NONPROFITS: CREEPING COMMERCIALIZATION AND THE SPECTER OF UNRELATED BUSINESS INCOME TAX

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Tags
Charitable Organizations
Nonprofit
U.B.I.T.

OVERVIEW

In 2018, charitable giving in the U.S. totaled over $427 billion. Of that amount, 68% of that giving came from individuals, 18% from foundations, 9% from bequests, and 5% from corporations, according to Giving USA. Yet, while much attention goes to donations, charitable giving is not the only source of revenue for nonprofit organizations – and, importantly, in some cases that revenue may be subject to tax.

Listed under Code §501(c) are the purposes for which a charitable organization can be organized and operated, and thereby qualify for Federal tax exemption. The most common organizations are formed under Code §501(c)(3). Notably, there are boundaries for these organizations and crossing them can mean being subjected to adverse provisions, such as the unrelated business income tax ("U.B.I.T.") or even loss of tax-exempt status. The punitive effect of latter is clear. But what is the U.B.I.T.? And what boundaries was it meant to prevent charitable organizations from crossing?

INTRODUCTION TO CODE §501(C)(3) AND U.B.I.T.

Organizations that fall under Code §501(c)(3) are commonly known as charitable organizations or nonprofits, or simply as 501(c)(3)'s. Under the Code, a 501(c)(3) is "organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals."[1] With the exception of organizations testing for public safety, 501(c)(3)'s can receive tax-deductible contributions from donors.[2] The charities themselves are also exempt from tax on these donations as well as on income, other than income falling within the scope of the U.B.I.T. (detailed below).

Whether drawn by the appeal of tax exemption or public trend toward social responsibility, more and more commercial activities have begun creeping into the nonprofit sector – raising questions about whether an organization has, in fact, been "organized and operated exclusively" for its tax-exempt purpose.

Just recently, the I.R.S. (in a private letter ruling) denied tax-exempt status to a community coffeehouse on the grounds that it was not operated exclusively for tax-exempt purposes. The coffeehouse planned to act as a fundraising operation for nonprofits serving the local community and as a venue, with its profits going to other

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1 Code §501(c)(3).

2 "Exemption Requirements - 501(c)(3) Organizations," I.R.S., last reviewed or updated August 7, 2019.

charities selected by its customers and community members. Besides operating the coffeehouse, the organization was to conduct community-building programs such as forums with leaders from multiple religious groups, dialogue and bridge-building conversations, celebrations of holidays recognized by the many cultures living in the community, conversations about shared community values, and a neighborhood talent show where all proceeds would go to the winner's charity of choice.

Nonetheless, the I.R.S. maintained that no matter the number of exempt activities the coffeehouse planned to put on, the substantial purpose of the enterprise was commercial, not charitable.

Once an organization has been granted Federal tax-exempt status, in order to maintain it, the nonprofit will be subject to certain constraints.

First is the "non-distribution constraint." Although a charitable organization is allowed to make a profit and pay reasonable compensation to those who provide capital or services, no part of the net earnings can inure to the "benefit of any private shareholder or individual." Second, no substantial part of the organization's activities can consist of carrying on propaganda or otherwise attempting to influence legislation. And lastly, the organization also cannot participate in, or intervene in, any political campaign on behalf of or in opposition to any candidate for public office.

For those organizations that qualify as nonprofits, the penalty for unrelated commercial activities is primarily the U.B.I.T. The U.B.I.T. provisions permit charitable organizations to maintain their tax-exempt status while making some profit in the open market. Under these provisions, charitable organizations and most other exempt organizations will pay tax on any net income derived from an unrelated trade or business at the Federal corporate tax rates.[3]

WHAT LEAD TO THE U.B.I.T.?

The U.B.I.T. was not enacted until 1950, and like the ruling above, evolved in response to perceived abuses of tax-exempt status.

In part, its history can be traced back to a 1924 case in which the Supreme Court articulated the "destination of income" test. This ruling held that it was the destination of income, not the source, that was the ultimate criterion for tax exemption.[4] Following this standard, nonprofits could conduct business unrelated to their tax-exempt purpose – even as their sole activity – and still qualify for tax-exempt status as long as their net income was used to support an exempt purpose or paid over to a qualified charity.

In a notable example, the Mueller Macaroni Company, one of the nation's largest distributors of macaroni, did not pay income taxes for nearly 40 years because it was wholly owned by New York University and its profits were used to support the law school.[5]

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[3] Code §511.

[4] *Trinidad v. Sagrada Orden*, 263 U.S. 578, 581 (1924).

[5] Henry B. Hansmann, *Unfair Competition and the Unrelated Business Income Tax*, 75 VALR 605 (1989).

Situations like this raised fears that universities would monopolize entire industries, creating unfair competition for for-profit businesses and denying the U.S. Treasury of much-needed tax revenue.[6]

Besides the concerns surrounding nonprofits running businesses to fund their exempt purposes, there was concern over "feeder corporations," entities that operated a "business as their sole activity and [were] legally obligated to pay over their profits to an affiliated 501(c)(3) organization."[7]

Nonprofits claimed that their "income-producing activities [were] vital to support their missions and reduce [their] dependence on government and private philanthropy."[8] They further justified their position, claiming that they provide services to citizens that the government would otherwise be required to provide.[9] However, for-profits countered that their own existence in a given market was evidence that the government would not be required to provide that service.[10]

In the end, out of the chaos of competing voices arose the U.B.I.T. And clearly, the cries from the for-profit sector won out because, as both the Treasury Regulations and a House report reveal, a major function of the tax was the regulation of competition between the nonprofit and for-profit sectors.[11]

WHAT IS THE U.B.I.T.?

The U.B.I.T. was enacted in the Tax Reform Act of 1950 and then amended in the Tax Reform Act of 1969. As previously mentioned, it requires charitable organizations and most other exempt organizations to pay tax on any net income derived from an unrelated trade or business at the Federal corporate tax rates.[12]

Unrelated business income, as defined in Code §512, is "gross income derived by an organization from any unrelated trade or business regularly carried on by it, less the deductions allowed . . . which are directly connected with the carrying on of such trade or business." An unrelated trade or business is "any trade or business the conduct of which is not substantially related to the exercise or performance by such organization of its . . . purpose or function constituting the basis for its exemption."[13] In addition, Code §502(a) operates to deny tax-exemption to feeder corporations, providing that "an organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt from taxation under section 501 on the ground that all of its profits are payable to one or more organizations exempt from taxation under section 501."

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6 James J. Fishman, Stephen Schwarz, & Lloyd Hitoshi Mayer, *Nonprofit Organizations* (5th ed. 2015), p. 527.

7 Fishman, *Nonprofit Organizations*, p. 530.

8 *Id.* at p. 527.

9 *Id.* at p. 556.

10 *Id.*

11 Treas. Reg. §1.513-1(b); H.R. Rep. No. 2319, 81st Cong., 2d Sess. 36-37 (1950).

12 Code §511; Fishman, *Nonprofit Organizations*, pp. 530, 551.

13 Code §513.

As a result, since the introduction of the Revenue Act of 1950, feeder corporations are no longer allowed exempt status, while the U.B.I.T. applies to exempt organizations with income derived from (i) a trade or business that is (ii) regularly carried on and (iii) not substantially related to the organization's exempt purpose(s).

A Trade or Business

Clearly, income can be derived from many different sources; however, the U.B.I.T. is only concerned with income derived from a trade or business. A trade or business is defined as the selling of goods or the performance of services for the production of income with the intent to make a profit.[14] A trade or business will maintain its identity even if it is "conducted within a larger group of similar activities that may or may not be related to the exempt purpose."[15]

To illustrate, the I.R.S. provides the example of a hospital pharmacy that not only provides supplies to the hospital and its patients in line with its exempt purpose but also sells pharmaceutical supplies to the general public. In this situation, the pharmacy is considered a trade or business.

Regularly Carried On

Seemingly, the most debated element of the provision is whether a trade or business is being regularly carried on.

For an activity to be considered regularly carried on, it must be done frequently and continuously and be "pursued in a manner similar to comparable commercial activities of nonexempt organizations."[16]

The I.R.S. gives some examples that help to understand what is regularly carried on and what is not:

- A hospital running a sandwich stand for two weeks every year at a state fair would not be considered as a trade or business regularly carried on.
- However, if that hospital were to operate a commercial parking lot one day per week, year-round, that would constitute a trade or business being regularly carried on.

The reasoning is that the parking lot would compete with similar for-profit facilities that operate year-round but the sandwich stand would not.

Not Substantially Related

The use of the profits derived from an activity will not automatically make that activity substantially related to the organizations exempt purpose. In a 1986 Supreme Court decision, a unanimous court set the standard for what is "substantially related," focusing on the "manner in which the tax-exempt organization operates it business."[17]

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[14] *Tax on Unrelated Business Income of Exempt Organizations*, I.R.S. Pub. No. 598, Cat. No. 46598X (Rev. Feb. 2019).

[15] *Id.*

[16] *Id.*

[17] *U.S. v. Am. College of Physicians*, 475 U.S. 834, 849 (1986).

Competition in an industry, or the lack thereof, plays no part in whether an activity is substantially related to a charitable organization's exempt purpose(s).[18] This is interesting considering the fact that, as previously mentioned, regulating competition was Congress's asserted purpose for enacting the U.B.I.T.

What is significant is the size, scope, and extent of the activities being carried on when compared to the organization's exempt purpose.[19] If an activity is being carried out on a much larger scale than what is necessary for the organization's exempt purposes, the "excess may be treated as unrelated."[20] This is very fact specific, with particular focus on the size and extent of the activity. It essentially boils down to whether the activity "contributes importantly" to accomplishing the organization's exempt purpose.

WHAT DOES AND DOES NOT CONSTITUTE AN UNRELATED TRADE OR BUSINESS?

In an I.R.S. revenue ruling,[21] the tax-exempt organization in question was organized and operated to conduct and support medical and scientific research. The organization operated a medical illustration department that furnished "various photographic, illustrative, and similar services to medical and educational institutions" and ran a clinic for several hospitals. The I.R.S. concluded that these activities were conducted in a manner "similar to a commercial undertaking" and that the income from these activities was disproportionate to the actual "size and extent" of their exempt activities. Therefore, these activities were considered an unrelated trade or business and subjected to the U.B.I.T.

In contrast, the following is an example of an activity that is not an unrelated trade or business. An exempt art museum runs a dining room, cafeteria, and a snack bar. All are available for use by visitors and museum employees. The facilities allow visitors to stay in the museum and view more exhibits while also providing employees with a place to eat on-site. The operation of the dining room, cafeteria, and snack bar "contributed importantly" to the accomplishment of the organizations exempt purpose and therefore would not be considered an unrelated trade or business.[22]

Now take an exempt youth welfare organization. It operates a miniature golf course that is open to the public, managed by salaried employees, and substantially similar to commercial courses, including the charging of comparable fees.[23] Because this miniature golf course is run in a commercial manner, it does not "contribute importantly" to the accomplishment of the youth welfare organizations exempt purpose.[24] It is therefore considered an unrelated trade or business.

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18 *Taxation of Exempt Organizations*, Thomas Reuters Tax and Accounting, TEO WGL ¶ 22.05 (Mar. 2019).

19 *Id.*

20 *Id.*

21 Rev. Rul. 57-313.

22 I.R.S. Pub. No. 598.

23 *Id.*

24 *Id.*

Similarly, an organization is organized and operated under Code §501(c)(3) for the prevention of animal cruelty. If it provides animal boarding and grooming services to the general public, these services do not "contribute importantly" to the accomplishment of preventing animal cruelty and would therefore be an unrelated trade or business.[25]

Generally, when the business is run for the convenience of those the organization is formed to serve or those it employs, there's a better chance that the business will not be considered unrelated. This is especially true when looking at the proportion of services provided to those the nonprofit was organized to serve versus those provided to the general public.

CONCLUSION

"We must remember the vital role that nonprofits play in our economy."

As stated in the Treasury Regulations, "the primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete."[26] However, fairness is in the eye of the beholder. We must remember the vital role that nonprofits play in our economy. In addition to the direct benefits of their exempt purposes, the nonprofit sector is actually put at a disadvantage because they hire, train, and supervise individuals that would not otherwise be employable in the mainstream labor market. And there is potential for damage to our social fabric as well as our economy if the nonprofit sector cannot be sustained.

One thing is clear, while the U.B.I.T. may have many fans and an equal number of critics, as one looks out onto the horizon, the U.B.I.T. lives on.

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25 *Id.*

26 Treas. Reg. §1.513-1(b).