

Embarking on Social Enterprise: Part One

Introductory guide for understanding unrelated business income tax

by Kathryn M. Vanden Berk

Given the current reality of dwindling government resources, many nonprofit organizations are exploring new revenue streams. Opportunities for generating earned income from social enterprises are as varied as nonprofits themselves.

Earned income can be derived from any activity that results in revenue generation; however, in the context of social enterprise, we're talking about for-profit activities that may be significantly different from the day-to-day programs and services that define tax-exempt organizations like members of the Alliance for Children and Families.

If you have been thinking about how you might engage in social enterprise, you'll need to become informed about two essential considerations:

1. how to handle unrelated business income tax (UBIT) issues and
2. what sort of social enterprise activities are appropriate for your nonprofit.

I will examine UBIT in this article; then, I will address the various kinds of entities that are available to nonprofit organizations in my next column.

Will This Income Be Taxable?

Over the years, the Internal Revenue Service (IRS) has issued guidance in the form of IRS regulations, tax cases, and rulings. These can be used to evaluate whether or not a proposed activity will be taxed as UBIT.¹ A comprehensive discussion of UBIT is available in the IRS' Publication 598.2.

In order for your new enterprise to generate taxable income, it must:

1. be a trade or business,



2. be regularly carried on, and
3. not "substantially" relate to the organization's exempt purpose.

UBIT was added to the IRS Code in the 1950s when a number of 501(c)(3) exempt organizations began to engage in commercial activities as a way to earn money to subsidize their charitable operations. When their for-profit competitors cried foul, the IRS came up with the UBIT scheme as a way to level the playing field. Since then, a number of decisions—made by the IRS and courts—have created a complicated system of rules, exceptions, and exceptions to the exceptions.

If you wish to become a social entrepreneur, you must be willing to deal with UBIT issues. If the bottom line is that you will pay taxes on your earned

income, so be it. Everyone else pays taxes; and besides, you're still bringing in additional revenue. However, there are a number of ways that organizations can legally avoid paying taxes.

Justice Learned Hand once famously wrote:

"Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose a pattern which will best pay the Treasury; there isn't even a patriotic duty to increase one's taxes."

Let's begin the evaluation by looking at several key factors that could separate the new business venture from exempt programs and services already provided:

- **The person served:** Is your "buyer" part of your beneficiary class? Or is this a different buyer entirely?

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UBIT Examples

Consulting Services. If you provide consultation to other exempt organizations about the way that you do your business and your fees generate a profit, it will be considered taxable income. The IRS has said: “Providing managerial and consulting services on a regular basis for a fee is a trade or business ordinarily carried on for profit. The fact that the services in this case are provided at cost and solely for exempt organizations is not sufficient to characterize this activity as charitable within the meaning of section 501(c)(3) of the code. Furnishing the services

at cost lacks the donative element necessary to establish this activity is charitable.”

(IRS Revenue Ruling 72-369)

Gift Shops. If you have a gift shop that sells items directly related to your exempt purpose, the income from those sales is not taxed. If items are unrelated, then income from their sales is taxed. This so-called “fragmentation rule” comes from IRS rulings regarding museum shops. In 1973 the IRS ruled that the sale of scientific books and city souvenirs by a folk art museum was not related and therefore taxable. This has led to

the full time occupation of Smithsonian employees who decide whether or not gift shop items are related to Smithsonian displays and collections.

(IRS Revenue Ruling 73-105)

Travel Tours. A travel tour organized by an educational nonprofit whose exempt purpose is to teach people about the geography and the culture of the U.S. is exempt from UBIT if it is conducted by certified teachers and taken by students enrolled in degree programs. The same tour for alumni would generate taxable income.
(Rev. Rul. 67-327)

- **The organization served:** Is your “buyer” also exempt? Do you provide an essential service that it would otherwise have to provide for itself?
- **Your fees:** Do you make a profit? Or do you have to fundraise to subsidize your “buyer?”
- **The nature of your service:** Are you selling a program or service that is related to your exempt purpose? Some are inherently different. (See sidebar above.)
- **The nature of your marketplace:** Do for-profit businesses also provide this program or service? Are you competing with them in the market for buyers?

Exceptions to UBIT

Remember that not all for-profit activities are taxable. The topic of UBIT is complex and the rulings are numerous. Here are some general rules that create exceptions to UBIT:

- If the enterprise earns less than \$1,000 per year, there is no UBIT, regardless.
- If the program is active only one or two weeks per year, it will not be taxable, unless that is the way the same kind of for-profit business operates. For example, an auction site that operates for two weeks during an annual fund drive will probably not be taxable; however, one

that operates year-round is taxed. If the auction is for a product that is available only two weeks of the year and the auction site is one of many that operate for those two weeks, then it is likely your organization will be indistinguishable from the for-profit auctioneers.

- If it is passive income, it is not taxable. Investment income is passive; therefore, your dividend income and capital gains from stocks, bonds, etc. is not taxed. Rental use of your facilities also can be tax-free if your role is that of a passive lessor. If you rent out your empty parking lot on weekends to a nearby movie theater, your rent is not taxable; however, if you operate a parking garage that charges by the hour and has an attendant at the gate, then your parking income is taxed.
- Royalty income is not taxable. If you receive income from a passive “affinity” credit card program, it is not taxed. Income from renting out your mailing list is also considered passive, so long as your role is limited to providing names and addresses.

If it is operated by volunteers, it is not taxable. Income from a thrift shop that has only volunteered labor will not be taxed, while the same income is taxed if the shop is staffed

by paid employees.

- If real estate is not debt-financed, then rents are not taxable. Rents from an office building that you own outright will not be taxed, while the same rents are taxable if the building is debt financed. This is because the IRS considers you are just like a commercial lessor when you rent out buildings that you don’t fully own.
- If your income is from activities carried on for the convenience of your members or clients, it is not taxable. A cafeteria operated for the convenience of your staff will not generate taxable income.
- Corporate sponsorship payments are not taxed, but advertising is taxable. A corporate sponsorship must conform to IRS standards for tax-free sponsorship payments. Corporate sponsorships that include a “call to action,” such as a link to the sponsor’s website or price comparisons are taxed as advertising income.
- If your business service is purchased only by other nonprofits and is an “essential service” that they would otherwise have to provide for themselves, the income is not taxable. I have provided some larger examples

in the sidebar above. These are prototypical UBIT cases that can help you sort out the various factors involved.

Beware of Commerciality

Remember that too much unrelated business activity can jeopardize your tax-exempt status. The principle of “commerciality” is not an IRS Code provision or regulation. Rather, it is a judicially-created remedy that arose out of a number of tax cases where the courts found charities so focused on commercial activities that they no longer looked or acted like charities.

On this basis, the IRS has frequently revoked an organization’s exemption where involvement in for-profit activities becomes significant and pervasive. Factors that are considered include:

1. direct competition with commercial firms, including similar locations and similar hours of operation;
2. a pricing structure designed to produce a profit;
3. extensive advertising and use of

commercial advertising methods; and
4. a lack of proof in the organization’s record of donations to the organization or significant “relief of the poor.”

So, as long as you continue to spend the majority of your time pursuing your exempt mission, you should have no problem with the IRS. The key message is not to let your for-profit adventure become all consuming.

Watch for the next column on for-profit corporations and hybrid organizations for social enterprise. ■

ENDNOTES

1. Unrelated business income is taxed under Section 512 of the Internal Revenue Code (26, U.S.C. §512), which states: “Except as otherwise provided in this subsection, the term ‘unrelated business taxable income’ means the gross income derived by any organization from any unrelated trade or business . . . regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business.
2. View Publication 598 at irs.gov/publications/p598/ch03.html.



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