-1(d)(1).

\textsuperscript{64} I.R.C. § 513(a); Treas. Reg. § 1.513-1(d)(1).

\textsuperscript{65} Treas. Reg. § 1.513-1(d)(2).

\textsuperscript{66} See I.R.C. § 511.
scale larger than is reasonably necessary to accomplish the exempt purposes, the income attributed to the excess activities constitutes unrelated business income.67

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.68 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.69

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.70 In particular, the following types of passive income are excluded from unrelated business taxable income:

   i. dividends,71
   ii. interest;72
   iii. annuities;73
   iv. payments with respect to securities loans;74
   v. amounts received or accrued as consideration for entering into agreements to make loans;75
   vi. royalties;76

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67 Id.
68 I.R.C. § 513(a)(1).
69 I.R.C. § 513(a)(3).
70 See generally Trinidad v. Sagrada Orden de Predicadores, 263 U.S. 578 (1924).
71 I.R.C. § 512(b)(1).
72 I.R.C. § 512(b)(1).
73 I.R.C. § 512(b)(1).
74 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.
75 I.R.C. § 512(b)(1).
vii. gains or losses from the sale, exchange, or other disposition of property other than inventory;77 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.78

2. 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.79 Accordingly, section 512 of the Code provides that a charity’s UBTI generally does not include royalties.80 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.81 The royalty may be in the form of a fixed fee or a percentage of sales of the products utilizing the charity’s IP. In addition, the tax-exempt organization may retain the right to approve the use of its IP by the licensee 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.82 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.83

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.84 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.

76  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.
77  I.R.C. § 512(b)(5).
78  I.R.C. § 512(b)(5).
79  See Sierra Club Inc. v. Comm’r, 86 F.3d 1526, 1533 (9th Cir. 1996).
80  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).
82  Sierra Club, 86 F.3d at 1533-35.
83  See Rev. Rul. 81-178.
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 IP by a licensee. As is prudent business practice, a charity would want to maintain quality control over the use of its IP by the licensee 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. 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. 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 commercial 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. . . . When 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 commercial and therefore subject to the UBIT. . . .

Bringing royalty income that accrues only to athletic departments under the UBIT would be problematic, however . . . . If 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. . . .

C. 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. Organizations that have unrelated business income also have to file a Form 990-T return. Charitable organizations

86 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).
87 CONG. BUDGET OFFICE, PUB. NO. 3005, TAX PREFERENCES FOR COLLEGIATE SPORTS T3 (2009).
described in Section 501(c)(3) are required to make their Form 990-T returns available for public inspection. 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. 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. However, if a substantial portion of the charity’s income is from unrelated activities, the organization fails to qualify for exemption.

D. 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. Whether an organization has a substantial non-exempt purpose is a question of fact.

E. 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-exempt status. 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 public inspection.

89 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.


94 Treas. Reg. § 1.501(c)(3)-1(c)(1).

95 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’d, 55 T.C.M. 1602 (1988) (denying exempt status where an organization received approximately one-third of its gross income from unrelated business activities).

96 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).
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.\(^97\) 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, 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.\(^98\)

VI. Application of Unrelated Business Income Tax to Cause-Related Marketing.\(^99\) 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. Many cause-related marketing alliances involve recognition of the corporate partner’s participation by the charity on its website and in print materials. Thus, this section first analyzes the possible application of the corporate sponsorship rules to cause-related marketing alliances. Cause-related marketing alliances also involve payment for the use of the charity’s name, logo, or trademark; accordingly, this section next analyzes the application of the royalty exception to cause-related marketing alliances. Finally, because consumer perception of product endorsement by the charity might be considered as a factor in the UBTI analysis, this section analyzes whether the income received from cause-related marketing alliances could be included in UBTI as advertising income.

A. Corporate Sponsorship Rules in General. 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.\(^100\) A “qualified sponsorship payment” is “any payment\(^101\) by any person engaged in a trade or business with respect to which there is no arrangement or

\(^97\) I.R.C. § 357(c); Rev. Rul. 77-71, 1977-1 C.B. 155.

\(^98\) I.R.C. § 512(b)(13).

\(^99\) 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).

\(^100\) 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.

\(^101\) “Payment” means “the payment of money, transfer of property, or performance of services.” Id. § 1.513-4(c)(1).
expectation that the person will receive any substantial return benefit.” A “substantial return benefit” is any benefit other than a “use or acknowledgement” of the corporate sponsor and certain disregarded benefits. Substantial benefits include the charitable organization’s provision of facilities, services, or other privileges to the sponsor; exclusive provider relationships; and any license to use intangible assets of the charitable organization. “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.” 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.”

The tax treatment of any payment that does not represent income from a qualified sponsorship payment is governed by general UBIT principles. 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. 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

102 Id. For purposes of these rules, it is irrelevant whether the sponsored activity is temporary or permanent. Id
103 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.
104 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.
105 The Treasury Regulations define an “exclusive provider” relationship as any arrangement which “limits the sale, distribution, availability, or use of competing products, services or facilities in connection with an exempt organization’s activity.” Id. § 1.513-4(c)(2)(vi)(B). “For example, if in exchange for a payment, the exempt organization agrees to allow only the payor’s products to be sold in connection with an activity, the payor has received a substantial return benefit.” Id.
106 Id. § 1.513-4(c)(2)(iii)(D).
107 Id. § 1.513-4(d).
108 Id.
109 Id. § 1.513-4(f).
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.” 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.” For example, the Internal 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,” and (ii) “Visit the Music Shop today for the finest selection of music CDs and cassette tapes.” 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.

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, 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

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111 Treas. Reg. § 1.513-4(c)(v).
112 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 (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).
113 Id. § 1.513-4(f), example 7.
114 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).
115 See, e.g., State Police Ass’n of Mass. v. Comm’r, 125 F.3d 1, 6 (1st Cir. 1997).
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.” Rejecting the organization’s claim and ruling that the advertising income was UBTI, the Supreme Court analyzed this issue as follows:

All 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 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 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.

B. 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

\[117 \text{Id. at 847.} \]

\[118 \text{Id. at 848–50 (citation omitted). Several cases and rulings follow the reasoning of American College of Physicians. See, e.g., Minn. Holstein-Frisian Breeders Ass’n v. Comm’r, 64 T.C.M. (CCH) 1319 (1992) (holding that advertisements that may have been of “incidental benefit to breeders in running their day-to-day operations” but that did not “contribute importantly to improving the quality of the breed of Holstein-Friesian cattle” were not substantially related to a cattle breeding organization’s exempt purposes); Fla. Trucking Ass’n v. Comm’r, 87 T.C. 1039 (1986) (holding that advertisements of products of particular interest to the trucking industry did not bear a substantial relationship to the exempt functions of a trucking trade association); Rev. Rul. 82-139, 1982-2 C.B. 108 (concluding that a bar association’s publication of advertisements for products and services used by the legal profession was not substantially related to the association’s exempt purposes).} \]
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.\(^{119}\) 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.\(^{120}\) 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.\(^{121}\)

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.\(^{122}\) 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.

C. 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,\(^{123}\) 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

\(^{119}\) See Treas. Reg. § 1.513-4(c)(1).
\(^{120}\) 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).
\(^{121}\) Treas. Reg. § 1.513-4(c)(2)(iv).
\(^{123}\) 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 § 7.276.6.7.3 (CCH 1999).
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.124

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.125 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.

D. 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 purposes.126 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

124 See Sierra Club Inc. v. Comm’r, 86 F.3d 1526, 1532 (9th Cir. 1996).
125 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.
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.

VII. Participation in Joint Ventures. Charitable organizations may partner with other charitable organizations or with for-profit organizations to produce or market an invention or copyrighted work. Participation in these 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. 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.

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. 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.

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

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128 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.
130 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.
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 jeopardize its tax exempt status. 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. 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. 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.

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. The IRS’s Two-Part Test for Joint Ventures. 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. 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.

131 Plumstead Theatre Society v. Comm’r, 675 F.2d 244 (9th Cir. 1982) aff’g 74 T.C. 1324 (1980).
132 Id.
134 Id.
136 Id.
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.\(^{137}\)

The foregoing required a finding that the benefits received by the limited partners are incidental to the public purposes served by the partnership.\(^{138}\)

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 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.\(^{139}\) 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.\(^{140}\) 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.\(^{141}\) The IRS scrutinizes a variety of factors that determine whether the nonprofit has sufficient control over the venture.\(^{142}\) Although Revenue Ruling 98-15 lists a number of relevant factors, four factors appear to be most

\(^{137}\) Id.
\(^{138}\) Id.
\(^{140}\) Id.
\(^{142}\) Id.
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.143

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.144 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 98-15.145 The court noted, most 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.146 Moreover, the relevant organizational documents did not include an overriding charitable purpose.147 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.”148 Affirming the Tax Court, the Ninth Circuit Court of Appeals held that ceding “effective control” of partnership activities impermissibly serves private interests.149 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.”150

3. St. David’s Health Care System v. United States. 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

143 See generally Mirkay, supra note 127.
144 Redlands Surgical Services v. Comm’r, 113 T.C. 47 (1999), aff’d, 242 F.3d 904 (9th Cir. 2001).
145 Id.
146 Id.
147 Id.
148 Id.
149 242 F.3d 904 (9th Cir. 2001).
organization “ceded control” of its tax-exempt hospital. 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.” The charitable partner also must have the “capacity to ensure that the partnership’s operations further charitable purposes.” Thus, “the [charity] should lose its tax-exempt status if it cedes control to the for-profit entity.” 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.

4. Revenue Ruling 2004-51. 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. 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 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. 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.

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.

151 St. David’s Health Care System v. United States, 349 F.3d 232 (5th Cir. 2003).
152 Id. at 243.
153 Id.
154 Id. at 239.
155 Id.
157 Id.
158 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.
D. UBIT Treatment for a Charity Investing in a Joint Venture. When a charity invests in a joint venture, 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 joint venture, 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. Similarly, if the joint venture is formed as a corporation, and the charity’s investment in the joint venture is structured as the acquisition of shares of stock in the corporation, 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. These interest and dividend exclusions may not apply, however, to the extent the interest or dividend income is treated as unrelated debt-financed income.

However, joint ventures are generally are treated as a partnership for federal income tax purposes. Accordingly, the joint venture does not pay income tax on its net earnings. Rather, the profits and losses of the joint venture are 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. For example, if a charity invests in a joint venture that is formed as a partnership, the charity would be required to report its allocated items of profit and loss from the joint venture 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., royalties, rents, and capital gains), then the charity typically must apply the general three-prong UBIT test to determine whether the income from the business operated by the joint venture is unrelated business income for the charity. Usually, investment in the joint venture will easily meet the first two prongs: the activity conducted by the joint venture 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 joint venture substantially furthers the charitable purposes for which the charitable investor was granted tax-exemption. This is a case by case determination. Accordingly, a charity desiring to invest in a joint venture that is treated as a partnership for tax purposes must be careful to structure the joint venture to conduct activities which are closely aligned with the charity’s own mission.

VIII. Compensation to Employees. If a nonprofit assigns its rights to IP produced by an employee to the employee, then careful consideration should be taken to ensure that the assignment of the IP rights does not produce unreasonable compensation to the employee.

159 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.
160 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).
161 See I.R.C. § 512(b)(1).
162 See generally I.R.C. § 514.
163 See id. at 624.
164 See I.R.C. § 512(b). If the joint venture 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.
165 See I.R.C. § 513.
Similarly, if the nonprofit and the employee share the rights to the IP, the employee’s share of revenues produced from licensing the IP needs to be taken into account in determining whether the employee receives unreasonable compensation. Additionally, if the employee is a “disqualified person” with respect the nonprofit, the nonprofit will need to consider and approve the employee’s total compensation package, including the value of the rights retained by the employee, in accordance with the rebuttable presumption procedures described below.

A. Excess Benefit Transactions Generally. 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. 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.

When it applies, Section 4958 imposes an initial tax equal to 25% of the excess benefit on any disqualified person. 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. The initial excise tax on organization managers is capped at $20,000. 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.

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. 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.”

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

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166 I.R.C. § 4958(c)(1).
168 I.R.C. § 4958(a)(2).
169 I.R.C. § 4958 (d)(2).
172 Treas. Reg. § 53.4958-3(c).
organization. Factors tending to show that an individual exercises substantial influence include:

i. the individual is a founder of the organization;
ii. the individual is a substantial contributor to the organization;
iii. the individual’s compensation is primarily based on revenues derived from activities of the organization, or of a particular department or function of the organization, that the individual controls;
iv. the individual has or shares authority to control or determine a substantial portion of the organization’s capital expenditures, operating budget, or compensation for employees;
v. the individual manages a discrete segment or activity of the organization that represents a substantial portion of the activities, assets, income, or expenses of the organization, as compared to the organization as a whole; or
vi. the individual owns a controlling interest (measured by either vote or value) in a corporation, partnership, or trust that is a disqualified person.

Factors tending to show that an individual does not exercise substantial influence include:

i. the individual has taken a bona fide vow of poverty as an employee, agent, or on behalf, of a religious organization;
ii. the individual is a contractor (such as an attorney, accountant, or investment manager or advisor) whose sole relationship to the organization is providing professional advice (without having decision-making authority) with respect to transactions from which the individual will not economically benefit either directly or indirectly (aside from customary fees received for the professional advice rendered);
iii. the direct supervisor of the individual is not a disqualified person;
iv. the individual does not participate in any management decisions affecting the organization as a whole or a discrete segment or activity of the organization that represents a substantial portion of the activities, assets, income, or expenses of the organization, as compared to the organization as a whole; or
v. any preferential treatment the individual receives based on the size of that individual’s contribution is also offered to all other donors making a comparable contribution as part of a solicitation intended to attract a substantial number of contributions.

1. Exception for Non-Highly Compensated Employees. Nonetheless, an employee who does not receive economic benefits from the organization in excess of the indexed amount for being considered a highly compensated employee ($120,000 in 2015), is not a disqualified person even if the above factors indicate that the individual may have substantial influence over

173 Treas. Reg. § 53.4958-3(e).
174 Treas. Reg. § 53.4958-3(e)(2).
175 Treas. Reg. § 53.4958-3(e)(3).
176 Notice 2014-70, 2014-48 I.R.B. 905 (Nov. 21, 2014). Note that this is a different standard than the one used to determine which individuals are “highly-compensated employees” for Form 990 reporting purposes.
the affairs of the organization. This exception does not apply to employees who are automatically considered disqualified or who are substantial contributors to the organization.

2. Initial Contract Exception. The theory behind the initial contract exception is that an individual who negotiates an employment agreement in good faith before the individual is in a position to exercise substantial influence over the organization should not be subject to sanctions even if the compensation under the employment agreement turns out to be excessive. Accordingly, Section 4958 does not apply to any fixed payment made to an individual with respect to an initial contract, regardless of whether the payment would otherwise constitute an excess benefit. An “initial contract” is a binding written agreement between the charitable organization and an individual who was not a disqualified person immediately before entering into the agreement. A “fixed payment” an amount of cash or other property specified in the agreement, or determined by a specified objective fixed formula, which is to be paid or transferred in exchange for the provision of specified services or property. A fixed formula may incorporate an amount that depends on future specified events or contingencies (such as the amount of revenues generated by one or more activities of the organization), provided that no person exercises discretion when calculating the amount of a payment or deciding whether to make a payment. If an initial contract provides for both fixed and non-fixed payments, the fixed payments will not be subject to Section 4958 while the non-fixed payments will be evaluated under an excess benefit transaction analysis, taking into account the individual’s entire compensation package.

B. What Constitutes Compensation? A disqualified person’s entire compensation package must be evaluated to determine whether on the whole, the compensation received by the individual is reasonable for the services provided. Accordingly, if the organization is relying on the rebuttable presumption of reasonableness, the organization’s board of directors must consider and approve the disqualified person’s entire compensation package, not merely salary and bonuses. The compensation package includes all forms of cash and noncash compensation, all forms of deferred compensation if earned and vested, most fringe benefits whether or not taxable, employer-paid premiums for liability insurance coverage, expense allowances and reimbursements, and other economic benefits received by the disqualified person from the organization in exchange for the performance of services. However, the following benefits may be disregarded in evaluating the compensation package under Section 4958: (i) employee fringe benefits that are excluded from gross income under Section 132; (ii) expense reimbursements paid pursuant to an accountable plan; (iii) economic benefits provided to a

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177 Treas. Reg. § 53.4958-3(d)(3).
178 Id.
182 Id.
184 A charitable organization’s payment of premiums for liability insurance covering Section 4958 excise taxes or indemnification of such taxes will not be an excess benefit if the premium or indemnification is included in the disqualified person’s compensation when paid and the disqualified person’s total compensation is reasonable. Treas. Reg. § 53.4958-4(b)(1)(B)(2).
disqualified person solely as a member of or volunteer for the organization if the same benefit is available to the general public in exchange for a membership fee of no more than $75 per year; and (iv) economic benefits provided to a disqualified person solely as a member of a charitable class that the organization is organized to serve.186

1. Determination of Reasonable Compensation. In general, the value of services is the amount that would ordinarily be paid for like services by like enterprises (whether taxable or tax-exempt) under like circumstances (i.e., reasonable compensation). Section 162 standards apply in determining reasonableness of compensation, taking into account the aggregate benefits (other than any benefits specifically disregarded under Treasury Regulation Section 53.4958-4(a)(4)) provided to a person and the rate at which any deferred compensation accrues.187 The factors generally considered for purposes of Section 162 include (i) the employee’s qualifications, (ii) the nature, extent and scope of the employee’s work, (iii) the size and complexities of the employer’s business, (iv) the prevailing economic conditions, (v) the prevailing rates of compensation for comparable positions in comparable employers, and (vi) the employer’s salary policy that applies to all employees.188 The fact that bonus or revenue-sharing arrangement is subject to a cap is a relevant factor in determining the reasonableness of compensation. The fact that a state or local legislative or agency body or court has authorized or approved a particular compensation package paid to a disqualified person is not determinative of the reasonableness of compensation for purposes of Section 4958.189

Normally, the facts and circumstances to be taken into consideration in determining reasonableness of a fixed payment are those existing on the date the parties enter into the agreement pursuant to which the payment is made.190 However, in the event of substantial non-performance, reasonableness is determined based on all facts and circumstances, up to and including circumstances as of the date of payment. In the case of any payment that is not a fixed payment under an agreement, reasonableness is determined based on all facts and circumstances, up to and including circumstances as of the date of payment.191

2. Substantiation of Economic Benefit Treated as Compensation. To monitor disguised compensation, the Treasury Regulations require a charitable organization to clearly indicate its intent to treat an economic benefit as compensation when it is paid. This rule is intended to prevent a charitable organization from later claiming that an excess benefit transaction, such as a below-market loan or personal expense allowance, was actually compensation and that the overall compensation package of the disqualified person was reasonable.192 To establish its intent, the organization must provide contemporaneous written substantiation of the economic

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188 Mayson Manufacturing Co. v. Comm’r, 178 F.2d 115 (6th Cir. 1949).
190 These general timing rules also apply to property subject to a substantial risk of forfeiture. Therefore, if the property subject to a substantial risk of forfeiture satisfies the definition of fixed payment, reasonableness is determined at the time the parties enter into the agreement providing for the transfer of the property. Treas. Reg. § 53.4958-4(b)(2)(i).
192 See, e.g., Treas. Reg. § 53.4958-4(c)(4) Example 2.
benefit intended to be compensation for services.\textsuperscript{193} Contemporaneous written substantiation can be accomplished through the inclusion of the economic benefit on the individual’s Form W-2 or Form 1099, through a written employment agreement, or through the written contemporaneous documentation of the approved compensation package under the rebuttable presumption of reasonableness.\textsuperscript{194} However, the organization is not required to provide written substantiation of its intent to include nontaxable economic benefits, such as employer-provided medical insurance or employer contributions to a qualified retirement plan, as part of the individual’s compensation.\textsuperscript{195} As a result, even though contributions to qualified retirement plans and other nontaxable benefits are required to be taken into account in evaluating whether the overall compensation package is reasonable, they are not subject to the contemporaneous written substantiation requirement.

3. Revenue-sharing Compensation Arrangements. Revenue-sharing arrangements between a charitable organization and a disqualified person may be treated as an excess benefit transaction if the transaction results in prohibited private inurement.\textsuperscript{196} The scope of this rule is uncertain and is not addressed in the final regulations. However, the implications of this rule may be significant for performance-based compensation arrangements and more complex arrangements to share revenue from intellectual property or other income-producing activities.

After the enactment of Section 4958, proposed regulations were issued that addressed the application of the excess benefit transaction rules to revenue-sharing compensation arrangements. These rules were not incorporated into the final regulations, and the Internal Revenue Service may later issue guidance in this area. In the meantime, revenue-sharing compensation arrangements are evaluated under the general rules governing reasonableness of compensation paid to a disqualified person, leaving a fog of uncertainty about whether these arrangements are in fact reasonable.

Since the old proposed regulations provide the only guidance on this issue, they are discussed herein for informational purposes, although they have no precedential value. In general, whether a revenue-sharing arrangement constitutes an excess benefit transaction depends on all relevant facts and circumstances. The arrangement may result in excess benefit if it permits a disqualified person to receive additional compensation without providing proportional benefits for the charitable organization. Relevant factors include the relationship between the size of the benefit provided and the quality and quantity of the services provided, and the ability of the disqualified person to control the activities generating the revenues.\textsuperscript{197} The proposed regulations provided three examples illustrating the principles for determining whether a revenue-sharing transaction resulted in an excess benefit.\textsuperscript{198}

\textbf{i.} In the first example, the disqualified person was an in-house investment manager for the charitable organization. In addition to the individual’s regular salary and benefits, the

\textsuperscript{193} Treas. Reg. § 53.4958-4(c)(1).
\textsuperscript{194} Treas. Reg. § 53.4958-4(c)(3).
\textsuperscript{195} Treas. Reg. § 53.4958-4(c)(2).
\textsuperscript{196} I.R.C. § 4958(c)(4).
\textsuperscript{197} Prop. Treas. Reg. § 53.4958-5(a) (withdrawn).
\textsuperscript{198} Prop. Treas. Reg. § 53.4958-5(d) (withdrawn).
individual was entitled to a bonus equal to a percentage of any increase in the net value of the portfolio. The bonus was considered an incentive to maximize benefits and minimize expenses to the organization. Thus, even though the individual had a measure of control over the portfolio performance, the bonus produced a proportional benefit for the organization. Therefore, the revenue-sharing arrangement was not considered an excess benefit transaction.

   ii. In the second example, the disqualified person was a third-party management company managing the charitable organization’s charitable gaming activities. The management company controlled all of the activities generating revenues and paid the charitable organization a percentage of the net profits from these activities. Since the management company provided all the personnel and equipment for the activities, the management company controlled all the costs charged to revenues and net revenues. This structure did not provide the management company with an appropriate incentive to maximize benefits and minimize costs to the charitable organizations because the management company benefitted whether the net revenues were low because expenses were high or net revenues were high because expenses were low. In contrast, the charitable organization only benefitted if the net revenues were high. As a result, the entire transaction was considered an excess benefit transaction.

   iii. In the third example, the disqualified person was a university professor who was the principal investigator in charge of certain scientific research. In addition to the professor’s regular salary and benefits, the professor was entitled to a specified percentage of any patent royalties on inventions produced by the professor’s research. This arrangement provided an incentive for the professor to produce especially high quality work and no incentive to act contrary to the university’s interest. Moreover, the university shared proportionately with the professor. Lastly, the university owned and controlled the patent and the professor had no control over the revenues generated from the patent. This arrangement was not considered an excess benefit transaction. Many research institutions have invention and research policies similar to this example.

C. Rebuttable Presumption of Reasonableness. 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.\textsuperscript{199} 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.\textsuperscript{200} 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.\textsuperscript{201}

\textsuperscript{199} Non-fixed payments to a disqualified person not subject to a cap are generally not advisable.


\textsuperscript{201} Treas. Reg. § 53.4958-6(a)(1)-(3).
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.\(^{202}\) A person is not considered part of the authorized body if he merely meets to provide information to the board and then recuses himself.\(^{203}\) No person voting on the matter may have a conflict of interest with respect to the transaction.\(^{204}\) 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.\(^{205}\)

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.\(^{206}\)

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;

\(^{202}\) Treas. Reg. § 53.4958-6(c)(1)(i)(A)-(C).

\(^{203}\) Treas. Reg. § 53.4958-6(c)(1)(ii).

\(^{204}\) Treas. Reg. § 53.4958-6(a)(1).

\(^{205}\) Treas. Reg. § 53.4958-6(c)(1)(iii)(A)-(E).

\(^{206}\) Treas. Reg. § 53.4958-6(c)(2)(i).
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.  

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.  

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208 Treas. Reg. § 53.4958-6(c)(3)(ii).