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In this article, McLaughlin explains how tax-exempt organizations engaged in cause-related marketing of tangible property run the risk of

violating the unrelated business taxable income rules, and he proposes several solutions to avoid the UBTI problem.

This article is one in a series of proposals sponsored by the California Lawyers Association Taxation Section and presented to various policymakers and government officials. The comments in it reflect the individual views of the author who prepared them and not the position of the California Lawyers Association.

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Introduction

Cause-related marketing (CRM) occupies a unique position at the intersection of commerce and conscience. It has evolved into a widely used marketing strategy over the last half century, praised for its dual potential to improve brand

equity and contribute to social good. Few consumers are unfamiliar with the now commonplace messages of “a portion of proceeds will be donated to X cause,” or “buy one, and we’ll donate one.”

CRM is not monolithic. It can be brand aligned, when the cause and product share thematic or strategic congruence (for example, a fitness apparel company supporting heart disease research), or nonaligned, when the cause is unrelated to the product (for example, a snack food brand supporting rainforest conservation). Both strategies aim to influence consumer behavior while projecting a socially responsible corporate image. CRM can be particularly advantageous in saturated markets by providing a distinct, competitive advantage; by embedding a cause into its marketing, a company can differentiate itself from competitors whose value propositions are otherwise similar. This is particularly valuable in commoditized sectors such as retail, food and beverage, and fast fashion.

The reason for CRM’s increasing usage is debatable. At its core, CRM is likely driven by the belief or expectation that consumers are often willing to pay a premium for products associated with a good cause. Some commentators cynically attribute CRM’s rise to sophisticated marketing strategies to hijack a consumer’s personal values to enhance brand attachment and increase purchasing potential. Consumer behavior may be inherently influenced by perceived reciprocal benefits — in this case, the psychological reward of supporting a cause through consumption, which companies seek to tap into.

Despite its benefits, CRM is not without criticism when misused. One major concern is consumer skepticism. As CRM has become more widespread, consumers have become more

discerning — and sometimes suspicious — about corporate motives. If a campaign appears disingenuous or opportunistic, it can backfire. Perceived insincerity in CRM initiatives can lead to negative evaluations and reduced purchase intent. Another issue is the “fit” between brand and cause. When this fit is perceived as weak or confusing, consumers may struggle to understand the company’s motives or feel manipulated. Incongruencies between brand identity and cause can hurt CRM attempts. Finally, impact transparency is critical. Consumers are increasingly demanding clarity about how much money is actually donated, where it goes, and what outcomes it produces. A lack of transparency can erode trust and lead to public backlash, especially in the era of social media.

Whatever the root of CRM, it is hard to deny its effectiveness and pervasiveness. Numerous studies and consumers’ personal experience demonstrate how CRM can positively affect consumer perceptions of a brand. CRM can foster emotional connections that lead to stronger brand loyalty and trust when executed thoughtfully and with strategic alignment, transparency, and authenticity. It can thus generate significant benefits, and significant benefits drive the existence of tax-exempt organizations under section 501(c)(3).

In a typical CRM arrangement, a business agrees to contribute a portion of its sales proceeds to the exempt organization, while the EO permits its name, logo, or messaging to be used in the marketing of those products or services. When this licensing arrangement is used properly, the two partners extend the mission and values of the EO; increase public awareness of the chosen cause; provide unrestricted funds to the organization without the time, cost, and uncertainty of traditional fundraising; and avoid the issue of unrelated business taxable income through section 512(b)(2).

Used improperly, this licensing relationship dilutes an otherwise valuable fundraising source and can harm the organization’s overall goals and causes with poor partnerships.

To bypass these risks and still capitalize on the good that CRM provides, some EOs have chosen to pursue their own product developments to

concurrently advance their mission and diversify funding sources. The direct sale of EO-branded merchandise is becoming increasingly valuable. For example, an EO may want to further certain charitable or educational purposes by selling its own merchandise (T-shirts, stickers, posters, etc.) displaying its brand identity. At the same time, the naturalistic CRM status of these sales advances the organization’s charitable purpose by giving purchasers access to further resources through accompanying packaging, mobile apps, promotional material, and similar information delivery tools.

Unfortunately, current IRS guidance for these tax-exempt organizations on the topic of CRM and direct sales of tangible property is inadequate for the times. The application of unrelated business income tax to EOs selling products in a CRM effort creates tension between justifiable revenue growth, advancing worthy causes, and maintaining the goal of equal competition.

The UBTI Problem

Section 501(a) provides an exemption from federal income taxation for organizations described in section 501(c), which includes entities organized and operated exclusively for charitable or educational purposes. Likewise, charitable or educational purposes are listed in reg. section 1.501(c)(3)-1(d)(1)(i) as among the purposes for which an EO may be organized and operated.

Reg. section 1.501(c)(3)-1(d)(2) defines charitable, in part, as follows:

The term charitable is used in section 501(c)(3) in its generally accepted legal sense and is, therefore, not to be construed as limited by the separate enumeration in section 501(c)(3) of other tax-exempt purposes which may fall within the broad outlines of charity as developed by judicial decisions.

Reg. section 1.501(c)(3)-1(d)(3) defines educational, in part, as follows:

The term educational, as used in section 501(c)(3), relates to: . . . (a) The instruction or training of the individual for the purpose of improving or developing his capabilities; or (b) The instruction of the

public on subjects useful to the individual and beneficial to the community.

In some situations, an EO may want to further these charitable or educational purposes by selling merchandise that not only has an independent purpose to the wearers or observers but, through its CRM efforts, raises the organization's visibility. This can be done in several ways, including by providing purchasers access to further resources through accompanying packaging, mobile apps, promotional material, and similar information delivery tools.

But if an EO seeks to capitalize on CRM independent of a licensee, it soon encounters the significant issue of UBTI. Section 511 imposes an income tax on the UBTI of an organization recognized as exempt under section 501(c)(3). The structure of sections 511-513 was designed to prevent tax-exempt organizations from unfairly competing with for-profit businesses.

A section 501(c)(3) organization will become subject to the UBIT if three conditions are present: (1) the income is from a trade or business (2) that is regularly carried on and (3) is not substantially related to the EO's exercise or performance of its exempt function.¹

Section 513(a) defines the term "unrelated trade or business" as meaning, for any organization subject to the UBIT imposed by section 511, any trade or business whose conduct is not substantially related (aside from the organization's need for income or funds or the use it makes of the profit derived) to the organization's exercise or performance of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501. The existence of an unrelated trade or business is a factual question.

Reg. section 1.513-1(d)(2) provides that a trade or business is related to exempt purposes only when the business activities have a causal relationship to the achievement of exempt purposes (other than through the production of income). The trade or business is "substantially related" for purposes of section 513 only if the causal relationship is substantial. For this

relationship to exist, the sales from which the gross income is derived must contribute importantly to the accomplishment of the taxpayer's purposes. Whether activities productive of gross income contribute importantly to an organization's accomplishment of any purpose for which it is granted exemption depends in each case on the facts and circumstances. Section 513(c) provides that an activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors that may or may not be related to the exempt purposes of the organization.

An EO thinking about selling promotional items with its logo attached, or other messages to enhance the public's awareness and encourage engagement, must be mindful of these UBTI pitfalls. If these items were utilitarian in nature, notwithstanding the delivery of the cause-related message, the organization may be unclear whether it is subject to UBIT. Given this risk, there are only four practical options for EOs, aside from seeking a letter ruling from the IRS.

First, the organization may choose to abandon its CRM of promotional product efforts entirely for fear of UBIT. The unfortunate side effects of this choice are a loss of fundraising and a missed opportunity to advance the EO's values and gain greater visibility.

Second, the EO may seek alternative arrangements with for-profit organizations and avail itself of the royalty exemption under section 512(b)(2). Although the tax-exempt entity may still have strict supervision over the products, the very nature of a licensing operation dilutes an important fundraising source, which can hurt the organization's overall goals and causes. Moreover, it is somewhat unclear how to properly structure an exempt royalty.²

Third, the organization could forge ahead with selling its CRM tangible products and risk UBIT and perhaps even a revocation of its exempt status. The only comfort in that situation is the

¹Sections 511, 512, 513(a), and 513(c).

²See, e.g., *Sierra Club v. Commissioner*, 86 F.3d 1526 (9th Cir. 1996).

statute of limitations, which may be cold comfort. For example, in *California Thoroughbred Breeders*,³ the taxpayer challenged the IRS's proposed UBIT deficiency by arguing that more than three years had passed since it filed applicable Forms 990, "Return of Organization Exempt From Income Tax." The IRS unsuccessfully argued that the failures to file Forms 990-T, "Exempt Organization Business Income Tax Return (and Proxy Tax Under Section 6033(e))," meant that the statute of limitations never began to run for purposes of section 6501(g)(2). Although the IRS eventually accepted the outcome in *California Thoroughbred Breeders*, the decision's precedential value is shaky.⁴ Future cases may have different outcomes, and the EO would still need to disclose "sufficient facts" to rely on *California Thoroughbred Breeders*.

Fourth, the EO could hire a tax professional to conduct an intensive case-by-case analysis of prior IRS guidance. But as detailed below, that option can be costly and yield little assurance given the stakes involved.

The modern efforts of EOs have outpaced the UBTI structure and revealed a conflict between the stated design of avoiding unfair competition over for-profit businesses and furthering noble charitable or educational purposes.

IRS Guidance

The scant IRS guidance on CRM related to EOs is decades old. For example, Rev. Rul. 73-104, 1973-1 C.B. 263, concluded that the sale of greeting card reproductions of artwork by an art museum exempt from tax under section 501(c)(3) did not constitute an unrelated trade or business. The museum sold cards through its gift shop in the building and through a catalogue that

³ *California Thoroughbred Breeders Association v. Commissioner*, 47 T.C. 335 (1966).

⁴ Rev. Rul. 69-247, 1969-1 C.B. 303 ("However, the decision in *California Thoroughbred Breeders Association* will be followed in those instances where the taxpayer has disclosed sufficient facts on Form 990, Form 990-A, or Form 990-P, filed in good faith within the meaning of section 6501(g)(2) of the Code, to apprise the Service of the potential existence of unrelated business taxable income. The return must state the nature of the income-producing activity with sufficient specificity to enable the Commissioner to determine whether the income is from an activity related to the organization's exempt purpose, and the return must disclose the gross receipts from this activity. Revenue Ruling 62-10 is applicable where a taxpayer has not disclosed such facts on an information return.").

solicited mail orders. The rationale of the ruling was that the card sales contributed importantly to achievement of the museum's exempt educational purposes by stimulating and enhancing public awareness, interest, and appreciation of art.

Issued around the same time, Rev. Rul. 73-105, 1973-1 C.B. 264, ruled that the sales of a particular line of merchandise would be considered separately to determine its relatedness to the exempt purpose. The IRS concluded that the museum's sale of reproductions of works from its own collection and reproductions of artistic works from the collections of other art museums did not constitute an unrelated trade or business. The sale of these items contributed importantly to the achievement of the museum's exempt educational purposes by making works of art familiar to a broader segment of the public, thereby enhancing the public's understanding and appreciation of art, the IRS reasoned.

Likewise, in Rev. Rul. 74-399, 1974-2 C.B. 172, the operation of dining areas, including a cafeteria and snack bar, by an exempt art museum for its staff, employees, and visiting public was not considered an unrelated trade or business activity. Those facilities were designed to complement the needs of museum patrons, being accessible from within the museum galleries rather than from the street, the IRS noted. The museum did not actively promote the facilities as a public restaurant, and any profits generated were used to support its exempt purposes. By providing on-site eating options, the museum enhanced visitors' experiences, allowing them to spend more time exploring exhibits without needing to leave for refreshments. Further, the facilities enabled staff to remain on the premises throughout the day, contributing to the museum's overall efficiency. As such, the eating facilities played a vital role in furthering the museum's mission, the IRS concluded.

In 1995 the IRS released a technical advice memorandum (TAM 9550003) in which it reasoned as follows:

To determine if the sale of an item . . . is related to its exempt purpose, it is necessary to ascertain the [EO's] primary purpose for selling the item. (The buyer's reasons for purchase are immaterial.) Where the primary purpose behind the

production and sale of the item is to further the organization's exempt purpose, the sale is related, and income earned from that sale is exempt, even though the item has a utilitarian function or value. It is only where the primary purpose behind the production and sale of the item is to generate income, that the sale is taxable. Thus, the primary purpose test examines the nature, scope and motivation for the particular sales activities in making a determination that there may be a connection between a particular item and the achievement of an exempt purpose. In every instance, the determination of ultimate causal relationship must be based on the facts and circumstances of each case. A number of differing factors must be considered in analyzing the primary purpose underlying the sale of each item to determine whether sales activities are related. These factors are generally only a means to determine the primary purpose of each article, but these factors could include, for example, the degree of connection between the item and the [EO's] collection, as well as the extent to which the item relates to the form and design of the original item. The overall impression conveyed by the article is another factor to be considered. If the dominant impression one gains from viewing or using the article relates to the subject matter of the original article, picture or likeness, substantial relatedness would be established. If the non-charitable use or function predominates, the sale would be unrelated.

Most recently, in LTR 200722028, the IRS found that the sale by a breast cancer educational nonprofit of merchandise of a particular color that did not otherwise display a logo or name was related to the organization's exempt purpose of breast health education. The ruling concluded that such a sale reminds — and encourages those who wear, display, or see the color — about breast cancer. The sold items were deemed to be “inherently educational, providing information on breast cancer, related topics and resources.”

The IRS has apparently been reluctant since 2007 to issue further guidance on CRM and EOs. Organizations are left with uncertainty about the tax consequences of a critical strategy that would benefit them and the causes they serve. As noted, an analysis of the limited and decades-old IRS guidance may not provide EOs much assurance, and a detailed consideration of whether an activity is subject to UBIT can be extremely expensive.

Given this uncertainty and the risks involved, one practical option for EOs may be to seek a letter ruling from the IRS. Unfortunately, this issue is on the IRS's “no-rule” list, meaning that the agency will not issue taxpayer-specific letter rulings on “whether a joint venture between a tax-exempt organization and a for-profit organization affects an organization's exempt status, furthers an exempt purpose, or results in unrelated business income.”⁵ Thus, without new guidance, EOs are left to choose the best of several bad options.

Possible Solutions

The uncertainty whether UBIT applies to CRM tangible sales puts EOs in a precarious position. Although an organization can request an opinion from its accountant or attorney, those opinions may be of little value other than as potential protection from IRS penalties. Additional guidance or other options are desperately needed.

One potential solution is more guidance on when a marketing relationship is “substantially related.” An interpretation of modern CRM efforts could give organizations some assurances, but a workable definition of substantially related is admittedly difficult to craft.

Another possible solution — one that would be easier in practice and interpretation — is a safe harbor provision. Development of a structure in which CRM tangible sales, or any other unrelated trade or business income, is seen as *de minimis* would be helpful. It is relatively easy to determine whether CRM activities generate an acceptably low or proportionate amount of revenue compared with other funding sources. In combination with simplified reporting

⁵ See Rev. Proc. 2025-3, 2025-1 IRB 142, item 78.

requirements, EOs and the IRS would both be able to avoid superfluous UBTI concerns for those activities.

There are other possible solutions, including statutory amendments and expanded regulatory interpretations. Although these would be the best solutions for the EO community, the likelihood of them happening is questionable.

Thus, the greatest solution for an otherwise fact-intensive, case-by-case problem may be a revival of letter rulings on this issue. A renewed effort to serve the EO community with letter rulings, particularly if coupled with a reduction of the costly user fee for requesting a ruling, would go far. But without new and modern guidance, EOs contemplating CRM efforts for tangible property sales are left in a risky position that hurts the organizations and diminishes the effectiveness of their otherwise important functions. ■

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