

CLIENT ADVISORY:

ANALYSIS OF A TAX-EXEMPT NONPROFIT ORGANIZATION

Tax-exempt organizations exist for purposes recognized by federal law to fill a need not otherwise provided by government in the areas of charitable, educational, scientific and literary. The restrictions on revenue and profit for tax-exempt organizations are designed to maintain an even playing field with for-profit organizations while providing an opportunity to sustain the existence of nonprofits. Three questions commonly asked about tax-exempt organizations are:

1. Is it permissible for a tax-exempt organization to generate revenue?
2. Is it permissible for a tax-exempt organization to earn a profit?
3. What is unrelated business income and how does it impact a tax-exempt organization?

Tax-exempt Organization Examination



The activities of an organization are critical to assure its status as tax-exempt and should be examined so they meet the organization's mission. Considerations include:

- Earnings from activities may not enure to the benefit of private individuals;
- The organization may not engage in political activity as a substantial part of its business, and
- Earnings must be from activities consistent with its purpose.

Types of tax-exempt organizations

There are 30 types of tax-exempt organizations. The most common tax-exempt structures are 501(c)(3); 501(c)(4); 501(c)(5), and 501(c)(6). These types of organizations can be religious, charitable, scientific, educational and literary.

General Rule for Tax-exempt Organizations to Generate Profits

Although exempt organizations do not typically generate profits, they are permitted to engage in profit generating activity in addition to fundraising without incurring a tax as long as the activity is related to its mission. For example, collecting dues from its members to attend seminars consistent with its mission and purpose is allowable. However, collecting dues from members in exchange for health insurance is considered a trade or business activity and is taxable to the organization.

Another test is to consider if the tax-exempt organization enjoys a competitive advantage over a tax-paying entity. The general rule is to determine if the trade or business which produces the income is not substantially related to the exempt purpose. If that is found to be the case, then income is taxable. Determination of whether the activities are consistent with purpose and mission is performed on a case by case analysis. Some factors to consider include:

- The activity must benefit the membership as a group rather than their individual capacities;
- Fees charged by the organization must be proportional to the benefits received;

- The service is less likely to be substantially related to an organization's tax-exempt purpose if the service provided is commonly provided by for-profit entities;
- Taxability depends on how the revenue and profit is derived from its operation;
- If the profit is from a related to purpose for which the nonprofit was created to cover its expenses or invest in the enterprise, and
- Are the profits earned a result of activities related to the purpose for which the nonprofit was created?

Unrelated Business Income for a Tax-exempt Organization

Unrelated business income is income derived from a trade or business that is regularly conducted by an exempt organization that is not substantially related to the performance of its exempt purpose, except that the organization uses the profits derived from the activity. An activity must be conducted with the intent to profit in order to constitute a trade or business and can range from the production of income from selling goods or performing services. An activity does not lose its identity as a trade or business merely because it is conducted within a larger group of similar activities that may or may not be related to the exempt purpose of the organization.

An exempt organization will not be taxed on income that is derived from an activity that is substantially related to its exempt purpose; i.e., education. However, if the organization is regularly carrying on a trade or business not substantially related to its exempt purpose, the organization may be subject to tax at the corporate rate on the income derived from the unrelated trade or business. [See internal revenue publication no. 598 (rev. March 2012) at pg. 9.]

Examples of trade or business

- Sale of pharmaceutical supplies to the general public by a hospital pharmacy that is part of the hospital's trade or business even though the pharmacy also furnishes supplies to the hospital and patients of the hospital in accordance with its exempt purpose.

However...

- Soliciting, selling and publishing commercial advertising has been considered a trade or business even though the advertising is published in an exempt organization's periodical that contains editorial matter related to the organization's exempt purpose.

Regularly conducted activity: Regularly conducted trade or business is business activities of an exempt organization that demonstrate a frequency and continuity and are pursued in a manner similar to comparable commercial activities of non-exempt organizations.

Examples of regularly conducted and non-regularly conducted business:

- Operating a commercial parking lot every Saturday on a year round basis would likely be considered "regularly conducted trade or business."
- A hospital's auxiliary operation of a sandwich stand for two weeks at a state fair would more than likely not be considered "regularly conducted trade or business."

Not substantially related: A business activity is not substantially related to the exempt purpose of an organization if it does not contribute importantly to accomplishing that purpose other than through the production of funds.

[Note: Determination is performed on a case by case basis. Size and extent of the activities involved must be considered in relation to the nature and extent of the exempt function that they are intended to serve.]

Example of “not substantially related activity”

- Activity conducted on a scale larger than is reasonably necessary to perform exempt purposes would not be considered to contribute importantly to the accomplishment of exempt purposes and would be deemed unrelated.

Exceptions to the unrelated business rule

Certain “passive” income is specifically excluded from unrelated business income and not subject to taxation. This typically includes interest earnings, dividends, royalty payments, rents from real property, and revenues from the sale of property. In addition, income from certain research and volunteer activities, sales of contributed property, trade shows, bingo and charitable games, membership and mailing lists, and low cost items may be excluded from classification as unrelated business income.

Summary of Unrelated Business Income

There is no “magic” number. However, too much unrelated business income could jeopardize an organization’s tax-exemption if it tips the scale of demonstrating substantial activities not-related to an organization’s exempt purpose.



**GARY R.
PANNONE**
Managing Partner

Gary R. Pannone is the Managing Partner of Pannone Lopes Devereaux & West LLC and has been representing closely held business owners for thirty years. He is an experienced business lawyer specializing in the areas of business formations, corporate restructuring, mergers, acquisitions, corporate compliance and health care. His practice includes the representation of nonprofit organizations with respect to consolidations, mergers and acquisitions.

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PLDW

PANNONE LOPES DEVEREAUX & WEST LLC

counselors at law