FINAL REGULATIONS REGARDING THE TAX TREATMENT OF CORPORATE SPONSORSHIP PAYMENTS TO TAX-EXEMPT ORGANIZATIONS

On April 25, 2002, the Internal Revenue Service (the "IRS") published final regulations (the "Final Regulations") regarding the tax treatment of corporate sponsorship payments received by tax-exempt organizations. The Final Regulations affect the reporting of income from corporate sponsorship payments received by exempt organizations in connection with a broad range of common activities, including bowl games conducted by colleges and universities, walkathons conducted by health organizations, and exhibitions conducted by museums. In general, the Final Regulations implement section 513(i) of the Internal Revenue Code,[1] which provides that "qualified sponsorship payments" will not be subject to the unrelated business income tax ("UBIT").

The Final Regulations contain some minor modifications of proposed regulations (the "Proposed Regulations") issued on March 1, 2000. Therefore, the explanation below summarizes both the Final Regulations and the more significant changes from the Proposed Regulations.

The Final Regulations are effective April 25, 2002, and apply to corporate sponsorship payments solicited or received by an exempt organization after December 31, 1997.

TAX TREATMENT OF QUALIFIED SPONSORSHIP PAYMENTS

An exempt organization generally must pay tax on its unrelated business taxable income ("UBTI"), i.e., the gross income the organization receives from any unrelated trade or business (as defined in section 513) regularly carried on by the organization, less any permitted

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

deductions which are directly connected with the carrying on of such trade or business, and subject to certain exclusions.[2] However, under section 513(i), an exempt organization's receipt of "qualified sponsorship payments" does not constitute the receipt of income from an unrelated trade or business and therefore does not subject the organization to UBIT. In essence, section 513(i) provides a safe harbor from UBIT for "qualified sponsorship payments" received by exempt organizations.

The Final Regulations define a "qualified sponsorship payment" as any payment, whether in the form of money, the transfer of property or the performance of services, made by a sponsor to an exempt organization without an arrangement or expectation that the sponsor will receive any "substantial return benefit" from the organization. The Final Regulations provide that, in determining if a particular payment constitutes a qualified sponsorship payment, it is not relevant whether the sponsored activity is related or unrelated to the organization's exempt purposes or whether the sponsored activity is temporary or permanent.

In situations where the section 513(i) safe harbor does not apply because a sponsor is receiving a substantial return benefit in return for a sponsorship payment (as discussed below), the determination of whether the payment is subject to UBIT is made under existing rules and principles.

DEFINING A SUBSTANTIAL RETURN BENEFIT

The Final Regulations provide that a substantial return benefit is any benefit other than (i) an exempt organization's "use or acknowledgement" of the name, logo or product lines of the sponsor's trade or business, or (ii) any goods or services that have an insubstantial value and therefore qualify as "disregarded benefits."

Use or Acknowledgment of a Sponsor.

The Final Regulations provide many examples of permitted uses or acknowledgments of a sponsor's name, logo or product lines. For example, an exempt organization's acknowledgment of a sponsor as the exclusive sponsor (or the exclusive sponsor representing a particular trade, business or industry) of an activity of the organization will not by itself result in a substantial return benefit. Other acknowledgments of a sponsor permitted by the Final Regulations include : (a) a sponsor's logo or slogans (so long as they do not contain qualitative or comparative descriptions of the sponsor's products, services, facilities or company); (b) a list of the sponsor's locations, telephone numbers or Internet addresses; and (c) value-neutral descriptions, including displays or visual depictions, of the sponsor's product-line or services.

The Preamble to the Final Regulations notes that a sponsorship payment, even though it does not constitute a "qualified sponsorship payment," may still not be subject to UBIT. For example, if the payment is received in connection with an activity of an exempt organization that is not an unrelated trade or business (within the meaning of section 513(a)) or that is not

[2] These exclusions are set forth in section 512(b) and include passive income such as certain dividends, interest, rent and royalties.

regularly carried on (within the meaning of section 512(a)(1)), then the payment will not be subject to UBIT. In addition, the payment may be of a type, such as rent or royalty income, that is excluded from the definition of UBTI . For example, if an exempt organization receives a payment that is not a qualified sponsorship payment, the organization will not be subject to UBIT if all of the work in carrying on the trade or business giving rise to the payment is performed by volunteers. Under these facts, the activity giving rise to the payment would not constitute an unrelated trade or business.

Disregarded Benefits.

The Final Regulations provide that "benefits" provided to a sponsor are disregarded if the aggregate fair market value[3] of all the benefits provided to the sponsor (or persons designated by the sponsor) (other than use or acknowledgment benefits discussed above) in connection with the sponsorship arrangement during the exempt organization's taxable year is not more than 2% of the sponsorship payment.[4] If a sponsor receives a substantial return benefit (e.g., complimentary tickets to an exhibition at a museum having a fair market value in excess of the 2% threshold), only the amount of the sponsorship payment which exceeds the fair market value of the substantial return benefit will be a qualified sponsorship payment. Significantly, the exempt organization (and not the IRS) bears the burden of proving the fair market value of any substantial return benefit and establishing the amount of the sponsorship payment which exceeds the fair market value of the substantial return benefit.

The Final Regulations include a list of four kinds of benefits that may be provided to a sponsor and that are subject to the 2% threshold. These benefits are (i) goods, facilities, services or other privileges, (ii) exclusive or nonexclusive rights to use an intangible asset (e.g., trademark, patent, logo or designation) of the exempt organization; (iii) advertising and (iv) exclusive-provider arrangements. The latter two types of benefits are discussed in greater detail below.

Advertising as a Substantial Return Benefit. Advertising provided by an exempt organization having a fair market value greater than the 2% threshold amount will be treated as a substantial return benefit to the sponsor. The Final Regulations define advertising as any message or material (whether broadcast, transmitted, published, displayed or distributed) that

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[3] For these purposes, fair market value is the price at which the substantial return benefit would be provided between a willing recipient and a willing provider of the benefit, with neither being compelled to enter into the arrangement and with both having reasonable knowledge of relevant facts. The fair market value of the substantial return benefit is determined when the benefit is provided.

[4] In response to comments received by the IRS, the "2% rule" for disregarded benefits was included in the Final Regulations and represents a change from the Proposed Regulations. The Proposed Regulations provided that benefits to a sponsor would be disregarded only if they had a fair market value of the lesser of not more than 2% of the sponsorship payment, or $79 (as adjusted for 2002). The IRS' rationale, as explained in the Preamble to the Final Regulations, is that (i) a 2% threshold is used in other areas of the Code and Treasury Regulations to describe insubstantial amounts and (ii) the 2% threshold "keeps the level of disregarded benefits low enough so that the entire amount of a qualified sponsorship payment may be treated as a contribution for public support purposes."

promotes or markets any trade or business or any service, facility or product of a sponsor. Advertising includes any message containing qualitative or comparative language, price information or other indications of savings or value, an endorsement, or an inducement to purchase, sell, or use any company, service, facility or product. Of note is that the Final Regulations treat a single message that contains both advertising and an acknowledgment as advertising alone.

However, advertising does not include activities conducted by the sponsor on its own initiative. For example, if a sponsor purchases broadcast time from a television station during a sponsored event, the exempt organization's safe harbor is unaffected. In addition, the mere display or distribution, whether for a fee or without charge, of a sponsor's product to the general public at a sponsored event of the exempt organization is not considered an inducement to purchase, sell or use the sponsor's products (i.e., advertising).

Exclusive-Provider Arrangements as a Substantial Return Benefit. While "exclusive-sponsorship" arrangements are considered to be permissible acknowledgments of a sponsor under the Final Regulations, "exclusive-provider" arrangements will result in a substantial return benefit to the sponsor and may subject the exempt organization to UBIT. The Final Regulations provide that any arrangement that limits the sale, distribution, availability or use of competing products, services or facilities in connection with a sponsored activity constitutes an "exclusive-provider" arrangement and generally results in a substantial return benefit to the sponsor.

However, payments received pursuant to exclusive-provider arrangements may not always be subject to UBIT. In general, an exempt organization's type or level of activity with respect to the exclusive-provider arrangement will often dictate whether the arrangement is subject to UBIT. For example, assume a museum enters into a contract with a soft-drink company pursuant to which the company will be the exclusive provider of soft drinks in the museum in return for a fixed monthly payment. The company agrees to provide, stock and maintain the vending machines located in the museum, leaving the museum with little or no obligation to perform any services in connection with the contract. Under these facts, although the contract constitutes an exclusive-provider arrangement, it is likely that the museum's level of activity with respect to the contract will not rise to the level of a trade or business under Code section 513(a) and therefore the museum will likely not be subject to UBIT with respect to payments received under the contract.[5]

As highlighted in the Preamble to the Final Regulations, an exclusive-provider arrangement results only from an exempt organization's agreement to limit distribution of competing products, services or facilities in connection with a sponsored activity. Therefore, if the nature of the goods or services being provided in connection with a sponsored activity

[5] In addition, several of the exclusions from UBIT contained in section 512(b) may apply to payments received by an exempt organization in connection with exclusive-provider arrangements. For example, if the museum instead enters into a contract with a t-shirt company to produce t-shirts bearing the museum's name and logo, the portion of the payment received under the contract attributable to the value of the license may be excludable from UBIT as a royalty under section 512(b)(2).

necessitates the use of the sponsor because of limited space or because the competitive-bidding process requires only the lowest bid be accepted (and the lowest bid is submitted by the sponsor), the exempt organization will not be treated as having entered into an exclusive-provider arrangement, unless it also agrees to limit distribution of competing products. In addition, the Preamble to the Final Regulations further clarifies that if the exempt organization negotiates a discount or rebate with the sponsor as part of the competitive bidding process, the amount of the discount or rebate will not be subject to UBIT.

EXAMPLES PROVIDED IN THE FINAL REGULATIONS

Examples Regarding the Use of the Internet and Hyperlinks.

In response to numerous comments received by the IRS, the Final Regulations contain two examples analyzing the use of hyperlinks from an exempt organization's website to that of a sponsor.[6] In the first example, a symphony orchestra posts a list of its sponsors on its website and includes a hyperlink to each sponsor's website. The example concludes that the posting of the sponsor's name and the hyperlink to the sponsor's website constitutes acknowledgement of the sponsorship and the payment received by the orchestra from the sponsor is a qualified sponsorship payment, not income from an unrelated trade or business.

In the second example, a pharmaceutical company provides funding to a health-based charity to assist the charity in producing educational materials for distribution and posting on the charity's website. The charity's website contains a hyperlink to the pharmaceutical company's website. The pharmaceutical company's website contains an endorsement from the charity for one of the company's products. The example concludes that the endorsement is advertising and that, because the fair market value of the advertising exceeds 2% of the total payment received from the pharmaceutical company, only the portion of the funding from the company that the charity can demonstrate exceeds the fair market value of the advertising is a qualified sponsorship payment.

General Examples.

In addition to the examples analyzing hyperlinks between an exempt organization's website and a sponsor's website discussed above, the Final Regulations also provide other helpful examples regarding the tax treatment of corporate sponsorship payments. Four of those examples are summarized below.

Sponsorship of a Sports Tournament. An exempt organization coordinates sports tournaments for local charities. An auto manufacturer agrees to underwrite the expenses of the tournaments. The exempt organization recognizes the auto manufacturer by including the manufacturer's name and established logo in the title of each tournament, as well as on signs, scoreboards and other printed material. In addition, the auto manufacturer receives

[6] The Preamble to the Final Regulations specifically provides that these examples are for purposes of section 513(i) only and that the analysis of particular Internet issues, such as the use of hyperlinks, may differ for other sections of the Code.

complimentary admission passes and pro-am playing spots that have a combined fair market value in excess of 2% of the total sponsorship payment made by the manufacturer. The auto manufacturer also is permitted to display the latest models of its luxury cars at each tournament.

Although the organization's use of the manufacturer's name and logo and the display of its cars at each tournament constitute acknowledgment of the sponsorship, the admission passes and pro-am playing spots constitute a substantial return benefit. Therefore, only the portion of the payment, if any, that the organization can demonstrate exceeds the fair market value of the admission passes and pro-am playing spots is a qualified sponsorship payment.

Sponsorship of an Annual College Football Bowl Game. An exempt organization conducts an annual college football bowl game. A major corporation agrees to be the exclusive sponsor of the bowl game. In exchange for a payment of $1 million, the name of the bowl game will include the name of the corporation. In addition, the corporation's name and established logo will appear on the player's helmets and uniforms, on the scoreboard and stadium signs, on the playing field, on cups used to serve drinks at the game, and on all related printed material distributed in connection with the game. Furthermore, the contract between the organization and the corporation provides that the television cameras will focus on the corporation's name and logo on the field at certain intervals during the game. Finally, the organization also agrees to give the corporation a block of game passes for its employees with a fair market value of $6,000 and to provide advertising in the bowl game program book with a fair market value of $10,000.

The use of the corporation's name and logo in connection with the bowl game constitutes acknowledgment of the sponsorship. In addition, because the fair market value of the game passes and program advertising ($16,000) does not exceed 2% of the total payment ($20,000), these benefits are disregarded and the entire payment is a qualified sponsorship payment, which is not income from an unrelated trade or business.

Sponsorship of a Noncommercial Broadcast Station. A noncommercial broadcast station airs a program funded by a local music store. In exchange for the funding, the station broadcasts the following message: "This program has been brought to you by the Music Shop, located at 123 Main Street. For your music needs, give them a call today at 555-1234. This station is proud to have the Music Shop as a sponsor."

Because this single broadcast message contains both advertising[7] and an acknowledgment, the entire message is treated as advertising. If the fair market value of the advertising exceeds 2% of the total payment made to the station by the music shop, the advertising will be a substantial return benefit and only the portion of the payment that the station can demonstrate exceeds the fair market value of the payment will be a qualified sponsorship payment.

[7] The conclusion that this message constitutes advertising results from the statement "For your music needs, give them a call today at 555-1234," which represents a call to action.

Sponsorship of a Health-Related Charity. A national charity dedicated to promoting health organizes a campaign to inform the public about potential cures to fight a serious disease. As part of the campaign, the charity sends representatives to community health fairs around the country to answer questions about the disease and inform the public about recent developments in the search for a cure. A pharmaceutical company makes a payment to the charity to fund the charity's booth at a health fair. The charity places a sign in the booth displaying the pharmaceutical company's name and slogan, "Better Research, Better Health," which is an established part of the company's identity. In addition, the charity grants the pharmaceutical company a license to use the charity's logo in marketing its products to health care providers around the country. The fair market value of the license exceeds 2% of the total payment received from the company.

The charity's display of the pharmaceutical company's name and slogan constitutes a permitted acknowledgment of the sponsorship. However, the license granted to the pharmaceutical company to use the charity's logo is a substantial return benefit. Only that portion of the payment, if any, that the charity can demonstrate exceeds the fair market value of the license granted to the pharmaceutical company is a qualified sponsorship payment.

OFFSETTING EXPENSES

The IRS has adopted an example contained in the Proposed Regulations regarding the offsetting of expenses related to exempt activity with income from a separate, unrelated business activity. The example further illustrates the rule that the business activity must have a close connection or a "proximate and primary relationship" to the exempt activity if the expenses are to be charged against the income that the activity generates. Specifically, the example provides that the net advertising income received from a museum's exhibition catalog may not be used to offset the costs associated with the exhibition, but only to offset the net losses from the production of the catalog, as the costs of presenting the exhibition are not directly connected with the conduct of the unrelated advertising activity and do not have a "proximate and primary relationship" to that activity.

TREATMENT OF QUALIFIED SPONSORSHIP PAYMENTS AS CONTRIBUTIONS

The Final Regulations provide that qualified sponsorship payments in the form of money or property (but not services) are treated as contributions received by an exempt organization for purposes of determining the organization's level of public support under sections 170(b)(1)(A)(vi) or 509(a)(2).

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If you have any questions about specific situations or would like further information or assistance regarding the Final Regulations, please contact Victoria B. Bjorklund (212-455-2875 or vbjorklund@stblaw.com), David A. Shevlin (212-455-3682 or dshevlin@stblaw.com), Jennifer Goldberg Reynoso (212-455-2287 or jreynoso@stblaw.com), Jennifer L. Franklin (212-455-3597 or jfranklin@stblaw.com), Garry W. Jenkins (212-455-2316 or gjenkins@stblaw.com), or Joanna Pressman (212-455-2494 or jpressman@stblaw.com) of our Exempt Organizations Department.

SIMPSON THACHER & BARTLETT