

NONPROFITS – Giving and Earning Together

Use of tax-exempt organizations for network marketing activities can clearly be a bonanza for all of the parties involved. The most important advice that can be given is included below.

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Picture this - one sales call from you triggers sales presentations to 10,000 customers. Can it happen? Yes. How?

Network marketers should not overlook a golden opportunity to promote sales through nonprofit or charitable organizations. The distributor makes money and so does the organization.

The network marketing industry has become attracted to nonprofit organizations (NPO), their members and friends as a vast potential source of distributors.

Handled correctly, the benefits of a networkers involvement with an NPO are mutual and substantial.

The tax-exempt organization receives a source of funds that are necessary to carry out its functions and to support the causes that are deemed worthy enough for tax-exempt status. The network marketing company gains access to a potentially large and motivated customer base.

In recent years, nonprofit organizations have played a growing role in network marketing sales. Overnight, the membership of a charitable organization may become an instant sales organization of hundreds of thousands. The charitable organization raises these funds for worthy causes and a network marketing company finds a new market for its products, all in all, a very sound match.

We have all seen pancake breakfasts, spaghetti dinners, dances and car washes for fundraising purposes. Such activities are generally sporadic or one-time events, which for the most part, have no legal ramifications. A charitable organization, which signs on as a network marketing distributor and sells products through its membership, is conducting a business activity, however, which may trigger some important legal questions affecting the group's tax-exempt status.

Use of charitable organizations for network marketing distribution typically works as follows. The charitable organization signs on as a network marketing distributor. The charitable organization in turn sponsors its membership as independent distributors. The charitable organization sells products and derives profit. The charitable organization also receives override commissions on sales of products by its downline, its membership being the first level of its downline.

Another approach is for the organization to allow access to members for recruitment and sales, and to encourage voluntary contributions back to the group from members' discounts and overrides.

A third approach which may be more complex to establish, but which may yield the most favorable of tax results, involves the establishment by the nonprofit organization of a wholly-owned "for profit" corporation for network marketing activities - see a future article on this approach.

Tax-Exempt Status

An important question raised by network marketing distribution through charitable organization goes right to the heart of the tax-exempt status of the charitable organization. The extent to which a tax-exempt organization may engage in income-generating activities without jeopardizing its exempt status has never been clarified by the courts or the Internal Revenue Service. The fact that there are so few cases that clearly define the scope of permissible business activities is perhaps resolved in the number and diversity of exempt organizations that have little or nothing in common with one another. Consequently, an activity deemed proper for one category of organization may result in the denial or loss of exempt status by another organization.

There are two possible consequences to an organization conducting a trade or business. First, the organization may be subject to unrelated business income tax. In addition, the organization may be denied tax-

exempt status entirely if the trade or business is carried on to such an extent that it constitutes the primary purpose of the organization.

Unrelated Business Income

The Internal Revenue Code imposes a tax on the unrelated business income of otherwise tax-exempt organizations.

"Unrelated business income" includes income derived by an organization from any unrelated trade or business regularly carried on by it. However, the first \$1,000 of "unrelated business income" is not subject to tax.

It ought to be noted, however, that an exempt organization is entitled to only one \$1,000 deduction regardless of the number of unrelated businesses in which it is engaged.

The IRS has been fairly generous in terms of exempting unrelated business income of charitable organizations when the business activity is engaged in only discontinuously or periodically, for instance, for a period of a few weeks per year. For instance, the IRS regulations specifically provide:

"[c]ertain intermittent income producing activities occur so infrequently that neither their recurrence nor the manner of their conduct will cause them to be regarded as trade or business regularly carried on. For example, income producing or fund raising activities lasting only a short period of time will not ordinarily be treated as regularly carried on if they recur only occasionally or sporadically. Furthermore, such activities will not be regarded as regularly carried on merely because they are conducted on an annually recurrent basis. Accordingly, income derived from the conduct of an annual dance or similar fund raising event for charity would not be income from trade or business regularly carried on [emphasis added]."

The whole point of the IRS taxing unrelated business income is to eliminate unfair competition by placing unrelated business activities of otherwise tax-

exempt organizations on the same tax footing with other businesses that do have to pay income taxes. In addition, the IRS recognizes that it will not tax business-type income if the sale of the goods or the performance of the services contribute importantly to the accomplishment of the tax-exempt purpose of the organization, for instance, musical organizations that put on concerts, educational organizations that sell educational books, or churches that sell Bibles are likely engaging in "substantially related" activity and thus will not be taxed for their profits.

IRS cases and rulings indicate that a good method, for tax purposes, of avoiding taxable income to a nonprofit organization is to approach the organization, gain access to its members through use of the organization's lists or a meeting. (It is important not to compensate the organization for the list of members as this may result in taxable income.)

The direct seller would then offer the members the opportunity to participate in its program in their own right. Any payments to the organization must be voluntary contributions by the members.

This could be achieved by offering each member the choice of either receiving any payments from the direct seller or assigning the payments to the organization. A one-time assignment is probably sufficient; however, assignments on a regular basis would provide a more solid case.

Caveat for Tax-Exempt Organizations

A tax-exempt organization, acting as an actual distributor of products or services, disseminated through a network marketing arrangement, is clearly engaged in a trade or business. In general, there is little relationship between the tax-exempt purposes of the organization and the products that are being sold. Finally, the duties of the charitable organization and its distributor are typically ongoing rather than sporadic. Therefore, income of an exempt organization derived from network marketing distributor activities will be subject to unrelated business income tax. Network marketing companies' distributors who sign up charitable organizations should be careful to point this out to the charitable organizations when they sign up as distributors.

The charitable organization should also be careful not to allow the network marketing distribution activity to endanger its tax-exempt status altogether. Under 501(c)(3) of the Internal Revenue Code, tax-exempt organizations must be organized and operated "exclusively" for nonprofit purposes. The IRS has interpreted this provision to mean, however, that an organization which engages "primarily" in activities that further its exempt purposes will be considered to be operating "exclusively" for exempt purposes. However, the operation of a particular activity may jeopardize the organization's exempt status if the activity is more than "insubstantial" in comparison to overall organization activities. Unfortunately, few cases discuss or define "substantial" in quantifiable terms. In one recent case, the Tax Court held that a tax-exempt organization, which derived more than 25 percent of its revenue from a business activity, was "too substantial" and thus it was denied its tax-exempt status. It is unclear from the opinion whether 25 percent is the "high water mark" to be applied in all cases or merely the line applicable to the particular facts in the individual tax case. Without further guidance, charitable organizations, which are engaged in network marketing activities, must carefully monitor their activities to assure that the activities do not become "too substantial," although just what constitutes "too substantial" is as yet unclear.

Wholly-Owned Profit Making Subsidiary

The least risky method of collaborating with an NPO is through the establishment of a wholly-owned subsidiary corporation to engage in business on the NPO's behalf. This corporation could be signed on as a distributor in the same manner as any individual. The corporation would be taxable on its income. Dividends paid by the subsidiary to the tax-exempt parent, however, would not be unrelated business income to the parent by virtue of 512(b)(1) of the Internal Revenue Code.

IRS letter rulings to tax-exempt organizations desiring to do business, indicate the appropriate business structure for such an arrangement. In the private letter ruling, a tax-exempt organization began operating as a distributor of a food product and enjoyed some success in the next year. The organization did not want to jeopardize its exempt status. Therefore, it set up a wholly-owned taxable subsidiary to act as distributor of the food product, and the exempt organization would be paid through dividends. The IRS stated that for federal income tax purposes, a parent corporation and a subsidiary are considered separate taxable entities, so long as the subsidiary has a legitimate business purpose and the parent corporation does not completely dominate the day-to-day management of the subsidiary. In that 512(b)(1) of the IRC excludes dividends from the

definition of unrelated business taxable income, the dividends would not be taxable.

Use of tax-exempt organizations for network marketing activities can clearly be a bonanza for all of the parties involved. The most important advice that can be given, however, is that the company, the distributors, and the tax-exempt organizations should be fully briefed by professional tax, accounting and legal advisors on the network marketing legal requirements as well as the tax ramifications of marketing through the network marketing format.



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On any given day you can catch Jeffrey Babener, Babener & Associates, lecturing on Network Marketing at the University of Texas or the University of Illinois, addressing thousands of distributors in Los Angeles, Bangkok, Tokyo and Russia, or writing a new book on Network Marketing, an article for *Entrepreneur Magazine* or a chapter for a University textbook.

Over two decades he has served as marketing and legal advisor to some of the world's largest direct selling companies. An active spokesperson for the industry, he has assisted in new legislation and served on the Lawyer's Council and Government Relations Committee of the Direct Selling Association (DSA) as well as serving as General Counsel for the Multilevel Marketing International Association.

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