

# **Advanced Issues in Fundraising**

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## Advanced Issues in Fundraising

Post COVID-19 pandemic, charities are continuing to pursue various fundraising opportunities in the constant search for sustainable, unrestricted revenue. As fundraising events shift back to in-person, 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”)<sup>1</sup> 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.<sup>2</sup> 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.<sup>3</sup> The Code defines unrelated business taxable income (“UBI”) as income from an unrelated trade or business that is regularly carried on.<sup>4</sup> 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.<sup>5</sup> Its origin was to prevent tax-exempt organizations from competing unfairly with businesses that pay tax on earnings.<sup>6</sup>

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 opportunity for such “unfair competition.” UBIT is applicable to most forms of tax-exempt organizations.<sup>7</sup> 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

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<sup>1</sup> All section references in this Article refer to the Code, unless otherwise indicated.

<sup>2</sup> Section 511(a)(1).

<sup>3</sup> Section 513(a).

<sup>4</sup> Section 512(a)(1).

<sup>5</sup> Section 511.

<sup>6</sup> *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).

<sup>7</sup> Sections 511(a)(2)(A) and 511(b)(2); Treas. Reg. §1.511-2(a)(3)(iii).

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.”<sup>8</sup> 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.<sup>9</sup>

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.<sup>10</sup> 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.<sup>11</sup> A seasonal undertaking can also be considered regularly 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.<sup>12</sup>

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?

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<sup>8</sup> Treas. Reg. §1.513-1(b).

<sup>9</sup> *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).

<sup>10</sup> Treas. Reg. §1.513-1(c).

<sup>11</sup> Tech. Adv. Mem. 201544025.

<sup>12</sup> Treas. Reg. §1.513-1(c).

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First appeared as part of the conference materials for the  
41<sup>st</sup> Annual Nonprofit Organizations Institute session  
"Advanced Issues in Fundraising"