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Sources of Revenue for Nonprofits: Rules of the Road and Potential Opportunities

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Klavens Law Group, P.C.

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- Small Boston law firm focused on clean energy ventures and projects, as well as other innovative ventures with positive environmental or social impact
- Represents companies, investors, public entities and nonprofits
- Provides start-up, outside general counsel, transactional, project development and regulatory services
- Brings critical interdisciplinary approach by drawing on experience in corporate, securities, energy, real estate, land use, environmental and nonprofit law

Topics

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- Types of Revenue for Nonprofit Incubators
- Foundational Concept – Organization’s Exempt Purpose(s)
- Unrelated Business Taxable Income (UBTI)
- Qualified Sponsorship Payment
- Impermissible Private Benefit
- Private Inurement
- Doctrine of Commerciality

Types of Revenue

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- Grants
- Membership fees – flat fees, fees for additional services
- Corporate sponsorships – annual, program/event
- Limited use fees – co-working space day passes, etc.
- Event hosting fees
- Referral fees/commissions
- Equity in incubator members – services for equity; participation rights

What Is Your Exempt Purpose?

- What do your organizational documents say?
- What do you tell the IRS?
- Can you modify your exempt purpose?

Unrelated Business Taxable Income

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- Basic rule – nonprofit's income taxable if derived from activity:
  - from trade or business regularly carried on AND
  - not substantially related to its exempt purposes
- Exemptions (examples)
  - Passive income, including certain rental income, interest, dividends, certain capital gains, royalties
  - convention and trade show income
  - corporate sponsorship payments
  - activities for convenience of members
  - other: volunteer labor, donated goods, low-cost incidentals

Unrelated Business Taxable Income

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- My organization earned UBTI – now what?
  - UBTI is generally taxed as if earned by comparable for-profit entity, subject to standard corporate tax rates and deductions
  - Return filed on Form 990-T
  - If UBTI is "substantial," tax-exempt status could be at risk
- What if activity is break-even or doesn't result in net income to organization as a whole?
  - For nonprofit, UBTI calculated based on comparison of income and expenses of particular unrelated business (i.e., assessed on activity-by-activity basis)
  - For taxable subsidiary of nonprofit, taxable income of subsidiary based on all of subsidiary's income and expenses (i.e., on an aggregate basis)

Qualified Sponsorship Payment

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- Receipt of qualified sponsorship payment does not constitute UBTI
- Qualified sponsorship payment
  - Payment made by person engaged in trade or business (*e.g.*, corporate sponsor)
  - Sponsor may not receive any substantial return benefit for payment
- Substantial return benefit means any benefit other than "use or acknowledgment" of sponsor's name or logo
- If sponsor receives substantial return benefit, only that portion of payment that organization *can demonstrate exceeds FMV of substantial return benefit* is considered qualified sponsorship payment

Qualified Sponsorship Payment

- "Substantial return benefits" include any benefit *other than* use or acknowledgment, including
  - Advertising (beyond mere use or acknowledgment)
  - Exclusive provider arrangements (*i.e.*, limiting sale or distribution of competing products, usually to benefit of sponsor)
    - *Exclusive <u>sponsor</u> arrangements are generally permissible*
  - Rights to use intangible assets of the exempt organization (*e.g.*, name, logo, trademark)
    - *This may, however, constitute a tax-free royalty already excluded from UBTI*
  - Other privileges – goods, facilities, services (*e.g.*, tickets to for-fee event; luxury box at sponsored event)
- Benefit may be disregarded if value is not substantial
  - Aggregate FMV of all benefits provided to sponsor during the nonprofit's taxable year must be ≤ 2% of the sponsorship payment amount

Qualified Sponsorship Payment

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- Use or acknowledgment
  - Identification of sponsor and recognition of sponsorship payment
  - Includes use of sponsor's name, logo and slogan; contact information; neutral descriptions of sponsor's service, facility, or product; distribution of product at sponsored event
- Advertising
  - Promotes or markets sponsor's trade or business, or any service, facility, or product
  - Includes messaging with qualitative or comparative language; price information; other indications of value; endorsements to purchase, sell, or use the sponsor's service, facility, or product
- If messaging includes both acknowledgement and advertising, then considered advertising

Qualified Sponsorship Payment

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- Other exceptions to qualified sponsorship payments (may be UBTI)
  - Payments that are contingent on public exposure (*e.g.*, minimum attendance or rating)
  - Payments for advertising or acknowledgement in organization's regular periodical are governed by different regulations (26 CFR 1.512(a)-1(f)) and considered UBTI.
    - *However, payments that result in the sponsor's name or logo being included in materials related to sponsored event will be considered qualified sponsorship payments and not taxable income*
  - Different rules govern payments made in connection with certain convention or trade show activity by 501(c)(5) or 501(c)(6) organizations (26 CFR 1.513-3).
- Rules and useful examples found at 26 CFR 1.513-4

Other Issues

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- Impermissible Private Benefit
  - Benefit to individual or for-profit entity more than incidental – qualitatively and quantitatively – to furthering organization's exempt purposes
  - Qualitative – is private benefit not just a necessary by-product of organization's activities but something more?
  - Quantitative – is amount of private benefit more than insubstantial compared to overall charitable benefit from organization's activities?

Other Issues

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- Private Inurement
  - Improper financial benefit to insiders (directors, officers, etc.)
  - Largely address by (1) ensuring transaction is on arm's length/FMV terms and (2) having and complying with conflicts of interest policy
- Doctrine of Commerciality
  - Loose doctrine providing that nonprofit won't qualify for – or can forfeit – 501(c)(3) status if it acts too much like for-profit business in the relevant market sector

Practical Tips

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- Be proactive - an ounce of prevention is worth a pound of cure
- Be mindful of Form 990 disclosure requirements
- Document how arrangements further nonprofit's exempt purpose(s) – organizational documents, board minutes, contract language
- Ensure sponsorships satisfy rules for qualified sponsorship payments, including establishing and documenting FMV of substantial return benefits
- Have and follow conflict of interest policy
- Generally stay close to the pack, but don't be afraid to innovate

Questions

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