Advanced Issues in Fundraising

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In spite of the COVID-19 pandemic, charities are continuing to pursue various fundraising opportunities in the constant search for sustainable, unrestricted revenue. As fundraising events shift between in-person and virtual, individuals are driving many fundraising initiatives, whether as soliciting their peers, donating at the register, or purchasing products associated with a charitable purpose.

As charitable fundraising and marketing programs have evolved, so have the legal and tax requirements applicable to tax exempt organizations and for-profit marketers. This paper will discuss the regulatory schemes relating to consumer-driven fundraising and cause-related marketing, including federal taxation and federal and state statutes and various structures.

I. **Regulatory Schemes**

A. Federal

As tax-exempt organizations, charities are subject to scrutiny based on their privileged position. The Internal Revenue Service and the Federal Trade Commission both serve a role in ensuring the integrity of the charitable sector.

1. Unrelated Business Income

Section 501(c)(3) of the Internal Revenue Code of 1986, as amended (the "Code")[1] provides for exemption for charitable organizations from federal income tax. However, a tax is imposed on these organizations that derive net income from activities that do not further their exempt purposes.[2] Section 513 defines an "unrelated trade or business" as any trade or business, the conduct of which is not substantially related to the exercise by such organization of its charitable, educational, or other purpose constituting the basis for its exemption. [3] The Code defines unrelated business taxable income ("UBI") as income from an unrelated trade or business that is regularly carried on.[4] An organization pays income tax, called unrelated business income tax or "UBIT" on its net UBI at either the corporate tax rates or the trust tax rates, depending on the form of organization of the entity.[5] Its origin was to prevent tax-exempt organizations from competing unfairly with businesses that pay tax on earnings.[6]

UBIT serves to equalize the economics of a transaction, regardless of whether the activity is conducted by a nonprofit or for-profit. The tax removes the competitive advantage of the increased margin available if income tax is not a cost of doing business, thereby leveling the playing field and reducing the

[1] All section references in this Article refer to the Code, unless otherwise indicated.

[2] Section 511(a)(1).

[3] Section 513(a).

[4] Section 512(a)(1).

[5] Section 511.

[6] *U.S. v. American Bar Endowment*, 477 U.S. 105 (1986). *See also* C. F. Mueller Co. v. Comm'r, 190 F.2d 120 (3rd Cir. 1951).

opportunity for such "unfair competition." UBIT is applicable to most forms of tax-exempt organizations.[7] Both private foundations and public charities are subject to UBIT, as well as state colleges and universities.

With respect to fundraising activities, the tax-exempt organization will need to determine whether its activities fall within the definition of UBI (or are excluded by one of the exceptions or modifications). Further, the implementation of Section 512(b)(6) now requires organizations operating one or more unrelated trade or businesses to compute UBIT separately for each trade or business, resulting in increased administrative burden and the inability to net losses across separate unrelated businesses. The following outlines the elements of what is considered UBI and explains how the fundraising activities of the charity may implicate the UBI rules.

a. UBI - Is there a trade or business?

Section 513(c) states that "the term 'trade or business' includes any activity which is carried on for the production of income from the sale of goods or the performance of services." The Treasury Regulations provide that the definition of a trade or business for purposes of Section 513 has the same meaning it has in Section 162 (which concerns the requirements of the business expense deduction) and "generally includes any activity carried on for the production of income from the sale of goods or performance of services."[8] As a result, "trade or business" is broadly construed, encompassing most activities.

Section 513(c) specifies that merely because an activity does not result in profit does not mean that it will not constitute an unrelated trade or business. However, courts have held that the presence of a "profit motive" is important to the determination of the existence of a trade or business.[9]

b. UBI - Is it regularly carried on?

The second condition is not met if an organization conducts activities on a less than regular basis. If the activity, even if conducted intermittently, manifests a frequency and continuity and is pursued in a manner generally similar to the comparable activity of a for-profit organization, the activity is regularly carried on.[10] This requirement is placed in the context of the purpose of UBIT to place exempt organization business activities on the same basis as competing for-profit business endeavors.

Thus, if an activity is conducted only for a short time, like the operation of a booth at a state fair for two weeks, the activity would not be regularly carried on. However, the operation of a parking lot every Saturday would be regularly carried on. In a recent case, a weekly fundraising event by an alumni association was found to be regularly carried on.[11] A seasonal undertaking can also be considered regularly

[7] Sections 511(a)(2)(A) and 511(b)(2); Treas. Reg. §1.511-2(a)(3)(iii).

[8] Treas. Reg. §1.513-1(b).

[9] *Professional Ins. Agents v. Comm'r*, 726 F.2d 1097, 1102 (6th Cir. 1984); *See also United States v. American Bar Endowment*, 477 U.S. 105, 110, note 1 (1986).

[10] Treas. Reg. §1.513-1(c).

[11] Tech. Adv. Mem. 201544025.

carried on if a for-profit enterprise would ordinarily conduct the activity on a seasonal basis. For example, the operation of a horse racing track for a portion of the year could be considered regularly carried on.[12]

Section 1.513-1(c)(2)(ii) of the Treasury Regulations states that where an organization sells goods primarily for convenience, casual sales which are unrelated to the organization's exempt purpose will not be treated as regularly conducted. On the other hand, where the non-qualifying sales are not merely casual, but are systematically and consistently promoted and carried on by the organization, they would be considered regularly carried on.

c. UBI - Is it Substantially Related to the Exempt Purpose?

The most difficult of the three conditions to analyze is whether the activity in question is not substantially related to the exempt purpose of the organization. The Treasury Regulations state that a trade or business is not "substantially related" to the organization's exempt purpose or purposes unless the activity has a "causal relationship to the achievement of exempt purposes," and such relationship is substantial.[13] The determination of "substantially related" is one of facts and circumstances and requires not only an analysis of the organization's exempt purposes, but also consideration of the size and extent of the activities to determine whether such activities do in fact "contribute importantly to the accomplishment of those purposes."[14] The mere fact that the activity produces income support for the organization does not aid in the determination of whether such activity is substantially related.

If the activity is related in part to the organization's exempt purposes, but nevertheless is conducted on a scale greater than necessary to achieve such purposes, the income attributable to the portion of the activity in excess of that necessary to accomplish its exempt purpose will be considered income from unrelated trade or business activities.[15] For example, in the case of an experimental dairy herd maintained for scientific purposes, income from the sale of milk and cream produced in the ordinary management of the herd would not be UBI, but the sale of ice cream or pastries created from the milk and cream would be considered UBI, unless the manufacturing activities themselves contribute to the accomplishment of the organization's exempt purposes.[16]

The fragmentation rule provides that an activity that is conducted as part of other larger or more complex activities does not lose its independent character and may or may not be related to an organization's exempt purpose.[17] As such, the fragmentation rule is applied to merchandise sales to require an item-by-item analysis of each product to determine which sales may produce UBI.[18] For example, the art museum shop that sells reproductions of art would not pay UBIT on such sales. However, the sales of "scientific books and souvenir items relating to the city where the museum is located have no causal

[12] Treas. Reg. §1.513-1(c).

[13] Treas. Reg. §1.513-1(d)(2).

[14] Id.

[15] Treas. Reg. §1.513-1(d)(3).

[16] Treas. Reg. §1.513-1(d)(4)(ii).

[17] Section 513(c).

[18] Rev. Rul. 73-105, 1973-1 C.B. 264.

relationship to art or to artistic endeavor and, therefore, the sale of these items does not contribute importantly to the accomplishments of the subject organization's exempt educational purpose which, as an art museum, is to enhance the public's understanding and appreciation of art." The ruling continues to state "[t]he fact that some of these items could, in a different context, be held related to the exempt educational purpose of some other exempt educational organization does not change the conclusion that in this context they do not contribute to the accomplishment of this organization's exempt educational purpose."[19]

d. UBI - What is the impact of activities on exempt status?

Section 501(c)(3) organizations must be operated exclusively for the purposes set out in Section 501(c)(3) in order to satisfy the operational test for tax-exempt status. A Section 501(c)(3) organization cannot be organized and operated for the primary purpose of the operation of an unrelated trade or business without risking the loss of its tax-exempt status. The facts and circumstances are considered, including the size and extent of the trade or business and the size and extent of the activities which are in furtherance of the exempt purposes of the organization.[20] There is no particular bright line when it comes to determining whether an activity would become a primary purpose of the organization.

If the UBI activity is significant, the Internal Revenue Service may question the organization's right to retain its exemption. If the UBI is so substantial that it becomes the primary purpose of the organization, an organization has jeopardized its exempt status.[21] Unfortunately, there is no objective percentage of gross revenues or time spent that constitutes an impermissible level of UBI that results in loss of exempt status. Therefore, tax-exempt organizations should proceed cautiously to avoid such a challenge by the Internal Revenue Service.

e. UBI Exception - Qualified Sponsorship Payments

As sponsorships continue to provide revenue for nonprofits, it is important to understand the tax considerations for sponsorships. Section 513 provides for certain exceptions from the definition of "unrelated trade or business" for purposes of UBI, including the activity of soliciting and receiving qualified sponsorship payments. A "qualified sponsorship payment" is defined as a payment by a person or business to an exempt organization, of which there is no arrangement or expectation that the person will receive any "substantial return benefit."[22] Qualified sponsorship payments are an exception from UBI and, therefore, a "substantial return benefit" that falls out of the exception will need to be examined under the rules of UBI to determine whether UBIT would be incurred.

Return benefits to a sponsor are disregarded if the aggregate fair market value of all the benefits provided to the sponsor in connection with the payment during the organization's taxable year is not more than 2% of the amount of the payment. If the aggregate fair market value of the return benefits exceeds 2% of the amount of the payment, then the entire fair market value of such benefits, not merely the excess

[19] Id.

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

[21] Id.

[22] Section 513(i).

amount, is a substantial return benefit.[23] Benefits can include advertising, exclusive provider arrangements, goods, facilities, services or other privileges and exclusive or nonexclusive rights to use an intangible asset.[24]

Organizations should be very cognizant of the sponsor benefits provided. In addition, the value of the benefit is determined when provided, but if the sponsor and the organization enter into a binding, written contract, the fair market value of any benefit provided pursuant to the contract, will be determined on that date. If the parties fail to make a reasonable and good faith valuation of any substantial return benefit, the Internal Revenue Service may determine the allocation of the payment to the substantial return benefit.[25]

Substantial return benefit does not include the use or acknowledgment of the name or logo of the sponsor's business in connection with the sponsorship.[26] Acknowledgements are distinguished from advertising in that they do not include the characteristics of advertising, namely, qualitative or comparative language, price information or other indications of savings or value, an endorsement or an inducement to purchase, sell or use such products or services. Note that a single message that includes both advertising and an acknowledgment is deemed advertising.[27] Acknowledgments can include exclusive sponsorship arrangements, logos and slogans that do not contain qualitative or comparative descriptions of the sponsor's products, listing of sponsor's locations, telephone numbers, website, value-neutral descriptions, visual depictions of the product, brand or trade names and service listings. Logos or slogans that are an established part of the sponsor's identity are not considered to contain qualitative or comparative descriptions. Display or distribution of the sponsor's products whether for free or paid to the general public is not considered an inducement to purchase and will not affect the sponsorship.[28] In many cases, simple language changes can modify what would otherwise be considered advertising into an acknowledgment.

Exclusive arrangements with sponsors can form part of a qualified sponsorship if the exclusivity relates to the organization's activity, as in the title sponsor, or a specific category of sponsors, as in the exclusive sponsor in a particular industry. In contrast, exclusivity that limits the sale, distribution, availability or use of competing products, services or facilities generally results in a substantial return benefit. For example, if the organization agrees that only the sponsor's products and no other competing products would be sold at an activity, then the sponsor has received a substantial return benefit.[29]

f. UBI Modification - Cause-Related Marketing and Royalty Income

Cause-marketing or cause-related marketing is a general term that denotes the association between a marketing scheme supporting a commercial endeavor that relates to or supports a charitable purpose. According to the Cause Marketing Forum, the origin of the term "cause-related marketing" is attributed to

[23] Treas. Reg. §1.513-4(c)(2)(ii).

[24] Treas. Reg. §1.513-4(c)(2)(iii).

[25] Treas. Reg. §1.513-4(d).

[26] Treas. Reg. §1.513-4(c)(2)(ii).

[27] Treas. Reg. §1.513-4(c)(2)(v).

[28] Treas. Reg. §1.513-4(c)(2)(iv).

[29] Treas. Reg. §1.513-4(c)(2)(vi).

American Express and its 1983 Statue of Liberty Restoration project. However, records of cause marketing programs date back to at least 1976, with Marriott and the March of Dimes.[30]

In a cause-related marketing program, also known by state regulations as a commercial co-venture, the organization permits the for-profit to use the charity's name and logo in connection with a sales promotion where a purchase triggers a donation back to the exempt organization in the form of a royalty. From a UBIT perspective, the cause-marketing agreement between the organization and the for-profit would likely be structured as a passive royalty arrangement. Section 512(b) provides for modifications to the definition of "unrelated business taxable income" to exclude income from a tax exempt organization that is derived from investment and other passive activities like royalty arrangements where payments are received for a valuable intangible property right.[31] Whether a particular item falls within the Section 512(b) modifications is a facts and circumstances determination.[32] There are limitations with respect to the modifications, essentially exceptions to the exceptions. Income from royalties is an exception, unless it is earned in connection with controlled organizations, for example, in which case, the income would be subject to UBIT.[33] Controlled organizations are defined as organizations where the ownership by the exempt organization is 50 percent or more.[34]

In addition, the activities of the exempt organization in connection with the promotion would need to be limited in order to maintain the characterization of the income as a royalty. Actual services provided by the exempt organization to the for-profit under a royalty arrangement would potentially cause UBI exposure as these portions of the royalty payments would likely be viewed by the Internal Revenue Service as payments in exchange for services.[35] Potential services could include advertising or active endorsement of the for-profit or its products.

For-profit counterparts to cause-related marketing agreements typically desire that the organization actively encourage sales as a means to increase the return on investment for the promotion, generally due to a lack of awareness of the tax implications for the exempt organization. Organizations run the risk of conducting advertising or other services on behalf of the for-profit by encouraging the purchase of the goods or services, incurring UBIT in the process and potentially putting other revenues at risk to be treated other than as royalties under section 512(b)(2) of the Code.

Note that the organization does have the option to provide the services and pay UBIT intentionally. The service provided and its value would need to be clarified and quantified, and the organization would pay the tax. In this circumstance, the preference would be for the services to be contained in a separate agreement.

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[30] The Cause Marketing Forum, "Background and Basics," available at http://www.causemarketingforum.com/site/c.bkLUKcOTLkK4E/b.6443937/k.41E3/Background_and_Basics.htm.

[31] *Sierra Club v. Comm'r*, 86 F.3d 1526, 1535 (9th Cir. 1996).

[32] Treas. Reg. §1.512(b)-1.

[33] Treas. Reg. §1.512(b)-1(a)(2).

[34] Section 512(b)(13)(D).

[35] *See* Rev. Rul. 81-178, 1981-2 C.B. 135.

2. Private Benefit

The private benefit proscription is found in the Section 501(c)(3) regulations. The regulations provide that an organization will be regarded as operating exclusively for exempt purposes only if it engages primarily in activities which accomplish one or more exempt purposes.[36] An organization will not be so regarded if more than an insubstantial part of its activities is in the furtherance of a non-exempt purpose.[37] The organization is not organized or operated exclusively for exempt purposes unless it serves a public rather than a private interest.[38] The Tax Court, in *American Campaign Academy v. Com'r*,[39] defined private benefit as "nonincidental benefits conferred on disinterested persons that serve private interests." The Supreme Court in *Better Business Bureau of Washington, D.C., Inc. v. United States*[40] held that private benefit, if substantial in nature, will destroy the organization's exemption regardless of an organization's other charitable purposes or activities.

As charitable organizations operate for public benefit, an incidental benefit to private individuals is common, but if such private benefits are served more than incidentally, the organization is at risk of denial or loss of exemption. To the extent that a tax exempt organization provides more than incidental private benefit to a for-profit in the context of a fundraising activity, whether through advertising or endorsements beyond the scope of a qualified sponsorship payment or the passive royalty arrangement of a commercial co-venture, the organization puts its tax-exempt status at risk. As cause-related marketing programs expand, for profit organizations continue to seek increased access to the exempt organization's constituent base. As the exempt organization engages with for-profit organizations in diverse ways, a private benefit analysis of the interaction is essential.

3. Commerciality

The commerciality doctrine is, essentially, a rule of law developed by the courts, with one mention in the Code[41] and a reference in the tax regulations.[42] The commerciality doctrine is where a charitable organization cannot be tax-exempt if it substantially operates in a commercial manner. An activity is a commercial one if it has a direct counterpart in, or is conducted in the same manner in, the world of for-profit organizations.[43] A recent private letter ruling determined that an organization operated in a commercial manner by conducting activities "indicative of a for-profit, commercial operation."[44] Caution is warranted if fundraising activities entail operating in a commercial manner.

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

[37] *Id*.

[38] Treas. Reg. §1.501(c)(3)-1(d)(1)(ii).

[39] 92 T.C. 1053 (1989).

[40] 326 U.S. 279 (1945).

[41] Section 501(m).

[42] Treas. Reg. §§1.513-1(c)(1), 1.513-1(c)(2)(ii).

[43] *See Living Faith, Inc. v. Commissioner* (7th Cir. 1991); *Airlie Foundation v. IRS* (D.D.C. 2003); *also Easter House v. U.S.* (Fed. Cir. 1988).

[44] PLR 201712017.

4. Federal Trade Commission

The Federal Trade Commission (FTC), through its Bureau of Consumer Protection, serves to protect consumers against unfair, deceptive or fraudulent practices. The FTC has historically taken enforcement action against deceptive and fraudulent practices in the name of charities pursuant to the Federal Trade Commission Act[45] and the Telemarketing and Consumer Fraud and Abuse Prevention Act.[46] The FTC has also acted in concert with the enforcement actions of the state regulators.

On March 21, 2017, the FTC co-hosted a conference with the National Association of State Charity Officials to explore consumer protection issues and charitable solicitations. The session included panels with academics, researchers, marketers, representatives from the sector, donor advocacy groups and staff from the FTC and state attorney general offices. The focus of the conference was to examine how evolving and new solicitation practices on behalf of charitable causes impact individual giving decisions.[47]

B. State

State regulations of charities and other entities that interact with charities are fundamentally based on consumer protection. Forty-one states regulate the solicitation of donations for charitable purposes by statute. In all states, some form of common law or other statutes provide additional consumer protection. Regulations typically cover categories of entities as follows:

- Charity
- Professional Fundraiser/ Professional Solicitor
- Fundraising Counsel/ Fundraising Consultant
- Commercial Co-Venturer
- California's new regulation of "charitable fundraising platforms"

Note that this Article's description of the state regulatory regime is meant to highlight the regulations generally and not intended as a comprehensive survey of all applicable regulations. Each state's requirements are distinct, and care should be taken to comply with each state's applicable laws.

1. Charity

Charities that solicit donations have annual registration requirements under charitable solicitation regulations in the various states.[48] Exemptions from registration may also be available.[49] In the event that a charity is not registered on a national basis, upon entering into a fundraising promotion or commercial

[45] 15 U.S.C. § 45.

[46] 15 U.S.C. §§ 6101-6108.

[47] For more information, *see* https://www.ftc.gov/news-events/events-calendar/2017/03/give-take-consumers-contributions-charity.

[48] Texas does not have a registration requirement for most charities other than organizations that solicit for law enforcement, public safety or veterans causes. More information about registration is available at https://www.texasattorneygeneral.gov/cpd/charities-nonprofits-registration-filings.

[49] Cal. Gov't Code § 12583 (West).

co-venture relationship with anticipated sales nationally, the charity should register in all states where required.[50]

2. Professional Fundraiser/ Professional Solicitor

A professional fundraiser is a person, other than an employee of the charity, who for compensation solicits funds for a charitable organization. Approximately 40 states regulate professional fundraisers. As an example, California's definition is as follows:

> "'Commercial fundraiser for charitable purposes' means any individual, corporation, unincorporated association, or other legal entity who for compensation does any of the following: (1) Solicits funds, assets, or property in this state for charitable purposes. (2) As a result of a solicitation of funds, assets, or property in this state for charitable purposes, receives or controls the funds, assets, or property solicited for charitable purposes. (3) Employs, procures, or engages any compensated person to solicit, receive, or control funds, assets, or property for charitable purposes."[51]

a. Obligations on a Professional Fundraiser

Of those states that regulate professional fundraisers, professional fundraisers are generally required to register prior to the solicitation of funds. In addition, professional fundraisers are to file an annual report and a financial report with the state. Some states require bonding. Further, professional fundraisers are required to enter into a written contract for the services performed.[52]

b. Obligations on a Charity

Generally, charities are required to enter into a written contract with registered professional fundraiser for the services performed.[53]

3. Fundraising Counsel/ Fundraising Consultant

Fundraising counsel are distinct from professional fundraisers in that they may plan or consult regarding fundraising solicitations for compensation, but they do not solicit nor retain the funds. Approximately forty states regulate fundraising counsel. California's definition is an example:

> "'Fundraising counsel for charitable purposes' is defined as any individual, corporation, unincorporated association, or other legal entity who is described by all of the following: (1) For compensation, other than

[50] *See* Charleston Principles regarding guidelines for fundraising regulation and the internet, available at http://www.nasconet.org/wp-content/uploads/2011/05/Charleston-Principles-Final.pdf.

[51] Cal. Gov't Code § 12599 (West).

[52] *E.g.*, Cal. Gov't Code § 12599 (West).

[53] *Id.*

> as a percentage of the funds, assets, or property received as a result of a solicitation campaign, plans, manages, advises, counsels, consults, or prepares material for, or with respect to, the solicitation in this state of funds, assets, or property for charitable purposes. (2) Does not solicit funds, assets, or property for charitable purposes. (3) Does not receive or control funds, assets, or property solicited for charitable purposes in this state…(4) Does not employ, procure, or engage any compensated person to solicit, receive, or control funds, assets, or property for charitable purposes."[54]

a. Obligations on a Fundraising Counsel

Of those states that regulate fundraising counsel, fundraising counsel are generally required to register prior to advising with respect to a solicitation of funds. In addition, fundraising counsel are to file an annual report with the state. Further, fundraising counsel are required to enter into a written contract for the services performed.[55]

b. Obligations on a Charity

Generally, charities are required to enter into a written contract with registered fundraising counsel for the services performed.[56]

4. Commercial Co-Venturer

Commercial co-venture programs are regulated either by specific state statutes or by the broad charitable solicitation statutes.

Commercial co-venturer is typically defined in a manner similar to the California definition:

> "'Commercial coventurer' is defined as any person who, for profit, is regularly and primarily engaged in trade or commerce other than in connection with the raising of funds, assets, or property for charitable organizations or charitable purposes, and who represents to the public that the purchase or use of any goods, services, entertainment, or any other thing of value will benefit a charitable organization or will be used for a charitable purpose."[57]

a. Obligations on the Commercial Co-Venturer

[54] Cal. Gov't Code § 12599.1 (West).

[55] *E.g.*, Cal. Gov't Code § 12599.1 (West).

[56] *Id.*

[57] Cal. Gov't Code § 12599.2(a) (West).

Of those states that specifically regulate commercial co-venturers (approximately half of the states), state law generally requires registration by the commercial co-venturer[58], posting of a bond by the commercial co-venturer[59], a written contract with the charity[60], specific information to include in advertising disclosures[61], accounting to the state[62] and recordkeeping.[63] In some cases, the commercial co-venturer has the obligation to file the contract with the state.[64]

b. Obligations on the Charity

In addition to registering as a charity soliciting in the respective state, in some states, the charity has additional requirements related to commercial co-venture programs. For example, some statutes require two signatories on the contract from the charity[65], written contract or summary filed by charity[66] and to provide an accounting to the state.[67]

In some cases, there are joint obligations of the for-profit marketer and the charity, where the filing must be co-signed by the for-profit marketer and the charity.[68]

5. California's Assembly Bill 488 – Charitable Fundraising Platforms and Platform Charities

On October 7, 2021, California Governor Gavin Newsom signed into law Assembly Bill 488[69], amending the Supervision of Trustees and Fundraisers for Charitable Purposes Act by establishing a new statutory framework to regulate online charitable fundraising platforms. Beginning January 1, 2023, the

[58] *E.g.*, Ala. Code § 13A-9-71; Mass. Gen. Laws Ann. ch. 68, § 24 (West); N.Y. Exec. Law § 174 (McKinney); S.C. Code Ann. § 33-56-110.

[59] *E.g.*, Ala. Code § 13A-9-71; Mass. Gen. Laws Ann. ch. 68, § 24 (West).

[60] *E.g.*, Ala. Code § 13A-9-71; Cal. Gov. Code § 12599.2; Mass. Gen. Laws Ann. ch. 68, § 22 (West); N.Y. Exec. Law § 173-a (McKinney); S.C. Code Ann. § 33-56-70.

[61] *E.g.*, N.Y. Exec. Law § 174-c (McKinney); S.C. Code Ann. § 33-56-70.

[62] *E.g.*, Ala. Code § 13A-9-71; Mass. Gen. Laws Ann. ch. 68, § 24 (West); S.C. Code Ann. § 33-56-70.

[63] *E.g.*, Ala. Code § 13A-9-71; Mass. Gen. Laws Ann. ch. 68, § 26 (West); N.Y. Exec. Law § 173 (McKinney); S.C. Code Ann. § 33-56-100.

[64] *E.g.*, Ala. Code § 13A-9-71; Mass. Gen. Laws Ann. ch. 68, § 22 (West); S.C. Code Ann. § 33-56-70.

[65] *E.g.*, Mass. Gen. Laws Ann. ch. 68, § 22 (West); 10 Pa. Stat. Ann. § 162.15 (West).

[66] *E.g.*, Conn. Gen. Stat. Ann. § 21a-190g (West); N.Y. Exec. Law § 173-a (McKinney).

[67] *E.g.*, N.Y. Exec. Law § 173-a (McKinney).

[68] *E.g.*, Mass. Gen. Laws Ann. ch. 68, § 24 (West); S.C. Code Ann. § 33-56-70.

[69] *See* the text of Assembly Bill No. 488 at https://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=202120220AB488, which amends, repeals and adds to Sections 12581, 12586.1, 12587, 12598, 12599, 12599.1, 12599.2, and 12599.6 of, and to add Sections 12599.9 and 12599.10 to, the California Government Code, relating to charitable organizations.

act will define a "charitable fundraising platform" as "any person, corporation, unincorporated association or other legal entity that uses the internet to provide an internet website, service, or other platform to persons in this state, and performs, permits, or otherwise enables acts of solicitation to occur." The broad definition of charitable fundraising platform applies to most consumer-facing websites that facilitate the receipt of online donations or that allow a portion of the purchase price from the sale of goods or services to be donated to specific charities. Examples of organizations that could potentially be included in the definition of charitable fundraising platform include Amazon, eBay, Facebook, GoFundMe, Google, and PayPal. The new provisions distinguish between potentially overlapping categorizations as a charitable fundraising platform, commercial fundraiser or commercial coventurer. The bill also regulates platform charities, which are charitable organizations that facilitate acts of solicitation on a charitable fundraising platform. The new provisions will require a charitable fundraising platform and platform charities to register and to file annual reports with the Attorney General's Registry of Charitable Trusts, to provide consumer disclosures in connection with solicitations, to obtain written consent of charity beneficiaries, to solicit or receive funds only for charities in good standing, to segregate funds, to account for fees and to make prompt distribution of donations.

C. Voluntary

1. Multistate Basic Consumer Law Standards and Guidance Principles

In 1999, a report entitled "What's In A Nonprofit's Name? Public Trust, Profit And The Potential For Public Deception" was issued by the attorneys general of sixteen states and the District of Columbia Corporation Counsel, containing six principles relating to consumer protection in the context of cause-related marketing promotions.[70] These principles reflected the concern of the attorneys general that cause-marketing relationships often communicate the false and misleading messages that the products have been endorsed by the nonprofit partner in the cause-marketing relationship and that such products are superior to other competing products.

The guidelines also focus on the possibility that some promotions may mislead the public about the effect consumers' purchases may have on the level of charitable contributions the commercial sponsor will make. Additionally, cause-marketing campaigns do not typically disclose that the charity is paid for the use of its marks and that the commercial co-venturer may have an exclusive relationship with the charity. The principles recommend compliance with consumer protection laws, clarity and conspicuousness in consumer disclosures about whether an endorsement exists, truthfulness in any claims of superiority of products, existence of exclusive relationships, whether the charity has been paid, and whether the consumer can influence the amount going to the charity. The guidelines contained in the report do not have the force of law, yet do describe the areas of concern in the sphere of enforcement and consumer protection.

2. BBB Wise Giving Alliance Standards for Charity Accountability

In 2003, the Better Business Bureau Wise Giving Alliance issued the twenty Standards for Charity Accountability as a method for evaluating charities against comprehensive standards, replacing the separate

[70] Available at http://ago.vermont.gov/assets/files/Whats%20in%20a%20Name_report-nonprofit_mkting.pdf.

standards of the National Charities Information Bureau and the Council of Better Business Bureaus' Foundation and its Philanthropic Advisory Service.[71] The standards address areas of governance, fiscal responsibility, fundraising and accuracy and availability of information about the charity.

Standard 9 relates to fundraising expenses:

> "Fund Raising Expenses - Spend no more than 35% of related contributions on fund raising. Related contributions include donations, legacies, and other gifts received as a result of fund raising efforts."

Interestingly, the Better Business Bureau Wise Giving Alliance recognizes that the 35% threshold is arbitrary in that the ability to demonstrate a variance is expressly provided: "An organization that does not meet Standard 9 may provide evidence to demonstrate that its use of funds is reasonable." The standard's explanation provides examples of several factors which may result in expenditures that are reasonable although they do not meet the 35% threshold. As this standard indicates, the national conversation about focusing on overhead costs as opposed to mission impact by nonprofit organizations continues to evolve.

Standard 19 deals specifically with cause-related marketing:

> "Cause Marketing Disclosures - Clearly disclose how the charity benefits from the sale of products or services (i.e., cause-related marketing) that state or imply that a charity will benefit from a consumer sale or transaction. Such promotions should disclose, at the point of solicitation: a) the actual or anticipated portion of the purchase price that will benefit the charity (e.g., 5 cents will be contributed to abc charity for every xyz company product sold), b) the duration of the campaign (e.g., the month of October), and c) any maximum or guaranteed minimum contribution amount (e.g., up to a maximum of $200,000)."

Several aspects of Standard 19 are important to emphasize. The key to the program disclosure is that it appears at the point of solicitation, all in an effort to provide appropriate information at the time when the consumer makes the purchasing decision. In addition, the requirement for a specific dollar amount or percentage of the purchase price is also intended to provide full information for the consumer to be able to calculate the exact amount of the donation if a purchase is made. The duration of the campaign and the maximum or minimum disclosures round out the purchasing decision, as the consumer is able to determine whether the program is still in effect, as well as whether a purchase will actually contribute toward the donation to the charity.

The explanation materials supporting the standards make clear that disclosures solely stating that the charity will receive "proceeds," "profits," "net proceeds," or some other general financial benefit as a

[71] Available at http://www.give.org/for-charities/How-We-Accredit-Charities/ and https://www.bbb.org/us/storage/0/Shared%20Documents/Standards%20for%20Charity%20Accountability.pdf.

result of sales will not meet Standard 19. The most frequent deficiency in disclosures is not enabling the consumer to calculate the donation at the time of purchase. For example, "10% of profits" is meaningless as a disclosure as the only point of comparison is the actual retail purchase price. If the amount of profits is known only to the for-profit that sells the product, the consumer has no way of knowing what donation will be triggered by a purchase.

Standard 19 stands as a best practice and goes further in disclosure than state commercial co-venture regulations. The issue with the Standards for Charity Accountability is that the standards only apply to charities. The consequences for failure to comply with the standards, including Standard 19, fall on the charity alone, risking their accreditation as an "Accredited Charity" by the BBB Wise Giving Alliance. In many cases, the failures of appropriate disclosure are caused by the for-profit cause-marketer that fails to make the proper information available at the point of solicitation.

3. New York

a. Pennies for Charity Program

The New York attorney general prepares an annual report of fundraising campaigns in New York in an effort to educate the public about charities and fundraising by professional fundraisers. The attorney general also posts the Pennies for Charity database, enabling public access to the financial reports filed with the attorney general's office by professional fundraisers who conduct fundraising campaigns.

b. Five Best Practices for Transparent Cause Marketing

In 2012, the New York Attorney General issued the "Five Best Practices for Transparent Cause Marketing" (the "NY Best Practices") focusing on transparency and consumer protection.[72] Although it requires similar disclosures to Standard 19 from the Better Business Bureau Wise Giving Alliance, the NY Best Practices expanded the amount of information to be provided to the consumer. The NY Best Practices include clearly and prominently disclosing the charity receiving the donation, as well as the mission of the organization if not readily apparent. It also recommends disclosure of any flat donation as well as any restrictions on the donation. All of the relevant consumer disclosure should be made in close proximity to the marketing materials, preferably in the form of a "donation information" label similar in structure to a nutrition label.

The NY Best Practices promote transparency in the negative as well: if the consumer purchase has no effect, state so; if the donation is not monetary (rather in-kind), state so; and if the marketing materials use a ribbon or other indicia commonly associated with a charitable cause, but no donation is intended, state so.

In addition, social media campaigns that include donations for connecting with the company should be subject to the same rigorous disclosure requirements as campaigns related to tangible consumer products.

[72] Schneiderman, Eric T., "Five Best Practices for Transparent Cause Marketing," 2012, available at https://www.charitiesnys.com/Five%20Best%20Practices%20for%20Transparent%20Cause%20Marketing.pdf.

Lastly, the financial results of the campaigns should be publicly disclosed as well, demonstrating accountability to the public.

D. Enforcement

Enforcement in the area of fundraising mainly focuses on consumer deception cases or the failure to comply with state statutes.

In January 2020, the Connecticut Attorney General announced a multistate agreement with PayPal Charitable Giving Fund, Inc. (PPGF), a third party fundraising platform, as the culmination of a multistate investigation launched in 2017 and co-lead by Connecticut and Nebraska.[73] States participating in the settlement include: Arkansas, Colorado, Connecticut, District of Columbia, Idaho, Illinois, Iowa, Kansas, Kentucky, Louisiana, Minnesota, Mississippi, Nebraska, Nevada, New Hampshire, New York, North Carolina Secretary of State, Ohio, Oklahoma, Oregon, Pennsylvania Texas, and Wisconsin. The Assurance of Voluntary Compliance (AVC) was reached after an investigation concerning the adequacy of PPGF disclosures to potential donors, including disclosures on the intended charity recipient, relationship between PPGF with enrolled vs. un-enrolled charities listed on its platform, PPGF's vetting process, the timing of donations, and PPGF's exercise and notice of its variance power to donors. The AVC required PPGF make unavoidable and prominent disclosures to donors regarding the identified concerns (e.g. donations/contributions are made to PPGF, not the chosen charity; notification to donors when donations are re-directed to one not selected by the donor).

In December 2019, the Minnesota Attorney General announced court approval of two settlement agreements regarding the American Federation of Police and Concerned Citizens, Inc. and related charity National Association of Chiefs of Police, Inc. for misrepresentation to donors.[74] The settlement agreements permanently ban the organizations from soliciting charitable contributions in Minnesota and required restitution in the amount of $298,637, representing every dollar that Minnesotans donated to the organizations in the last six years. The organizations used deceptive practices by misrepresenting that donations would only be used to help families of police officers killed in the line of duty. However, the vast majority of the funds went to paying its fundraisers and other for-profit agents to send mailers with claimed "public education" content, not providing aid to police families. The organizations also represented that donations would be used locally but were used for expenses nationwide.

In March 2019, the Illinois Attorney General sued Veterans Christian Network and its founders for multiple violations of Illinois charity laws, including using charitable assets for their own personal benefit rather than the benefit of veterans. In August 2019, a Cook County judge entered an order prohibiting the charity and its founders from engaging in future charitable activities in Illinois and are subject to a $28,337 judgment after allegedly collecting that amount from donors and failing to use the funds for charitable

[73] *See* "Attorney General Tong Leads Multistate Settlement with Paypal Charitable Giving Fund," January 14, 2020, available at https://portal.ct.gov/AG/Press-Releases/2020-Press-Releases/ATTORNEY-GENERAL-TONG-LEADS-MULTISTATE-SETTLEMENT-WITH-PAYPAL-CHARITABLE-GIVING-FUND.

[74] *See* "Attorney General Ellison permanently bans two charities that deceived Minnesotans about supporting families of fallen police officers," December 20, 2019, available at https://www.ag.state.mn.us/Office/Communications/2019/12/20_PoliceCharityBan.asp.

purposes.[75] A separate criminal case was brought against each of the founders for felony theft of charitable funds.

In March 2019, the Federal Trade Commission announced a settlement with Veterans of America with respect to allegations that the principal made millions of unlawful robocalls soliciting donations of cars, boats and other valuable items, ostensibly to benefit veterans.[76] The robocalls allegedly advised consumers that donations would support veterans causes and were tax deductible. The order settling these allegations banned the principal from charitable solicitations and robocalling, and included a suspended judgment of $541,032. The action formed part of a crackdown on fraudulent charities that falsely promise donations to help veterans called "Operation Donate with Honor" by the Federal Trade Commission and law enforcement officials and charity regulators from 70 offices in every state, the District of Columbia, American Samoa, Guam and Puerto Rico. Operation Donate with Honor included more than 100 actions and a consumer education initiative.

In January 2019, the California Attorney General settled with Giving Children Hope for misleading documents to increase the charity's ranking and generate more donations.[77] The charity misled the public by falsely claiming that 99% of contributions went to provide direct aid, when that percentage relied on the use of inflated valuation of gift-in-kind donations of pharmaceuticals. The charity paid $400,000 and agreed to stop providing misleading reports, and the directors and officers paid an additional $10,000.

The most prominent example of enforcement related to cause-marketing is the 1999 investigation of General Mills by the State of Georgia.[78] General Mills conducted a product promotion through its yogurt brand, Yoplait, named "Save Lids to Save Lives." The program advertised to the consumer that a contribution of 50 cents would be made for each lid returned from a unit of Yoplait purchased during the program period. The Georgia Secretary of State's office concluded that certain aspects of the program were deceptive and misleading to consumers. The focus of the investigation related to the limitation on the donation of $100,000 to the charity beneficiary (Breast Cancer Research Foundation), regardless of how many lids were returned. The disclosure of the donation limitation appeared on the underside of the lids,

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[75] *See* "Attorney General Raoul Sues Lombard Veterans Charity For Misappropriated Funds," March 19, 2019, available at https://illinoisattorneygeneral.gov/pressroom/2019_03/20190319.html and "Attorney General Raoul: Judge Finds Lombard Veterans Charity Misappropriated Funds," August 20, 2019, available at https://www.illinoisattorneygeneral.gov/pressroom/2019_08/20190820.html.

[76] *See* "Veterans of America," April 2, 2019, available at https://www.ftc.gov/enforcement/cases-proceedings/182-3049/veterans-america and "FTC and States Combat Fraudulent Charities That Falsely Claim to Help Veterans and Servicemembers," July 19, 2019, available at https://www.ftc.gov/news-events/press-releases/2018/07/ftc-states-combat-fraudulent-charities-falsely-claim-help.

[77] *See* "Attorney General Becerra Announces $410,000 Settlement with Giving Children Hope, After the Charity Engaged in a Misleading Reporting Scheme," January 29, 2019, available at https://oag.ca.gov/news/press-releases/attorney-general-becerra-announces-410000-settlement-giving-children-hope-after.

[78] *See* Press Release, Cathy Cox, Ga. Sec'y of State, Secretary Cox: Agreement with General Mills to Conclude Investigation into Yoplait Charitable Promotion Results in Additional $63,000 for Breast Cancer Research (Dec. 21, 1999), available at https://web.archive.org/web/20110827120618/http://www.sos.ga.gov/pressrel/pr991221.htm.

and was only visible to consumers after they had already purchased the product. General Mills agreed to make an additional $63,000 contribution to the charity and to reimburse the state for its investigative costs.

II. Common Structures for Consumer-driven Fundraising

Consumer-driven fundraising can be structured in a variety of ways. Each variation in structure will need to be examined in the context of tax and state and federal regulations.

A. Commercial Co-Venture

The most common structure for cause-related marketing is where a for-profit organization represents to the public that the purchase of a product or service by consumers will trigger a donation to a charitable organization, commonly referred to as a commercial co-venture in the state regulatory regimes described above. The organization and the for-profit enter into a licensing arrangement where the organization grants to the for-profit the use of its trademarks in connection with such a sales promotion.

An increasing trend is for the commercial co-venturer to incorporate the option for consumers to choose a charity to benefit, rather than to benefit a single, specific charity. This can create a problem for the commercial co-venturer in that to retain a list of available charities would require a contract with each charity and reporting obligations under the various commercial co-venture statutes. In the alternative, some commercial co-venturers have established a commercial co-venture relationship with a single charity that will then re-distribute funds to the consumer's chosen charity through either a donor-advised fund structure or a private foundation. The AmazonSmile program is a well-known example, where the consumer purchases Amazon products through a parallel website, www.smile.amazon.com, and the AmazonSmile Foundation will donate 0.5% of the purchase price from eligible AmazonSmile purchases to the consumer's chosen charity.[79] Per the AmazonSmile Foundation Form 990-PF from 2018, the foundation made $37,481,047 in qualifying distributions.

B. Sale of Merchandise

One common variation in cause-related marketing is with respect to the sale of merchandise bearing the organization's name and logo. If the charity were to be selling the merchandise directly, UBI may be an issue. The sale of merchandise would be considered a trade or business and of indefinite duration. Generally, income from the sale of merchandise by the organization as a means to fundraise would be considered UBI. In certain circumstances, the merchandise could be considered a related activity. In a private letter ruling, the Internal Revenue Service held that the sale of merchandise that included the pink ribbon symbol serves to remind and encourage those who wear, display or see the images about breast cancer, further enhancing the organization's mission.[80] A standard commercial co-venture where the charity licenses the trademarks to a third party to sell the merchandise would avoid the concerns of UBI, as long as the charity did not advertise on behalf of the marketer.

C. Flat Donation

[79] *See* https://smile.amazon.com/ and related website pages describing the AmazonSmile program.

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

A flat donation not contingent on the actions of the consumer or a donation made in the past is also an option. The for-profit marketer would need to clearly disclose that a donation has been made and that no additional donation will be made by a consumer purchase. From a state regulatory perspective, without the purchase component, many state regulations on commercial co-venture would not apply. However, some of the state statutes, like Massachusetts[81], may be broad enough to encompass this type of program. From a UBI perspective, the arrangement can still be structured as a passive royalty with a fixed fee.

D. Donations at Register

Another option is to accept donations at the register. The donation is not triggered by a consumer purchase of a product. However, if the for-profit marketer keeps any of the donated funds as a fee, then it may have to register in the various states as a professional fundraiser, a set of regulations that are more onerous than commercial co-venture statutes. From a tax perspective, the for-profit is serving as an agent for the charity in collecting donations.

E. Experiential Promotions

Experiential promotions are events or opportunities where participation would trigger a donation, like a donation to a charity for each person that takes a car for a test drive or "liking" a social media post. A careful reading of each state's commercial co-venture statute would be required to determine whether it satisfies the definition of commercial co-venture, as it may be captured by the states with broader definitions. These types of programs would follow the same tax analysis of UBI and private benefit.

F. Raffles, Bingo and Sweepstakes

Many charities employ a variety of games of chance in connection with fundraising, including raffles, bingo and sweepstakes. In some cases, third parties, such as Prizeo or Omaze, offer sweepstake entries in exchange for donations to charities, providing for an interesting mixture of state regulatory regimes.[82] Games of chance are heavily regulated at the state level as a form of gambling with limited exceptions like those for charitable fundraising. Each jurisdiction has particular rules regarding such exceptions and generally treats violations of the statutes with criminal penalties. From a tax perspective, these types of activities are generally not regularly carried on and would be excluded from UBI. In addition, Section 513(f) excludes certain bingo games from the definition of unrelated trade or business.

G. Blockchain-related Donations

[81] "'Commercial co-venturer', any person who for profit or other commercial consideration, conducts, produces, promotes, underwrites, arranges or sponsors a performance, event, or sale to the public of a good or service which is advertised in conjunction with the name of any charitable organization or as benefiting to any extent any charitable purpose. Any such person who will benefit in good will only shall not be deemed a commercial co-venturer if the collection and distribution of the proceeds of the performance, event or sale are supervised and controlled by the benefiting charitable organization", Mass. Gen. Laws Ann. ch. 68, § 18 (West).

[82] *E.g.*, www.prizeo.com and www.omaze.com.

Blockchain is a technology that provides a backbone for secure and transparent transactions.[83] With respect to charitable fundraising, cryptocurrency and non-fungible tokens have emerged as potential sources of charitable contributions. Cryptocurrency is a digital currency utilizing blockchain technology.[84] Non-fungible tokens are "unique and non-interchangeable unit of data stored on a blockchain" that can be sold and traded and have been utilized in connection with digital art to provide proof of ownership.[85] In 2014, the IRS issued Notice 2014-21, treating virtual currency as property for Federal income tax purposes.[86] The IRS has not issued any specific tax guidance regarding non-fungible tokens, but the treatment could follow cryptocurrency as a property for Federal tax purposes.[87]

H. Crowdfunding

The Oxford Dictionary defines "crowdfunding" as "[t]he practice of funding a project or venture by raising money from a large number of people who each contribute a relatively small amount, typically via the Internet."[88] The authors propose that "crowdfunding" by charities is not a new trend, rather describes the traditional method of obtaining charitable contributions from the general public. Curiously, this term has been made famous by start-up internet firms, like Kickstarter, that utilize this historical form of raising money for new ventures. The wrinkle for charities is that charities now have to differentiate charitable fundraising by a Section 501(c)(3) organization from other collective fundraising activities, like funding for particular individuals that have suffered hardship. Fundraising for particular individuals also may fall into the state regulatory regimes. With the current pandemic, crowdfunding in the form of peer-to-peer fundraising has taken on new importance. With organizations previously relying on in-person events to drive fundraising, the advent of the virtual event necessitates the drive of individual volunteer fundraisers to solicit their individual networks on behalf of the charities. Volunteers fall out of the state professional fundraiser regulations as a result of not being compensated for fundraising on behalf of a charity.

III. **"Hybrid Organizations"**

For-profit companies that are sometimes called social ventures incorporate a giving concept or a social good into their business model and may fall into a gray area of regulation. An example is Tom's Shoes, where for each shoe purchased, a pair of shoes is given to someone in need. In this particular type of program, there is no direct charity involvement. Some states have statutes broad enough to characterize

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[83] *See* https://en.wikipedia.org/wiki/Blockchain (last visited December 19, 2021).

[84] *See* https://en.wikipedia.org/wiki/Cryptocurrency (last visited December 19, 2021).

[85] *See* https://en.wikipedia.org/wiki/Non-fungible_token (last visited December 19, 2021).

[86] Notice 2014-21, 2014-16 I.R.B. 938. *See also* Rev. Rul. 2019-24 and Chief Counsel Advice 202114020.

[87] *See* Walter Effross, J.D., Leonard Goodman, CPA, Ph.D., Anthony Pochesci, CPA, and Jay Soled, J.D., LL.M., *Tax Consequences of Nonfungible Tokens (NFTs)*, JOURNAL OF ACCOUNTANCY (December 19, 2021, 8:00 AM), https://www.journalofaccountancy.com/news/2021/jun/tax-consequences-of-nfts-nonfungible-tokens.html.

[88] Available at: https://en.oxforddictionaries.com/definition/crowdfunding (last visited December 19, 2021).

these programs as charitable solicitations or commercial co-venture programs. Regardless of its regulatory status, consumer protection statutes would apply in the event the claims were misleading or untrue.

As this area of social venture becomes more common, states have responded by creating statutory entities that contemplate incorporating societal good as consistent with and part of the statutory purposes of these newer forms. Low-profit limited liability companies and benefit corporations are two such examples. In addition, as charitable organizations are finding it more difficult to maintain consistent revenue streams of unrestricted dollars, the creation of a taxable for-profit subsidiary could be an avenue to obtain such revenues. The taxable, for-profit subsidiary can conduct activities that may incur unrelated business income tax, produce more than incidental private benefit or otherwise put a charitable organization's tax-exempt status at risk if conducted by the charitable organization directly.

A. Low-profit Limited Liability Company (L3C)

A low-profit limited liability company, also called an L3C, is a form of limited liability company established by statute in eight states.[89] An L3C is a limited liability company that is specifically organized to further one or more charitable or educational purposes within the meaning of Section 501(c)(3) and would not have been formed but for the relationship to the accomplishment of those purposes. In addition, no significant purpose of the company is the production of income or the appreciation of property and no purpose of the company is to accomplish one or more political or legislative purposes.[90] These provisions are intended to mirror the requirements of a program-related investment in Section 4944 and the corresponding regulations to allow a private foundation to make a program-related investment to an L3C without exercising what is called expenditure responsibility. However, the Internal Revenue Service does not consider an L3C to be different from a traditional limited liability company for tax purposes and still requires expenditure responsibility to be exercised in connection with program-related investments with an L3C.[91]

B. Benefit Corporations

Benefit corporations, also called public benefit corporations, have been established by statute in 37 states and pending in four more, according to B Lab, a nonprofit that encourages the establishment of benefit corporation statutes.[92] Benefit corporations are for-profit corporate entities that include public benefits or positive impacts on society as part of its corporate purpose. State statutes generally require accountability with respect to such purposes. Public benefits may include environmental or social goals, in addition to the standard financial purposes of a for-profit organization. From a federal tax perspective, benefit corporations are treated as either C corporations or S corporations, consistent with traditional corporations.

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[89] *See* https://www.intersectorl3c.com/l3c for a tally of L3Cs as of July 20, 2021 in each jurisdiction and 2,015 L3Cs total.

[90] *See* 805 Ill. Comp. Stat. Ann. 180/1-26 as an example of the definition of low-profit limited liability company.

[91] *See* Comment 3, Examples of Program-Related Investments, 81 FR 24014-01 (T.D. 9762).

[92] Available at: http://benefitcorp.net/policymakers/state-by-state-status (last visited December 19, 2021).

C. Texas Public Benefit Corporation

On September 1, 2017, Texas enacted Subchapter S of Chapter 21 of the Texas Business Organizations Code ("TBOC") creating Public Benefit Corporations. A "Public Benefit Corporation" is a for-profit corporation that elects to be a public benefit corporation and includes one or more specific public benefits in its certificate of formation.[93]

The purpose of a public benefit corporation is to produce a public benefit or benefits and to operate in a responsible and sustainable manner. A public benefit corporation is to be managed "in a manner that balances: (1) the shareholders' pecuniary interests; (2) the best interests of those persons materially affected by the corporation's conduct; and (3) the public benefit or benefits specified in the corporation's certificate of formation."[94] A "public benefit" according to the TBOC means "a positive effect, or a reduction of a negative effect, on one or more categories of persons, entities, communities, or interests, other than shareholders in their capacities as shareholders of the corporation, including effects of an artistic, charitable, cultural, economic, educational, environmental, literary, medical, religious, scientific, or technological nature."[95]

At least every two years, the public benefit corporation must provide to its shareholders a statement that contains (i) the objectives the board of directors has established to promote the public benefit or benefits and interests; (ii) the standards the board of directors has adopted to measure the corporation's progress in promoting the public benefit or benefits and interests; (iii) objective factual information based on those standards regarding the corporation's success in meeting the objectives for promoting the public benefit or benefits and interests; and (iv) an assessment of the corporation's success in meeting the objectives and promoting the public benefit or benefits and interests. The certificate of formation or the bylaws can require a statement more frequently or that it be made public.[96] Certain shareholders of the public benefit corporation can pursue a derivative claim on behalf of the corporation to enforce the duties of the directors.[97] The name of the public benefit corporation may contain "public benefit corporation," "P.B.C.," or "PBC." If not, it must provide notice to acquirers of its shares that it is a public benefit corporation.

D. B-Lab Certification

The term "Certified B Corporation" has led to confusion with respect to benefit corporations. As opposed to forming a benefit corporation as an entity structure under state laws, B-Lab Certification is a third-party standard that provides certifications for a business to be called a "Certified B Corporation." B-

[93] Tex. Bus. Orgs. Code Ann. § 3.007(e) (West). Interestingly, prior to the amendment creating a public benefit corporation, the TBOC already provided that a for-profit corporation could include any social purpose specified in its certificate of formation in discharging the duties of directors or officers. *See* Tex. Bus. Orgs. Code Ann. § 3.007(d) (West). Critics point out that such provisions do not provide the same accountability as the benefit corporation statute.

[94] Tex. Bus. Orgs. Code Ann. § 21.953 (West).

[95] Tex. Bus. Orgs. Code Ann. § 21.952 (West).

[96] Tex. Bus. Orgs. Code Ann. § 21.957 (West).

[97] Tex. Bus. Orgs. Code Ann. § 21.958 (West).

Lab offers the certification to any business regardless of corporate structure, not only to benefit corporations, and charges a fee based on an organization's revenue for such certification.[98]

Benefit corporation statutes typically provide for a form of accountability, such as a report to the shareholders. The use of a third-party certification process that evaluates the organization's progress may satisfy the reporting requirements of state benefit corporation statutes.

E. For-profit Subsidiary of Section 501(c)(3) Organization

A charitable organization may consider the creation of a for-profit subsidiary to conduct activities that may otherwise put the charitable organization's tax-exempt status at risk if conducted by the charitable organization directly. Section 501(c)(3) provides that organizations must operate "exclusively" for charitable, educational, or other exempt purposes to retain their exempt status. However, "exclusively" does not mean exclusively for purposes of this rule. Exempt organizations can be involved in some activities unrelated to its exempt purposes provided the exempt organization is "primarily" engaged in exempt activities. If the exempt organization desires to enter into a significant "unrelated" and/or commercial activity which may not further its exempt purposes, the primary purpose test may not be met. To avoid this threat to the exempt status of the organization, a for-profit subsidiary may be formed by public charities to avoid violating the primary purpose rule. Public charities may own up to 100% of the stock in the for-profit organization without the imposition of excise taxes and without jeopardizing its exempt status.

A tax-exempt organization can invest a portion of its assets and engage in a certain amount of unrelated activities. In capitalizing a subsidiary, a tax-exempt organization should only part with an amount of resources that is reasonable under the circumstances and that can be rationalized in relation to amounts devoted to its programs and invested in other fashions. In addition to cash contributions, tax-exempt organizations often capitalize wholly-owned for-profit subsidiaries with licenses to use their trademarks, logos, member mailing lists, and other intangible assets. These types of assets can be transferred in exchange for an ongoing royalty fee or transferred solely in exchange for stock in the subsidiary.[99]

If a for-profit subsidiary is used, however, it must be operated "separately" from the exempt organization to avoid a claim by the Internal Revenue Service that the activity is being conducted by the exempt organization itself. If the for-profit subsidiary is not separately operated, the Internal Revenue Service will view the subsidiary activities as activities of the exempt organization and may challenge the exempt status of the organization that owns the for-profit subsidiary if the activities of the subsidiary are not "reasonably commensurate in scope" to the exempt activities of the organization. Therefore, the relationship between the exempt organization and the for-profit subsidiary must be carefully structured to avoid attribution.

Any income received by the for-profit subsidiary will be taxable to the for-profit subsidiary as it is a separate taxable entity (C Corporation) from the exempt organization. The dividends paid to the exempt organization by a for-profit subsidiary will be tax free, as dividends are excluded from unrelated business income. The profits of the operation, therefore, will be taxed only once given that the owner of the for-

[98] *See* http://benefitcorp.net/businesses/benefit-corporations-and-certified-b-corps (last visited December 19, 2021).

[99] *See* PLR 199938041.

profit subsidiary is tax-exempt. Other types of income received by the exempt organization from a for-profit subsidiary can cause the recognition of unrelated business income under certain circumstances.

IV. **Conclusion**

As charitable organizations continue find new and inventive ways to tap into the charitable interests of donors, this area of tax and regulation will continue to evolve. As the states are focused on consumer protection, instances of abuse may drive continued regulation and enforcement. From a tax perspective, changes to the tax code and modifications to exceptions and modifications to UBI may also influence the future of royalty arrangements and cause-related marketing, as recent efforts of tax reform indicate.[100] Fundraising will continue to evolve as charities continue to seek increased unrestricted funds to further pursue their missions.

[100] For example, early proposals for tax reform in the U.S. Senate included a provision which would treat royalty income from name and logo licensing as unrelated business taxable income.