Nonprofit and Exempt Organizations Law

MBA 6431 – Nonprofit Management

University of San Francisco

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Outline

- Nonprofit vs. Tax-Exempt
- Legal Entities
- Tax-Exemption Categories
- 501(c)(3)
- Governance
- Fundraising
- Earned Income

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Nonprofit vs. Tax-Exempt

Nonprofit - State *corporate law* concept

- Corporate purpose is not primarily to earn a profit
- No owners / no distribution to "owners"

Tax-Exempt – Federal and State *tax law* concept

- Exempt from paying corporate income taxes on income generated from activities substantially related to the entity's exempt purpose

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Choice of Legal Entity

- Sole proprietorship
- Partnership
- Unincorporated association
- Trust
- Corporation
- Limited liability company (LLC)
- Low-profit limited liability company (L3C)

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Nonprofit Corporations

Public benefit corporations (Cal. Corp. Code §5110-6910)

- Organized primarily for charitable purposes
- Organized to act as a civic league or social welfare organization

Mutual benefit corporations (Cal. Corp. Code §7110-8910)

- Organized for other than religious, charitable, civic league or social welfare purposes

Religious corporations (Cal. Corp. Code §9110-9690)

- Organized to operate a church or to be otherwise structured for primarily religious purposes

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Nonprofit Corporation vs. Trust

	Corporation	Trust
Creation and operation	More complex	Simpler
Governance/ Liability	Lower fiduciary standard – business judgment rule	Higher fiduciary standard
Control	Board of Directors – majority disinterested	Trustees – can be appointed by founder as provided in the trust instrument
Flexibility	Greater – board readily elected/replaced; bylaws easily changed	Lesser – restricted by trust instrument; change may require court order

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Nonprofit Corporation Law (Corporations Code)

- Organization & Bylaws
- Directors & Management
- Members, Meetings, & Voting
- Corporate Changes (e.g., merger, dissolution)
- Records & Reports
- Crimes & Penalties

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Exempt Organizations – 501(c)(3)

501(c)(3) - Entity organized and operated exclusively for one or more of the following purposes:

- Religious
- Charitable
- Scientific
- Testing for public safety
- Literary
- Educational
- Foster national or international sports competition
- Prevention of cruelty to children or animals

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Exempt Organizations – Others

501(c)(4) - Civic leagues, social welfare organizations

501(c)(5) - Labor, agricultural, horticultural organizations

501(c)(6) - Business leagues, chambers of commerce

501(c)(7) - Social and recreational clubs

527 - Political organizations

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501(c)(3) – Organizational & Operational Tests

Organizational Test:

- organized exclusively for exempt purposes set forth in its governing documents.

Operational Test:

- ORG must be operated *primarily* for one or more exempt purposes
- Only "insubstantial part" of ORG's activities may be devoted to non-exempt purposes
  - E.g., operating an unrelated business.

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501(c)(3) – No Private Inurement

- No part of the ORG's net earnings may inure to the benefit of any private shareholder or individual.
  - an insider such as a director, officer or other person in a position to influence the ORG's decisions

Sanction: REVOCATION

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501(c)(3) – No Private Benefit

- ORG must serve a public rather than a private interest.
- ORG must not be operated for the benefit of private interests.
- ORG may confer benefits to individuals so long as they are incidental, quantitatively and qualitatively, to the furthering of ORG's exempt purposes.

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501(c)(3): Private Foundation vs. Public Charity

Default rule: All 501(c)(3) organizations are private foundations

Exceptions: Section 509(a)(1), (2), (3) or (4) organizations (aka "public charities"), including:

- *Per se* public charities: churches, schools, hospitals, college endowments, governmental entities
- 170(b)(1)(a)(vi) publicly supported orgs: 1/3 Support Test or Facts & Circumstances Test
- 509(a)(2) publicly supported orgs: 1/3 Support Test and Not-More-Than 1/3 Support Test
- 509(a)(3) supporting organizations

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Private Foundations – subject to more regs

- No self-dealing - IRC 4941
  - Self-dealing transactions with a *disqualified person** include:
    - Sale, exchange, or lease of property
    - Loans
    - Furnishing of goods, services, or facilities
    - Paying compensation or reimbursing expenses
      - Exception: reasonable and necessary personal services (not excessive)
    - Transferring foundation assets to, or for the use by or the benefit of, a disqualified person

* *Disqualified persons* generally include directors, officers, substantial contributors, and certain relatives and related entities

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Private Foundations – more regs

- Minimum distributions – IRC 4942
- No "excess business holdings" – IRC 4943
- No "jeopardizing investments" – IRC 4944
  - Exception: Program Related Investments (PRIs)
- Prohibition against certain expenditures (incl. lobbying and grants to orgs other than certain public charities) – IRC 4945
  - Exception: Expenditure Responsibility (due diligence)
- Taxed on net investment income – IRC 4940

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Private Foundations – less attractive to donors

- Lower potential deduction
- Expenditure Responsibility Rule (applicable to private foundations) – IRC 4945

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Public Charities – No Excess Benefit Transactions

Excessive economic benefit provided by a public charity to a disqualified person (current or former director, CEO, CFO, relatives, 35% entities)

- Penalties
  - 25%, 200% (disqualified person)
  - 10% (up to $10,000) (board, if knowing and willing participation)
- Presumption of Reasonableness
  - Approval in advance by disinterested board (or committee)
  - Appropriate comparability data
  - Concurrent documentation

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Public Charities – No Substantial Lobbying

Lobbying

- Communication
- Principal purpose is to influence legislation
- Reflects a view on specific legislation

What's *substantial*?

- Substantial Part Test
- 501(h) Expenditure Test

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Lobbying – Substantial Part Test

Vague standard: based on facts and circumstances

- 5% insubstantial safe harbor?
- Revocation if violation in any one year

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Lobbying – 501(h) Expenditure Test

Defined standard: measuring only lobbying expenditures

TOTAL:

- 20% of first $500,000 of EPE
- 15% of next $500,000 of EPE
- 10% of next $500,000 of EPE
- 5% of remaining EPE (up to $1 million)
  - EPE = Exempt Purpose Expenditures

GRASSROOTS:

- 25% of Total Lobbying Expenditure Limits

- Specific exclusions from lobbying
- Revocation based on 4-year period

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Is This Lobbying?

- Influencing an admin agency re: its regulations or rulings
- Influencing the Mayor / Governor / President re: executive branch decisions
- Influencing legislators on non-legislative matters
  - E.g., to conduct an investigative hearing
- Engaging in litigation
  - E.g., to get a favorable judicial interpretation of the law

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Two Types of Lobbying – 501(h)

- Direct
  - Communication to member of legislative body
  - Principal purpose is to influence legislation
  - Reflects a view on specific legislation
- Grassroots
  - Communication to general public
  - Reflects a view on specific legislation
  - With a call to action (e.g., to contact legislator)

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Exceptions to Lobbying – 501(h)

- Nonpartisan analysis, study or research
- Examinations of broad social, economic and similar problems
- Technical advice or assistance to governmental body upon written request
- Self-defense communications

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501(c)(3) – No Electioneering

Absolute prohibition

Electioneering =

- Directly or indirectly participating in, or intervening in, any political campaign
- On behalf of, or in opposition to, any candidate for elective public office

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501(c)(3) Electioneering Prohibitions

- Contribute to political campaign fund
- Make public statement of position on behalf of organization in favor of, or in opposition to, any candidate for public office (e.g., endorsement)
- Allowing one candidate to use organization's resources without giving equal opportunity to other candidates

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501(c)(3) Permissible Political Activities

- Voter education activities/expenditures
  - Public forums
  - Voter education guides
- Voter registration/get-out-the-vote drives

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Issue Advocacy vs. Political Campaign Intervention

Depends on facts and circumstances, including:

- Timing of statement
  - Close to election
  - Part of ongoing pattern
- Identification of candidates
- Issue distinguishes candidates

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Exempt Organizations – 501(c)(4)

501(c)(4) – Organization

- Not organized or operated for profit
- Operated primarily for the promotion of social welfare
  - Promote the common good and general welfare of the people of the community as a whole
- No private inurement; no excess benefit transactions
- **Unlimited ability to lobby** (can be an "action organization")
- **Some political campaign activities** (so long as not the organization's primary activity)
- Not eligible to receive deductible contributions

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Affiliated Organizations – 501(c)(3) & 501(c)(4)

- Affiliation created by:
  - Right of one entity to appoint the directors of the other
  - Overlapping directors
- 501(c)(3) eligible to receive deductible contributions*
- 501(c)(4) able to lobby and electioneer
- Easy for monies/assets to flow from c3 to c4
- More difficult for monies/assets to flow from c4 to c3

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Nonprofit Governance – Legal Duties

A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, **in good faith**, in a manner such director believes to be **in the best interests of the corporation** and **with such care**, <u>including reasonable inquiry</u>, **as an ordinarily prudent person in a like position would use under similar circumstances**.

- Cal Corp Code §5231(a)

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Duty of Care

- Ordinary prudent person standard
  - Reasonable inquiry (investigation)
  - Independent judgment
- Issues:
  - Reliance
  - Delegation
    - Limit authority
    - Reporting

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Duty of Loyalty

- In good faith
- In the best interests of the corporation
- Issues:
  - Conflict of interest
  - Corporate opportunity
  - Confidentiality

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Duty of Obedience

- Carry out the corporation's purpose
- Comply with the law
- Refrain from *ultra vires** activities

  * beyond the corporation's powers

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Areas of Potential Director Liability

- Breach of fiduciary duties
- Actions outside scope of authority
- Employment claims
- Discrimination claims
- Other claims (e.g., torts, contracts, IP)
- Failure to pay payroll taxes
- Failure to observe corporate formalities

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Fiduciary Duties and Investments

- Relevant laws
  - Duty to avoid speculation – Corp. Code §5240
  - UPMIFA – prudent investor standard = portfolio theory
- Lessons from Madoff
  - Use care
  - Understand what you invest in
  - Diversify across asset classes (portfolio theory)
  - Rely on appropriate advisors with due care
  - Consider strict conflict of interest provisions
  - Jeopardizing investment rules for Private Foundations

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Executive Compensation

- Nonprofit Integrity Act of 2004 (CA)
  - CEO & CFO compensation must be "just and reasonable"
- Board or Board Committee must approve compensation:
  - When hired
  - When term of employment is renewed or extended
  - When compensation is modified*
- Comparables for Rebuttable Presumption of Reasonableness
  - Compensation surveys
  - Form 990 of comparable organizations

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Fundraising

- Nonprofit Integrity Act of 2004 (CA)
  - Registration with the Attorney General's Registry of Charitable Trusts
  - No misrepresentation of charity's purpose or nature or purpose or beneficiary of a solicitation
  - Charity must "establish and exercise control" over its fundraising activities conducted for its benefit
  - Charity shall not enter into any agreement with, or employ, any unregistered Commercial Fundraiser or Fundraising Counsel
  - Charity shall not enter into any agreement with, or raise any funds for, any charity required to be registered but not yet registered (unless they agree to register prior to any solicitation)

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Commercial Fundraiser (CF)

CF =

a) Solicits "Funds" in CA for charitable purposes;

b) Receives & controls Funds; or

c) Employs person to do (a) or (b)

* Does not include employees/directors/trustees

CF Obligations

a) Notify AG before solicitation campaign

b) Written contract with Charity

c) Recordkeeping

d) Fundraising Obligations

- ☐ 5 working day deposit or delivery (Charity controlled)

Fundraising Counsel (FC)

FC =

a) For compensation plans, manages, advises, counsels, consults, or prepares material for, or with respect to, the solicitation in CA of Funds for charitable purposes ("ACTS")

b) Is not CF

* Does not include attorneys, employees/directors/trustees, or persons who makes $25K or less from ACTS

FC Obligations

a) Notify AG before solicitation campaign

b) Written contract with Charity

Contracts with CF or FC

Charity has the right to void a contract if CF or FC has not registered prior to the start of the solicitation

Charity has the right to cancel a contract –

- 10-day period without penalty
- Thereafter with 30-days notice
- Without liability if CF or FC –
  - makes material misrepresentations
  - harms the organization's reputation
  - was convicted of a crime arising from solicitation

NIA's 12 Prohibitions (condensed)

- Don't lie.
- Don't cheat.
- Don't steal.

Charitable Trust Doctrine

Restricted gifts – terms of restriction

Unrestricted gifts – declared purpose

Non-gifted assets – declared purpose

<u>Discussion</u>:

- Change in purposes – *cy pres* doctrine
- Bonuses

Written Acknowledgement

Donor requires for $250+ gift

- To claim charitable deduction

Requirements:

- Contemporaneous (e.g., by due date of donor's tax return)
- Name of org
- Amount of cash gifts
- Description (not value) of noncash gifts
- If no goods or services* provided by org in return:
  - Statement verifying this
- If goods or services* provided by org in return:
  - Description and good faith estimate of value of goods or services
  - Statement the return benefits were intangible religious benefits

Written Disclosure

Charity must provide to donor

- Payment exceeds $75
- Part-gift, part-exchange for goods or services* (*quid pro quo*)

Requirements:

- Amount deductible is payment less value of goods or services* provided by org
- Good faith estimate of value of goods or services*

Penalty: $10 per contribution,
up to $5,000 per fundraising event

* Goods or Services

Exceptions:

- Token exception – insubstantial
  - FMV does not exceed lesser of 2% of payment or $95*; or
  - Payment is at least $47.50*, return items bear org's name or logo, and cost is within "low-cost article" limit ($9.50*)
- Member benefits exception – insubstantial
  - In exchange for annual payment of $75 or more; and
  - Consists of annual recurring rights or privileges
    - Admissions, discounts from org's gift shop, parking, member's only events (if per person cost within "low-cost article" limit)

Receipts

Pension Protection Act of 2006

- Effective 1/1/07

Donor cannot claim deduction for contribution unless donor maintains a record of contribution

- Bank record or canceled check
- Written communication from charity
  - Name, date of contribution, amount of contribution

International Charity Issues

- Anti-terrorism
- Conduit transactions
- Control and oversight

Anti-Terrorism Laws

Executive Order 13224

- Prohibits transactions with entities associated with terrorism (e.g., SDN List)

Patriot Act

- Potential criminal and civil penalties for providing support to terrorists

Treasury: Anti-Terrorist Financing Guidelines

Coalition: Principles of International Charity

Conduit Transactions

- Donor gets no deduction for contribution to foreign charity
- If donor uses U.S. charity as conduit for contribution to foreign charity (earmarking), no deduction

Discretion and Control

If US charity exercises discretion and control over donation, and decides to grant donation to foreign charity, donor may get a deduction

"Friends of" organizations

- Consistency with charitable purposes
- Diligence on grantee, oversight on grant
- Not a mere conduit

Charitable Deduction – Federal Income Tax

IRC Section 170(c)(2) – Corporation, trust, or community chest, fund, or foundation –

(A) created or organized in the U.S.

(B) organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster amateur sports competition, or for the prevention of cruelty to children or animals

(C) no private inurement

(D) no substantial lobbying; no electioneering

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Earned Income

Can a charity run a business?

Yes, but …

- IRC § 501(c)(3)
  - Operational Test
  - No private inurement
  - No private benefit
- Articles of incorporation – purpose restriction?
- Bases for exempt status – incompatible activities?

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Related Businesses

Conducted as a means to accomplish ORG's exempt purposes

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Related Business

IRS considers the following factors:

- Nature and size of business
- Fees (less than cost)
- Who is served (charitable class vs. general public)
- Business operations (not in typical commercial manner in competition with other private businesses)

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"Charitable"

- Relief of the poor, distressed or underprivileged (low income, minority, elderly, disabled, other 501(c)(3) organizations, or similarly situated persons)
- Promotion of social welfare by lessening neighborhood tensions, eliminating prejudice and discrimination, defending human and civil rights, and combating community deterioration and juvenile delinquency
- Lessening the burdens of government
- Promotion of health
- Advancement of education

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Unrelated Business Income Tax (UBIT)

General Rule: An activity is an unrelated business (and subject to UBIT) if:

- It is a trade or business
- Regularly carried on
- Not substantially related to the org's exempt purpose

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UBIT: Trade or Business

- Any activity carried on for the production of income from selling goods or performing services.
- Even if carried on within a larger framework of other activities that may, or may not, be related to the organization's exempt purposes.

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UBIT: Regularly Carried On

- Activities that show a frequency and continuity, and are pursued in a manner similar to, comparable commercial activities of nonexempt organizations.

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UBIT: Not Substantially Related

- *Substantially related* when the conduct of the business activities has a substantial causal relationship to achieving exempt purposes (other than through the production of income).
- The activities that generate the income must contribute importantly to accomplishing the organization's exempt purposes to be substantially related.

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Exclusions from "Unrelated Trade or Business"

- Where substantially all of the work is performed by volunteers
- Where carried on primarily for the convenience of its members, students, patients, officers, employees
- Where sale of donated merchandise
- Passive income – interest, dividends, annuities, royalties, certain rents, gains from sale/exchange/transfer of capital asset
  - Exception: Debt-financed property, not substantially related to ORG's exercise/performance of its exempt functions
  - Exception: Income from a more than 50% controlled corporation

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Substantiality Test

- How much unrelated business activity is too much?
- Factors:
  - Relationship of the business activity to the overall activities of ORG in terms of time, effort and dollar income
  - Relationship between business activity and the exempt function of ORG (commensurate test)
  - Reason that ORG conducts the particular business activity
  - Methods of operation and the control exercised by the board over the business operations

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Taxable Subsidiaries

Nonprofit subsidiary

- ORG is sole member

For-profit subsidiary

- ORG is sole shareholder

<u>The key is separateness</u>

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Separateness

- Boards
- Officers
- Meetings
- Books
- Bank accounts
- Filings
- Stationary
- Phone numbers
- Parent does not participate in the day-to-day management of the Subsidiary – helpful facts:
  - Majority of Subsidiary's Board independent of Parent
  - CEO of Subsidiary is neither an Officer or Director of Parent

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Considerations regarding a Subsidiary

- If unrelated business, and substantial activity:
  - Form subsidiary
- Liability
  - Subsidiary may provide limited liability protection, but there are limitations:
    - ORG guarantees Sub's obligations
    - Veil piercing (failure to observe formalities, inadequate capitalization)
- Financing

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Taxation

- Dividend from a taxable subsidiary

  ➔ Not taxable income to ORG

- Payment of interest, annuity, royalty or rent from a subsidiary (controlled entity)

  ➔ ORG may exclude such payments if they do not exceed FMV (excess is subject to UBIT plus 20% penalty)

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Collaborations with For-Profits

- Contractual Relationships
  - Royalties
  - Sponsorships
- Joint Ventures

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Royalties

- Payment for the use of a valuable, intangible property right
  - Examples:
    - Name
    - Trademark
    - Copyright
- Not payment for services
- Favorable factor: fees tied to gross revenues instead of net profits

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Sponsorships

- Sponsorship payments to ORG not UBTI if sponsor does not receive any substantial return benefit (Qualified Sponsorship Payment or QSP)
  - The use or acknowledgment of sponsor
  - Insubstantial benefits - FMV does not exceed 2% of sponsorship payment

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Use or Acknowledgement of Sponsor

- Grant of exclusive sponsorship in an activity to a for-profit
- Use of logos and slogans that do not contain qualitative or comparative descriptions of sponsor's products, services, facilities or company
- Use of a list of sponsor's locations, telephone numbers or internet addresses
- Use of value-neutral descriptions, including displays or visual depictions of sponsor's product line or services
- Use of sponsor's brand or trade names and product or service listing

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Issue: Qualified Sponsorship Payment?

- "Ride for Life" sponsored by ABC Company
- "Buy ABC Widgets"
- "ABC Company – for the finest widgets"

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Nonprofit – For-profit Joint Ventures

- NP Hospitals + Physicians
  ➔ Ambulatory surgical center
- Developer + Nonprofit
  ➔ Low-income housing
- University + Health System
  ➔ Distance learning

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Joint Ventures – Motivating Factors (Nonprofit)

- Additional opportunities to further its charitable purposes
- Greater access to capital and expertise
- Possibility of capital appreciation
- Flexibility in operation
- Protection from liability

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Joint Ventures – Motivating Factors (For-profit)

- Enhanced good will
- Increased marketing opportunities
- Access to expertise and political capital
- Availability of financial opportunities (e.g., Low-Income Housing Tax Credits)

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Two-Prong Test

1. Whether participation in JV furthers a charitable purpose
2. Whether JV permits the nonprofit to act exclusively in furtherance of its exempt purpose and only incidentally for the benefit of its limited partners

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Favorable Factors

- Board Control: ORG controls at least 50% of JV's board
- JV's governing documents provide that JV cannot engage in activities that ORG cannot engage in
- ORG controls JV's related business activities (e.g., curriculum, teaching materials)
- Control over management
  - Unrelated management company
  - Limited term
  - Terminable unilaterally by ORG
- No insider transactions
- ORG has limited liability

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Forms of Legal Entities

- Partnership
  - General partnership
  - Limited partnership
- Corporation
  - C corporation (double taxation)
  - S corporation (no corporate shareholders)
- Limited liability company

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