Presented:
2013 Nonprofit Organizations Institute

January 16-18, 2013

Cause-Related Marketing

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Cause-Related Marketing

I. Introduction. This paper summarizes special tax considerations that should be taken into account when a charitable organization seeks to engage in a cause-related marketing alliance with a for-profit company. In particular, there are some areas of concern unique to charitable organizations with respect to cause-related marketing activities. In particular, a charitable organization's participation in a cause-related marketing alliance with a for-profit company may cause the charitable organization to incur unrelated business taxable income or lose its tax-exempt status. Underlying these risks is the overriding concern that a charitable organization be organized primarily for the conduct of its charitable purposes and not engage in any activity that results in private benefit.

A. Private Inurement. Section 501(c)(3) of the Code[1] provides that no part of the net earnings of an organization described therein may inure to the benefit of any private shareholder or individual. The Internal Revenue Service ("IRS") takes the position that *any* element of private inurement can cause an organization to lose or be deprived of tax exemption, and that there is no *de minimis* exception.[2] The private inurement prohibition contemplates a transaction between a charitable organization and an individual in the nature of an "insider," who is able to cause application of the organization's assets for private purposes because of his or her position.[3] In general, an organization's directors, officers, members, founders and substantial contributors are insiders. The meaning of the term "net earnings" in the private inurement context has been largely framed by the courts. Most decisions reflect a pragmatic approach, rather than a literal construction of the phrase "net earnings."[4] Common transactions that may involve private inurement include (i) excessive compensation for services; (ii) inflated or unreasonable rental prices; (iii) certain loan arrangements involving the assets of a charitable organization; (iv) purchases of assets for more than fair market value; and (v) certain joint ventures with commercial entities.

B. Private Benefit. A charitable organization may not confer a "private benefit" on persons who are not within the charitable class of persons who are intended to benefit from the organization's operations, unless the private benefit is purely incidental. The purpose of the private benefit limitation is to ensure that charitable organizations are operated for public

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[1] All references to the "Code" are to the Internal Revenue Code of 1986, as amended.

[2] Gen. Couns. Mem. 35855 (June 17, 1974). The U.S. Tax Court has also adopted this approach. McGahen v. Comm'r, 76 T.C. 468, 482 (1981), *aff'd*, 720 F.2d 664 (3d Cir. 1983); Unitary Mission Church of Long Island v. Comm'r, 74 T.C. 507 (1980), aff'd, 647 F.2d 163 (2d Cir. 1981).

[3] *See* Treas. Reg. § 1.501(a)-1(c); *see, e.g,* South Health Ass'n v. Comm'r, 71 T.C. 158, 188 (1978) (stating that the private inurement prohibition has generally been applied to an organization's founders or those in control of the organization).

[4] *See, e.g.,* Texas Trade Sch. v. Comm'r, 30 T.C. 642 (1958) (holding that net earnings inured to insiders' benefit when the insiders leased property to an organization and caused it to make expensive improvements that would remain after the lease expired); Rev. Rul. 67-4, 1967-1 C.B. 123 (holding that an organization did not qualify for tax exemption because private inurement occurred when (i) the organization's principal asset was stock in the insiders' family-owned corporation, and (ii) the organization's trustees failed to vote against the corporation's issuance of a new class of preferred stock, diluting the organization's holdings); Tech. Adv. Mem. 9130002 (Mar. 19, 1991) (concluding that private inurement occurred when a hospital sold a facility to a private entity controlled by insiders for less than the fair market value).

purposes because of their special tax status.[5] The determination of whether the private benefit is more than incidental is based on a "balancing test" set forth in a 1987 General Counsel Memorandum:

> A private benefit is considered incidental only if it is incidental in both a qualitative and a quantitative sense. In order to be incidental in a qualitative sense, the benefit must be a necessary concomitant of the activity which benefits the public at large, i.e., the activity can be accomplished only by benefiting certain private individuals. To be incidental in a quantitative sense, the private benefit must not be substantial after considering the overall public benefit conferred by the activity.[6]

If an organization provides more than incidental private benefit, the organization's tax-exempt status may be revoked.[7] The "private benefit doctrine" subsumes, and is technically distinct from, the private inurement doctrine, and is not limited to situations where benefits accrue to an organization's insiders.[8] The IRS has been more willing to accept the contention that incidental private benefit, as opposed to incidental private inurement, will not preclude or defeat tax exemption.[9]

II. Cause-Related Marketing, In General. [10] Cause-related marketing involves a charity forming alliances with one or more for-profit corporations to allow the charity's name or logo to be used in marketing the corporation's products or services.[11] Such alliances may include selling merchandise which prominently displays the charity's name, logo, or trademark message in conjunction with a corporate partner or allowing the charity's name or logo to be displayed on promotional products of the corporate partner, with a portion of the sales proceeds of those promotional products donated to the charity. Cause-related marketing activities are as diverse as the nonprofit sector. The alliances between charities and corporate partners can vary in a number of dimensions, including the number of corporate partners involved in the campaign, the length of the commitment and the level of investment by the corporate partner, the level of

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[5] *See* Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii). According to the Treasury Regulations, an organization does not qualify for exemption

> unless it serves a public rather than a private interest. Thus . . . it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

Id.

[6] I.R.S. Gen. Couns. Mem. 39,598 (Jan. 23, 1987) (citations omitted). The Internal Revenue Service's balancing test was adopted by the Tax Court in *American Campaign Academy v. Commissioner*, 92 T.C. 1053 (1989).

[7] For example, the Internal Revenue Service ruled that an organization formed to promote interest in classical music was not exempt because its only method of achieving its goal was to support a commercial radio station that was in financial difficulty. Rev. Rul. 76-206, 1976-1 C.B. 154.

[8] *See* Gen. Couns. Mem. 39876 (Aug. 10, 1992).

[9] *See, e.g.,* Priv. Ltr. Rul. 200044039 (Nov. 6, 2000) (ruling that a contract would not defeat an organization's tax-exempt status because it resulted in no private inurement and no more than incidental private benefit).

[10] Portions of this discussion on cause-related marketing are extracted from the author's previously published article, *The Taxation of Cause-Related Marketing*, 85 CHI-KENT L. REV. 883 (2010).

[11] *See, e.g.* Dennis R. Young, *Commercialism in Nonprofit Social Service Associations: Its Character, Significance, and Rationale*, *in* TO PROFIT OR NOT TO PROFIT 195, 198 (Burton A. Weisbrod ed., 1998) (defining cause-related marketing as involving "'a relationship which ties a company, its customers and selected products to an issue or cause with the goal of improving sales and corporate image while providing substantial income and benefits to the cause'" (citation omitted)).

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First appeared as part of the conference materials for the
30th Annual Nonprofit Organizations Institute session
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