WEBSITES, PART 2

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In "Websites, Part 1", I started a series of Notes on the legal issues related to the operation of websites by museums. And, as reported in therein, the only guidelines issued so far which are specific to the internet are: (1) exempt organizations may use e-mail to provide the required written acknowledgement to donors of gifts of $250 or more and of quid pro quo gifts of $75 or more; and (2) the providing of a hyperlink on an exempt organization's website to a sponsor's website does not of itself confer a substantial benefit to the sponsor so as to make the sponsor's donation unrelated business income to the exempt organization. As of today, the IRS has not issued any further guidelines to clarify the application of the Internal Revenue Code to the use of the internet by tax exempt organizations, and it does not appear likely that anything will come out in the near future.

We are probably safe if we draw analogies between websites and conventional non-electronic activity.

The web is a great place to sell stuff. Witness the success of eBay and Amazon.com. The website may be a virtual museum store either by itself or as an extension of a conventional store. The same rules apply to virtual stores as apply to the conventional museum gift shop.[1] If a museum sells items *related* to the mission of the museum such sales are an extension of the museum's tax exempt purpose, e.g., the sale of history books or replicas of historic objects by a history museum. However, if the *history* museum store sells reproductions of modern art, such sales will result in unrelated business income. (Such a sale would not be unrelated income if sold by an *art* museum). These rules should apply if the museum sells the same items over the internet.

Museums which have $1,000 or more in unrelated business income ("UBI") must file a form 990T with the Internal Revenue Service, even if the museum does not file a 990 or 990EZ. The tax rate on the unrelated business income of an organization otherwise tax exempt under Section 501(c)(3) is the same as the tax rate for regular non exempt corporations. [2]

The sale of merchandise in the museum store or on the museum's website would *not* be subject to unrelated business tax if (1) the items sold were donated to the exempt corporation, or (2) the sale was conducted exclusively by volunteers, or (3) the sale was random, i.e., not part of a business regularly carried on.

Exempt organizations may provide links on their websites to commercial e-commerce websites such as amazon.com and receive a percentage of all sales made through such connections. The IRS has not provided any specific guidance here, but it would seem that if the items sold (the books in this example) were substantially related to the organization's tax exempt purpose the sale would not give rise to unrelated business income, since if the same books were sold directly by the museum such sale would not be unrelated business income. However, if Amazon gave the museum a percentage on *all* books sold thru such connection, it would likely give rise to unrelated business income.

Sales which do not further the organization's exempt purpose may still avoid unrelated business income tax if they can be classified as royalties which are excluded from unrelated business income tax by Section 512(b)(2) of the Internal Revenue Code. The royalty payment to the exempt organization is for the use of the organization's name and logo, and the right to link to the exempt organization's website. The exempt organization's name and logo are intellectual property. However, the IRS has vigorously fought against the royalty characterization of the use of the exempt organization's name and logo in affinity credit card cases, and has lost. However, if the exempt organization has to perform some service in connection with the link the IRS may take the position that the payment is a referral fee (not a royalty) and is, therefore, unrelated business income.

In 1997, the Treasury issued final regulations on *corporate sponsorship payments*. Section 513(i) of the Internal Revenue Code distinguishes *advertising*, the net income from which is taxable as unrelated business

[1] See "UBI Federal Taxes Due on Unrelated Business Income, WMA Legal Brief, Summer 1997, Vol 8, No. 2.

[2] The tax rate on non exempt corporations is 15% of the first $50,000, 25% on the next $25,000, up to a maximum of 38%

income and *sponsorship payments* which are not taxable. To qualify as a *sponsorship payment,* a payment made by a person engaged in a trade or business, there must be no expectation or arrangement that the donor will receive any "substantial return benefit" for the payment. Any advertising is a substantial return benefit. Tax payment may, nevertheless, be avoided on the basis that it is a royalty for the use of the exempt organization's name and logo.

If a sponsor receives recognition in an exempt organization's periodical, any payment is *not* a qualified sponsorship payment and is subject to unrelated business income tax. A periodical is defined as any regularly scheduled material published by or on behalf of an exempt organization that is not related to or distributed in connection with a specific event. It includes material published electronically. This does not mean that every website is a periodical. A website is a periodical only if it looks like a periodical and its production practices are like those of a printed periodical However, if the website is treated as a periodical, it may be possible to deduct website expenses against advertising income. Such deduction, however, cannot be used to generate a loss.

A contribution to an exempt organization made by a person engaged in an unrelated trade or business in support of an event, such as a concert, a lecture, or an exhibit, is a *qualified sponsorship payment* and is not unrelated business income to the exempt organization and subject to tax, provided that the donor will *not* receive any "substantial return benefit" for the donation. Any advertising is a substantial return benefit.

An acknowledgement is not a *substantial return benefit*. Acknowledgements may include:

1. The sponsor's name, logo, and slogans that *do not contain qualitative or comparative description of the sponsor's products, services, facilities or company.*
2. The sponsor's address, telephone number, and or internet address.
3. Value *neutral* descriptions of the sponsor's goods or services, including displays and pictures.
4. The sponsor's brand or trade names and product or service listings.

It is common practice for exempt organizations to provide links to sponsor's websites. A regulation issued on April 25, 2002, provides part of the answer to the question as to whether such link is a substantial benefit to convert a qualified sponsorship payment into an advertisement. An example in the regulation describes an exempt organization that acknowledges a sponsor on its website, provides the sponsor's internet address, and provides a link to the sponsor's website. (Treas. Reg. Sec 1.513-4(f) Example 11.) This means that the link does *not* constitute a substantial return benefit so as to change the acknowledgement to advertising. However, the example is silent as to whether there is advertising content on the sponsor's linked site which, if attributed to the exempt organization, would constitute a substantial return. Presumably most sponsor sites would include advertising content.

In another example, with the same facts as above, a statement appears on the linked site (the sponsor's site) that the exempt organization endorses the sponsor's product and that the exempt organization gave its approval. Such endorsement is advertising and constitutes a substantial return benefit. (Treas. Reg. Sec 1.513-4(f) Example 12.)

Caveat: This law note is about federal taxes only!

In "Websites, Part 3" I will discuss using the internet by exempt organizations for intervention in political campaigns and for lobbying.