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PURPOSEFUL PROFIT: THE CASE FOR MODERN IRS GUIDANCE ON CAUSE-RELATED MARKETING OF TANGIBLE SALES AND UNRELATED BUSINESS INCOME (IRC §§ 511, 512, 513)

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[1] The comments contained in this paper are the individual views of the author who prepared them, and do not represent the position of the California Lawyers Association or its Taxation Section.

[2] Although the participants on this project might have clients affected by the rules and tax forms applicable to the subject matter of this paper and have advised such clients on applicable law, no such participant has been specifically engaged by a client to participate on this project.

EXECUTIVE SUMMARY

In an environment where tax-exempt organizations are in ever increasing competition for fundraising, many have turned to direct sales of tangible property to promote themselves, their causes, and diversify their funding sources. These efforts are in keeping with growing cause related marketing ("CRM") strategies where the marketing of a product is enhanced by incorporating the social good the underlying cause supports.

However, CRM of tangible property risks a tax-exempt organization running afoul of the IRS's unrelated business taxable income ("UBTI") rules. Designed to prevent unfair competition between tax-exempt organizations and other companies, these rules present significant tax burdens if: (1) the income is from a trade or business; (2) the trade or business is regularly carried on; and (3) the trade or business is not substantially related to the exercise or performance by tax-exempt organization of its exempt function. The UBTI problem was historically avoided by licensing arrangement with for-profit companies and the royalty exception of IRC § 512(b)(2). However, many tax-exempt organizations have grown frustrated with poor partnerships and a recognition that such an arrangement by definition dilutes the revenue such sales generate. Moreover, the proper structuring of a royalty arrangement may present complexities and challenges a tax-exempt organization would seek to avoid.

Tax-exempt organizations are thus left in a precarious position. Their choices include abandoning a diversified fundraising source that concurrently advances their cause, enter into royalty arrangements that dilute such fundraising, run the UBTI gauntlet and risk significant deficiencies, or seek guidance from a tax professional. Unfortunately, the last, and perhaps best, option comes with significant costs and little assurances. The shortcoming of professional advice is driven by the IRS's limited guidance on the topic of CRM in relation to tax-exempt organizations, particularly in the area of tangible property sales. Little guidance has been forthcoming, and that which exists has not been sufficient to keep up with modern issues.

This paper gives a brief overview of CRM and the UBTI problem tax-exempt organizations face. It continues by highlighting the unique problems and how existing IRS guidance has been inadequate. With the IRS's unwillingness or inability to issue more guidance (including letter rulings) this paper proposes several solutions to give tax-exempt organizations greater assurances that their noble CRM efforts will not inadvertently cause greater problems.

DISCUSSION

I. INTRODUCTION

Cause related marketing ("CRM") occupies a unique position at the intersection of commerce and conscience. The use of CRM has evolved into a widely employed marketing strategy over the last half century, praised for its dual potential to improve brand equity and contribute to social good. Few consumers are not familiar with the now commonplace messages of: "a portion of proceeds will be donated to X cause," or "buy one, and we'll donate one."

CRM is not monolithic. CRM can be brand-aligned, where the cause and product share thematic or strategic congruence (*e.g.*, a fitness apparel company supporting heart disease research), or non-aligned, where the cause is unrelated to the product (*e.g.*, a snack food brand supporting rainforest conservation). Both strategies aim to influence consumer behavior while projecting a socially responsible corporate image. CRM can be particularly advantageous in saturated markets by providing a distinct competitive advantage. By embedding a cause into its marketing, a company can differentiate itself from competitors whose value propositions are otherwise similar. This is particularly valuable in commoditized sectors such as retail, food and beverage, and fast fashion.

The reason for CRM's increasing usage is debatable. At its core CRM is likely driven by the belief or expectation that consumers are often willing to pay a premium for products associated with a good cause. Some commentators cynically attribute CRM's rise to sophisticated marketing strategies to hijack a consumer's personal values to enhance brand attachment and increase purchasing potential. Consumer behavior may be inherently influenced by perceived reciprocal benefits—in this case, the psychological reward of supporting a cause through consumption, that companies seek to tap into.

Despite its benefits, CRM is not without criticism when misused. One major concern is consumer skepticism. As CRM has become more widespread, consumers have become more discerning—and sometimes suspicious—about corporate motives. If a campaign appears disingenuous or opportunistic, it can backfire. Perceived insincerity in CRM initiatives can lead to negative evaluations and reduced purchase intent. Another issue is the "fit" between brand and cause. When this fit is perceived as weak or confusing, consumers may struggle to understand the company's motives or feel manipulated. Incongruencies between brand identity and cause can negatively impact CRM attempts. Finally, impact transparency is critical. Consumers increasingly demand clarity about how much money is actually donated, where it goes, and what outcomes it produces. A lack of transparency can erode trust and lead to public backlash—especially in the era of social media.

Whatever the root of CRM, it is hard to deny its effectiveness and pervasiveness. Numerous studies and a consumer's own personal experience support how CRM can positively affect consumer perceptions of a brand. CRM can foster emotional connections that lead to stronger brand loyalty and trust when executed thoughtfully—with strategic alignment, transparency, and authenticity. CRM can thus generate significant benefits, and significant benefits drive the existence tax exempt organizations under IRC § 501(c)(3).

In a typical CRM arrangement, a business agrees to contribute a portion of its sales proceeds to the tax-exempt organizations, while the tax-exempt organizations permits its name, logo, or messaging to be used in the marketing of those products or services. Used properly in this licensing arrangement the two partners extend the mission and values of the tax-exempt organization, increase public awareness of the chosen cause, provide unrestricted funds to the organization without the time, cost, and uncertainty of traditional fundraising, and avoid the issue of unrelated business taxable income ("UBTI") through IRC § 512(b)(2).

Used improperly, this licensing relationship dilutes an otherwise valuable fundraising source and can negatively impact the tax-exempt organization's overall goals and causes with poor partnerships.

In order to by-pass the dilution and risks of a poor licensing relationship while still capitalizing on the good that CRM provides, some tax-exempt organizations have chosen to pursue their own product developments to concurrently advance their mission and diversify funding sources. The direct sale of tax-exempt organization branded merchandise is becoming more and more valuable. For example, a tax-exempt organization may want to further certain charitable or educational purposes by selling its own merchandise (*e.g.*, t—shirts, stickers, posters, etc.) displaying its brand identity, but through the naturalistic CRM status of such sales, advances its charitable purpose by providing purchasers with access to further resources through accompanying packaging, mobile apps, promotional material, similar information delivery tools, and the existence of the tax-exempt organization as a while.

Unfortunately, current IRS guidance to these tax-exempt organizations on the topic of CRM and direct sales of tangible property is inadequate for the times. The application of UBTI to tax-exempt organizations selling products in a CRM effort create tension between justifiable revenue growth, advancing worthy causes, and maintaining the goal of equal competition.

II. THE UBTI PROBLEM

Section 501(a) of the Internal Revenue Code provides an exemption from federal income taxation for organizations described in IRC § 501(c). The organizations described in IRC § 501(c)(3) include organizations organized and operated exclusively for charitable or educational purposes. Treas. Reg. § 1.501(c)(3)-1(d)(1)(i) provides that an organization may be exempt as an organization described in IRC § 501(c)(3) if it is organized and operated for one or more particular purposes and lists, among others, charitable or educational purposes.

Treas. Reg. § 1.501(c)(3)-1(d)(2) defines "charitable," in part, as follows:

> *The term charitable is used in section 501(c)(3) in its generally accepted legal sense and is, therefore, not to be construed as limited by the separate enumeration in section 501(c)(3) of other tax-exempt purposes which may fall within the broad outlines of charity as developed by judicial decisions.*

Treas. Reg. § 1.501(c)(3)-1(d)(3) defines "educational," in part, as follows:

The term educational, as used in section 501(c)(3), relates to:

(a) The instruction or training of the individual for the purpose of improving or developing his capabilities; or

(b) The instruction of the public on subjects useful to the individual and beneficial to the community.

In some situations, a tax-exempt organization may want to further these charitable or educational purpose by selling merchandise that not only has an independent purpose to the wearers or observers, but through its CRM efforts, raises the visibility of the organization as a while. This can be done in several ways, including providing purchasers with access to further resources through accompanying packaging, mobile apps, promotional material, and similar information delivery tools.

But if a tax-exempt organization seeks to capitalize on CRM independent of some licensee, they soon encounter the significant issue of UBTI. Internal Revenue Code Section 511 imposes an income tax on the unrelated business taxable income of an organization recognized as exempt under IRC § 501(c)(3). The structure of IRC § 511-513 was designed to prevent tax-exempt organizations from unfairly competing with for-profit businesses.

Such a tax-exempt organization will become subject to the UBTI if three conditions are present: (1) the income is from a trade or business; (2) the trade or business is regularly carried on; and (3) the trade or business is not substantially related to the exercise or performance by tax-exempt organization of its exempt function. IRC §§ 511, 512, 513(a), and 513(c).

Section 513(a) of the Code defines the term "unrelated trade or business" as meaning in the case of any organization subject to the tax imposed by IRC § 511, any trade or business the conduct of which is not substantially related (aside from the need of organization for income or funds or the use it makes of the profit derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under IRC § 501. This is a factual question.

Section 1.513-1(d)(2) of the Income Tax Regulations provides that a trade or business is "related" to exempt purposes only where the conduct of the business activities has causal relationship to the achievement of exempt purposes (other than through the production of income). Further, it is "substantially related," for purposes of IRC § 513, only if the causal relationship is a substantial one. For this relationship to exist, the sales from which the gross income is derived must contribute importantly to the accomplishment of the taxpayer's purposes. Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends in each case upon the facts and circumstances involved. Section 513(c) of the Internal Revenue Code provides that an activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization.

A tax-exempt organization thinking about selling promotional items with their logos attached or other message to enhance the public's awareness and encourage engagement must be mindful of these UBTI pitfalls. If these items were utilitarian in nature, notwithstanding the delivery of the cause-related message, the tax-exempt organization may be unclear of whether they are subject to UBTI. Given this risk there are only four practical options for tax-exempt organizations aside from seeking a letter ruling from the IRS.

First, the tax-exempt organization may choose to abandon their CRM of promotional product efforts entirely for fear of UBTI. The unfortunate side-effect of this choice is a loss of fundraising and a missed opportunity to advance their values and gain greater visibility.

Second, the tax-exempt organization may seek alternative arrangements with for-profit organizations and avail themselves of the royalty exemption of IRC § 512(b)(2). Although the tax-exempt entity may still have strict supervision over the products, the very nature of a licensing operation dilutes an important fundraising source which can negatively impact the tax-exempt entity's overall goals and causes. Moreover, properly structuring what constitutes an exempt royalty is somewhat unclear. *See e.g., Sierra Club v. Commissioner*, 86 F.3d 1526 (9th Cir. 1996).

Third, the tax-exempt organization could forge ahead with selling its CRM tangible products and risk UBTI, and even a revocation of their status altogether, finding comfort only in the statute of limitations. This comfort is anything but great. For example, in *California Thoroughbred Breeders Ass'n v. Commissioner*, 47 T.C. 335 (1966), the taxpayer challenged the IRS's proposed UBTI deficiency by arguing that more than 3 years had passed since it filed applicable Forms 990, *Return of Organization Exempt from Income Tax*. The IRS had unsuccessfully argued that the failures to file Forms 990-T, *Exempt Organization Business Income Tax Return (and proxy tax under section 6033(e))*, meant that the statute of limitations never began to run for purposes of IRC § 6501(g)(2). Although the IRS eventually accepted the outcome in *California Thoroughbred Breeders Ass'n*, its precedential value is precarious. Rev. Rul. 69-247, 1969-1 C.B. 303 (IRS RRU 1969) ("However, the decision in *California Thoroughbred Breeders Association* will be followed in those instances where the taxpayer has disclosed sufficient facts on Form 990, Form 990-A, or Form 990-P, filed in good faith within the meaning of section 6501(g)(2) of the Code, to apprise the Service of the potential existence of unrelated business taxable income. The return must state the nature of the income-producing activity with sufficient specificity to enable the Commissioner to determine whether the income is from an activity related to the organization's exempt purpose, and the return must disclose the gross receipts from this activity. Revenue Ruling 62-10 is applicable where a taxpayer has not disclosed such facts on an information return."). Future cases may have different outcomes and the tax-exempt organization would still need to disclose "sufficient facts" to begin relying on this comfort, if any.

Fourth, the tax-exempt organization could invest in intensive case-by-case analysis of prior IRS guidance from a tax professional. But as detailed below, this yields little comfort for the cost associated therewith and consequences at stake.

The modern efforts of tax-exempt organizations have outpaced the UBTI structure and have revealed a conflict between the stated design of avoiding unfair competition over for-profit businesses and furthering noble charitable or educational purposes.

III. IRS GUIDANCE

The IRS has been reluctant to provide much guidance on the topic of CRM related to tax-exempt organizations. For example, Rev. Rul. 73-104, 1973-1 C.B. 263, held that the sale of greeting card reproductions of art works by an art museum exempt from tax under IRC § 501(c)(3) does not constitute unrelated trade or business. In that case the art museum sold cards through a shop in the museum and through a catalogue which solicited mail orders. The rationale of the ruling was that the card sales contribute importantly to the achievement of the museum's exempt educational purposes by stimulating and enhancing public awareness, interest, and appreciation of art.

Around the same time, Rev. Rul. 73-105, 1973-1 C.B. 264, provided that the sales of a particular line of merchandise would be considered separately to determine their relatedness to the exempt purpose. The ruling held that the sale by a museum of folk art of reproductions of works from the museum's own collection and reproductions of artistic works from the collections of other art museums, as well as metal, wood, and ceramic copies of American folk-art objects from its own collection and similar copies of art objects from other collections of art works do not constitute unrelated trade or business. The sale of these items contributed importantly to the achievement of the folk-art museum's exempt educational purposes by making works of art familiar to a broader segment of the public, thereby enhancing the public's understanding and appreciation of art.

Likewise, in Rev. Rul. 74-399, 1974-2 C.B. 172, the operation of dining areas, including a cafeteria and snack bar, by an exempt art museum for its staff, employees, and visiting public was not considered an unrelated trade or business activity. Those facilities were designed to complement the needs of museum patrons, being accessible from within the museum galleries rather than from the street. The museum did not actively promote the facilities as a public restaurant, and any profits generated are used to support its exempt purposes. By providing on-site eating options, the museum enhanced visitors' experiences, allowing them to spend more time exploring exhibits without needing to leave for refreshments. Additionally, the facilities enabled staff to remain on the premises throughout the day, contributing to the museum's overall efficiency. As such, the eating facilities played a vital role in furthering the museum's mission.

Since the mid-1970's, little in this area had developed. In 1995 the IRS did issue Tech. Adv. Memo. 950003 (IRS TAM Dec. 15, 1995), in which it opined that:

> *To determine if the sale of an item ... is related to its exempt purpose, it is necessary to ascertain the [tax-exempt organization]'s primary purpose for selling the item. (The buyer's reasons for purchase are immaterial.) Where the primary purpose behind the production and sale of the item is to further the organization's exempt purpose, the sale is related, and income earned from that sale is exempt, even though the item has a utilitarian function or value. It is only where the primary purpose behind the production and sale of the item is to generate income, that the sale is taxable. Thus, the primary purpose test examines the nature, scope and motivation for the particular sales activities in making a determination that there may be a connection between a particular item and the achievement of an exempt purpose. In every instance, the determination of ultimate causal*

relationship must be based on the facts and circumstances of each case. A number of differing factors must be considered in analyzing the primary purpose underlying the sale of each item to determine whether sales activities are related. These factors are generally only a means to determine the primary purpose of each article, but these factors could include, for example, the degree of connection between the item and the [tax-exempt organization]'s collection, as well as the extent to which the item relates to the form and design of the original item. The overall impression conveyed by the article is another factor to be considered. If the dominant impression one gains from viewing or using the article relates to the subject matter of the original article, picture or likeness, substantial relatedness would be established. If the non-charitable use or function predominates, the sale would be unrelated.

Most recently in P.L.R. 200722028 (IRS PLR June 1, 2007), the IRS held that the sale of merchandise merely displaying a particular color but not otherwise displaying a logo or name by a breast cancer educational non-profit organization was found to be related to the organization's exempt purpose of breast health education. The ruling held that the sale of merchandise of a particular color reminds and encourages those who wear, display or see the color, about breast cancer. The sold items were deemed to be "inherently educational, providing information on breast cancer, related topics and resources."

But since 2007 there has been a reluctance from the IRS to issue any further guidance regarding CRM and tax-exempt organizations. Tax-exempt organizations are left with uncertainty in a critical issue that would benefit themselves and by extension the causes they serve. An analysis of the limited guidance may not provide any greater assurances and a detailed consideration of whether an activity is or is not subject to UBTI can be extremely costly.

Given this uncertainty and the risks involved, one practical option for tax-exempt organizations may be to seek a letter ruling from the IRS. Unfortunately, the IRS has appeared unable or unwilling to issue taxpayer-specific guidance in the form of letter rules on this issue. Without more tax-exempt organizations are left with the best of several bad options.

IV. POSSIBLE SOLUTIONS

The ambiguity and uncertainty of UBTI application to CRM tangible sales put tax-exempt organizations in a precarious position. While an organization could request an opinion from their accountant or attorney, such assurances may be of little more value that protection from IRS penalties. Additional guidance or other options are desperately needed.

One potential solution would be increased guidance on when a marketing relationship is "substantially related." A modernized interpretation of CRM efforts could provide assurances to tax-exempt organizations, but a workable definition is admittedly difficult to craft.

Another possible solution, and one that would be easier in practice and interpretation is a safe harbor provision. Development of a structure in which CRM tangible sales, or any other unrelated trade or business income, is seen as de minimus would provide greater comfort to such tax-exempt organizations. By assessing whether the activities generate an acceptably low or

proportionate amount of revenue in comparison to other funding sources is relatively easy to accomplish. In combination with simplified reporting requirements tax-exempt organizations and the IRS would both be in a position to avoid superfluous UBTI concerns for such activities.

There are other possible solutions available, including statutory amendments and expanded regulatory interpretations. While most valuable to the tax-exempt organization community, their likelihood is understandably questionable.

In the absence thereof, perhaps the greatest solution for an otherwise factually intensive, case-by-case problem, would be the renewal of letter rulings. As it exists now the IRS has expressed an unwillingness or inability to issue such rulings. A renewed effort to serve the tax-exempt organization community with such rulings, particularly if coupled with some reduction on an otherwise costly user fee, would go far. But without new and modern guidance, tax-exempt organizations contemplating CRM efforts for tangible property sales are left in a precarious position that negatively impacts them and reduces the effectiveness of their otherwise important functions.