

## Unrelated Business Income

One of the concerns of religious and secular charities is whether the profit obtained from a commercial venture constitutes too great a percentage of its revenues. The income from a commercial venture is designated as "Unrelated Business Income" or "UBI". If the income from this venture exceeds even five (5%) percent of the total revenues, the tax exempt status of the charity may be put into jeopardy. However, the IRS recently broadened the scope of permissible UBI in certain cases. In one case in particular, which is memorialized in Technical Advice Memorandum #200021056, dated February 8, 2000, the IRS ruled that in this instance the tax exempt status would not be revoked even though the organization earned 62% of its gross income from taxable UBI.

In times past, churches opened small book stores or gift shops within its walls to hawk tapes and a few books of particular relevance with the genuine concern that although income tax is paid on the revenue, the status of the non-profit may be placed in jeopardy if the private, for-profit enterprise is "too successful."

This ruling opens the door for religious and other non-profit organizations to broaden the scope of their ministries to incorporate commercial enterprise, increase their income, better serve their constituencies, reduce the burden of dependence upon charitable giving, raise their status and visibility in the communities they serve and bolster their bottom line. It also serves to endorse and encourage creative solutions to the age-old question of producing sustainable economic viability by small organizations.

The ABC Charity (the IRS withheld the actual name for its own protection) had been recognized as a 501(c)(3) organization. Its purpose, as stated in the Articles of Incorporation was "to establish and maintain...a place for the reception, exhibition and sale of articles, the product and manufacture of industrious and meritorious women" and "generally to assist the needy and deserving women in their efforts to earn an honest livelihood by their own industry". (Technical Adv. Memo. #200021056 at Page 259.)

ABC claimed that its sole purpose was to aid such women to earn their own living by providing a place for them to sell their own handiwork and foods.

ABC operates three contiguous shop on site -- a consignment shop, tea room and gift shop. The consignment store is operated by volunteers as well as paid employees and displays the handiwork of the women they serve. The gift shop is also managed by volunteers and paid employees purchasing decorative items from for-profit vendors for retail sales to the general public. The tea room, also managed by both volunteers and paid employees, is a luncheon facility which is open to the general public and consists of a dining room and kitchen.

The consignment shop is the portion of the enterprise which works most closely with the needy women in the community. ABC selects women as consignors who produce handcrafted toys and clothes for purchase by the general public. Each crafter benefits financially from the sale of the item on a consignment basis. According to ABC,

the consignors have heard about the program by word of mouth and ABC publicity campaigns. Volunteers from ABC's membership evaluate the work of the proposed consignor for suitability. Once accepted, the members educate her on how to make goods that people will buy and for which they will pay high prices. They train the ladies thoroughly on fashion, fit, style, fabric, color, sewing and type of products. All work is supervised by ABC which sells its fabrics and other raw materials to the consignors at cost. The goods are sold in the shop to the general public.

ABC found that the consignment shop in and of itself would not bring in the prospective customers in sufficient numbers. It would be perceived as a "craft fair" with a few hand-made goods of secondary quality. As a result, the volunteers of ABC purchase decorative items from regular for-profit wholesale vendors for placement in the gift shop which is adjacent to the consignment shop. ABC stated that in order to attract quality clientele, it must 1) provide a reason for people to come to the shop which exposes them to the consignment items, 2) possess a showroom with the quality and ambiance that repeatedly attracts high end customers, and 3) provide attractive merchandising that suggests quality. ABC asserted that the gift shop goods were "sophisticated, tasteful and fashionable" and because they appear in the same shop as the consignment goods, they enhance the consignment items.

In order to enhance the prices of the consignment items, ABC developed a pricing strategy: 1) gift shop items cover a broader price range than consignment items with a greater number of goods in the low and high end. The low end items give the customers a sense of "bargain and comfort," while the high end items steer the clientele to the mid-range prices where the consignment items are situated. The price for the consignment items covers a range between \$4.50 and \$250.00, while the gift shop prices range from \$1.50 to \$1,500. After setting aside the highest end items, ABC stated that the representative sales from consignment items range from \$4.40 to \$95.00, while the range for the gift shop covers from \$1.50 to \$150.

The tea room is adjacent to the consignment and gift shops and serves lunches to the general public. All of the food consumed is purchased from regular for-profit vendors. ABC intentionally placed the tea room in such a way that in order to use it, customers would have to meander through the gift shop. It serves only light lunches which is deemed ideal for shoppers and the menu, décor, room arrangement and tableware is designed to be tasteful and sophisticated. ABC intended the tea room to enhance the shopping experience and to create a social activity. Three paid employees and three volunteers staff the facility.

It is important to note that ABC contends that its only purpose for the gift shop and the tea room is to further its clearly stated primary purpose of assisting people who have faced adversity to help themselves out of their difficult situation, and that the gift shop and tea room merely exists to support the handicrafts by attracting customers and help by generating funds to support its exempt purposes.

ABC also raises dues from women of the community as a “membership organization” and such women must also volunteer a certain amount of their time to the functions each year by contributing an average total in the aggregate of 5,000 hours. ABC indicated that in addition to the activities previously described, the volunteers enter data on the computers, perform bookkeeping services, oversee the arrangement and appearance of the premises, publicize the mission, buy items for the gift shop, fund-raise, assist with sales and work in the office. The paid staff fills in when the volunteers cannot complete their particular functions. ABC also employs a paid executive director and full-time bookkeeper.

Although the total revenue was not disclosed by the IRS in its holding, the relative income of each unit was discussed as a relevant factor in determining the exempt or non-exempt status of the organization. The tea room comprised the greatest single source of revenue – almost 34% of the total. The next greatest source was the consignment shop with 33% of the total. Third, the gift shop came in with 28% of the total. Only 3% came from donations and 1% from membership dues. ABC indicated that approximately 40% of the financial and physical resources were utilized by the consignment shop while the gift shop and tea room used 30%. Importantly, ABC reported its revenues for the tea room and gift shop as UBI – unrelated business income on its Form 990-T, Exempt Organization Business Income Tax Return and listed its largest expenses as the salaries (after the cost of the goods sold). It appeared to the IRS that the relative percentages of income and expenses for the year in question was representative of and consistent with prior years.

There are two questions that the IRS had to decide in this case:

1. Whether the tea room and gift shop enterprises represented a substantial non-exempt purpose that would cause revocation of ABC’s exempt status under section 501 (c)(3).
2. If the organization is exempt, does the income generated by the tea room and gift shop represent unrelated business income (UBI)?

Section 501 (c)(3) of the Code indicates that organizations are exempt from federal income tax as long as the entity is organized and operated exclusively for religious, charitable, or educational purposes and so long as “no part of the organization’s net earnings inures to the benefit of any private shareholder or individual.”

Section 1.501(c)(3) -1(a)(1) of the Income Tax Regulations provides that in order to qualify as an exempt organization under 501 (c) (3) an entity must be both organized and operated exclusively for one or more of the exempt purposes described. The IRS would conclude that the organization is “operated exclusively” only if the entity engages primarily in activities which accomplish one or more of the exempt purposes. It will not qualify, if more than an insubstantial part of its activities is not in furtherance of any exempt purposes [Section 1.501 (c) (3) – 1(c)(1)]. However, according to Section 1.501 (c) (3) – 1 (e) (1) of the Regulations, if the operation of a trade or business, even if it is a

substantial part of the enterprise, is deemed to be in furtherance of the organization's exempt purpose and if it is not operated with the primary purpose of carrying on an unrelated trade or business it will be considered compliant with 501(c)(3). If the IRS deems that the organization's primary purpose is for business, the IRS will disqualify it even though it is religious, or has religious overtones, and even if the profits are not paid to its members.

Section 511 (a) of the Regulations clearly impose a tax on UBI even on qualifying 501 (c) (3) organizations. Section 512 (a) (1) defines UBI as gross income derived from "any unrelated trade or business".

The IRS held as follows regarding the 501 (c) (3) status: Although the sale of the goods is normally a business activity that would tend to disqualify the organization, the ultimate test is the purpose of the sale of the items. The clear purpose in the case of ABC is to enable needy women to support themselves. They also stated and the IRS held that the purpose of the gift shop and tea room is to provide an "optimum market" for its clientele as a "draw" for the consignment shop.

The tea room not only attracts customers but it provides funds for the consignment shop. It qualifies if a "substantial part of the activities of the business is "in furtherance" of the exempt purpose. It was significant to the IRS that the code in Section 1.501 (c) (3) – 1 (e) does not require that the business be directly related to the exempt purpose (Sections 511-513 of the Code) only that it be "in furtherance" of the exempt purpose. As such, it is "in furtherance" if it raises money for the exempt purpose. Nevertheless, if the activity is "substantial" in nature, the IRS may still deem it disqualified. Therefore, the balance of the revenues between the consignment, the tea room and gift shop are significant to that holding. The IRS in this case was satisfied that the sole purposes of the tea room and gift shop were to raise funds and attract clientele for the consignment shop. There was no independent purpose.

If the tea room and gift shop had been operated at a loss, the IRS would have questioned the purpose – there may have been some non-exempt purposes to those enterprises, such as a tax deduction against income. Fortunately, they had income during the year in question.

The IRS has reviewed the viability of the sale of goods by non-profit entities on many occasions. One such group sold the cooking and needlework of needy women. In that case, the organization charged an insignificant sales commission on the goods, and the entity depended on public contributions because the enterprise was not self-supporting. The IRS clearly accepted its exempt purpose since the organization supported needy women and depended upon contributions [Rev. Rul. 68-171].

The second issue that the IRS reviewed was whether the income to the tea room and gift shop should be considered UBI. It had been reported as such on the Form 990. (The consignment income had not been reported as UBI and the IRS accepted this conclusion.)

The ABC had paid the UBI tax but argued that it should not need to because the income merely supported the exempt purpose. However, the IRS held that UBI is considered, not on the exempt purpose of the income, but on its source. UBI is triggered based upon the manner in which it is generated.

In its review, the IRS utilized a shadowy concept, not found in the IRS Code, to determine whether or not the tea room and gift shop are businesses that generate UBI. It is called the “commerciality rule” and it refers to whether or not the source of income is operated in “a commercial way”. For example, a non-profit youth group operated several recreational facilities as part of its programs. However, the profit generated in one of these programs, a miniature golf course, was hit with UBI tax. The reason is that the links looked too much like other miniature golf courses in the area: it was 1) open to the general public, 2) staffed by paid employees, and 3) it charged fees similar to the for-profit courses [Rev. Rul. 79-361].

However, a museum café was not charged UBI [Rev. Rul. 74-399]. In that case, the eating facility helped attract visitors and enhanced the efficient operation of the museum because both staff and customers could eat there. In that way, it served the exempt purpose by enhancing the efficient operation of the museum in an important way and was not competing directly with other restaurants [Rev. Rul. 74-399]. It should be noted however that the IRS considers an eating facility to be presumptively commercial, when it competes with other restaurants, uses profit-making pricing formulas, engages in advertising, opens during hours that compare with its competitors, and does not solicit contributions. Such was the case in Living Faith, Inc. v. Commissioner, 950 F.2d 365 (7<sup>th</sup> Cir. 1991) which was upheld in the Court of Appeals in a Tax Court decision found in CCH T.C. Memo. 1990-484. In that case, the entity operated restaurants and health food stores in conformance with religious principles, but the enterprise itself was considered presumptively commercial because it (a) competed directly with other restaurants and food stores, (b) utilized profit-making pricing formulas common to the food business, (c) advertised broadly, (d) utilized hours of operation that put it in direct competition with other retail stores, and (e) failed to have any plans in place to solicit donations.

The IRS held that ABC’s gift shop and tea room reflected the Living Faith scenario rather than the museum café and distinguished the case from the holding in Rev. Rul. 74-399. A significant factor in making that decision was the absence of clear evidence of the hours spent by volunteers. ABC documented over 5,000 hours of volunteer labor but the actual percentage of volunteer activities was not clear, and there clearly was a significant use of paid staff both the tea room and gift shop. As such, the organization could not be exempt from UBI based upon Section 513 (a) (1) of the code which exempts the business from UBI in which “substantially all the work in carrying on such trade or business is performed for the organization without compensation.”

Therefore, the IRS concluded that (1) ABC's activities with regard to the operation of a tea room and gift shop do not constitute substantial non-exempt purposes that would result in the revocation of its 501 (c) (3) status, and (2) the income generated by the tea room and gift shop is unrelated business income and taxable under Sections 511 through 513.

As a result of this ruling, you may consider broadening the scope of your for-profit business, if you represent a non-profit or serve in conjunction with a 501 (c) (3) organization. It is no longer the case that the IRS simply looks at the percentage of the for-profit income to the whole. You should consider how much of the UBI is put into the exempt programs and the percentage of the entity's time and resources which are spent in generating the UBI.

Source: Tech. Adv Mem. #200021056, Feb 8, 2002

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