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Commercial Co-Venturing
Tax Issues for the 501(c)(3)

I. Exclusively for Exempt Purposes

One of the requirements of maintaining 501(c)(3) status is that the 501(c)(3) organization operate exclusively for its charitable purposes. The regulations interpret this to mean that the organization is not entitled to 501(c)(3) status if it has a substantial activity unrelated to its charitable purposes.

- A. There is no bright-line test for what is substantial.
- B. Activities from which the 501(c)(3) receives passive income generally are not a threat to tax-exempt status.
- C. Exception:

Limited Partnership. If the 501(c)(3) is a passive limited partner in an unrelated trade or business activity, the trade or business activity is attributed to the 501(c)(3) and, if it is substantial, 501(c)(3) status could be at risk. The solution is to conduct the activity through a for-profit subsidiary of the 501(c)(3).

II. Unrelated Business Income Tax

A 501(c)(3) is by definition exempt from federal income tax, but is nevertheless subject to tax at regular corporate or trust rates or its net income from any unrelated business activity which is regularly carried on.

- A. Volunteer, Convenience, Thrift Shop Exceptions. There are exceptions for a business activity carried on primarily for the convenience of students, participants or employees, for a business activity substantially (85%) conducted by volunteers and, in the case of a business consisting of the sale of merchandise, where all of the merchandise is contributed.

B. Passive Income Exception. Passive income (except income received by the 501(c)(3) organization as a limited partner in an unrelated trade or business partnership) is not subject to unrelated business income tax. This means that, generally, dividends, interest, rent and royalties are not subject to tax.

Exceptions:

Debt-financed property. If the property producing the passive income is financed with debt, all or a portion of the net income is subject to tax.

Rental of Personal Property produces income subject to tax.

Rental of Real Estate Where Services exceed customary rental services produces income subject to tax.

Royalties. If the 501(c)(3) organization provides administrative or advertising services beyond those reasonably required to protect its name, a portion of the royalty is subject to tax.

S Corporation. Amounts attributed to a 501(c)(3) as a shareholder in an S corporation are subject to tax, even if the S corporation's trade or business is related to 501(c)(3)'s charitable purposes and even if the income attributed to the 501(c)(3) is passive.

C. Sponsorship Versus Advertising. Trade or business does not include a tax-exempt organization's receipt of "qualified sponsorship payments." This means that a 501(c)(3) is not taxed on its receipt of such payments.

A "qualified sponsorship payment" is any payment made to the 501(c)(3) by a trade or business where there is no expectation that the business will receive any substantial return benefit other than a permitted use or acknowledgement of the business's name, logo or product lines in connection with the tax-exempt organization's activities. A return benefit to the business is substantial if its value exceeds 2% of the amount of the business's payment to the tax-exempt organization.

1. Permitted Use or Acknowledgement

exclusive sponsorship arrangements

logos and slogans that do not contain qualitative or comparative descriptions (unless the description in the logo or slogan is an established part of the business's identity)

a list of the business's locations or contact information

value neutral descriptions of the business products (including displays or pictures)

a list of the business's brand names, products or services.

2. Advertising – Activities that Exceed Permitted Use or Acknowledgement

messages containing qualitative or comparative language, price information, or other indications of savings or value

endorsements (“X Charity endorses the use of our product”)

encouragements by the tax-exempt organization of anyone to purchase, sell or use any of the business’s services, facilities, or products.

3. Qualified Sponsorship Payments Do Not Include

income derived from the sale of advertising or acknowledgments in a tax-exempt organizations periodical (publications unrelated to a specific event conducted by the organization)

payments made in connection with qualified convention and trade show activities (a separate exception applies)

payments contingent on the level of attendance at events, broadcast ratings or any other factors in directing the degree of public exposure to the sponsored activity (although the payment may be contingent on the sponsored activity taking place)

III. Classification for Purposes of the Public Support Test

For a 501(c)(3) that must pass a public support test in order to avoid becoming a private foundation, income from commercial co-venturing can affect the test. Hospitals, educational institutions, churches and certain organizations related to them are deemed to be public charities and do not have to pass a public support test. A supporting organization does not have to pass a public support test.

A. Effect of Co-Venturing Income on a Donative Public Charity. If the co-venturing income is classified as a royalty or as unrelated business income, it increases the 501(c)(3)’s total support but is not counted as public support and the 501(c)(3) may need to increase its other public support to maintain public charity status. If the income is classified as sponsorship income, it qualifies as public support up to the 2% limit.

B. Affect of Co-Venturing Income on a Fee for Service Public Charity. If the co-venturing income is classified as a royalty or as unrelated business income, it increases the 501(c)(3)’s total support but is not counted as public support. In addition, if the income is classified as a royalty, it is investment income for purposes of the rule that a fee for service public charity’s investment income is limited to one-third of its total support over the five year test period. Sponsorship income is public support, unless the income is so large that the sponsor is considered a Disqualified Person.

C. Can the Consumer Be Considered to Have Made a Contribution? Not in the typical situation, where the for-profit promises to give a certain amount to the 501(c)(3) for each

purchase. If the promotion requests the consumer to pay an amount above the stated price that will go to the 501(c)(3), then each consumer's contribution portion would be public support to the 501(c)(3) (and would be deductible by the consumer).