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Legal and Tax Basics for Earned Income Activities and Social Enterprise

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I. INTRODUCTION

Earned income activities — selling services or goods to generate revenue — can be an important tool for a social enterprise. They can create self-sustainability, build revenues and help an organization achieve its mission.

Important legal and tax considerations apply to earned income ventures, however, and must be taken into account when planning or managing such ventures. Some ventures may generate taxable income for an organization, which should be factored into business plans.

Earned income ventures must also be structured to protect an organization's tax-exempt status. This consideration is particularly important in today's environment, where the Internal Revenue Service (the "IRS") has increased audit and enforcement over exempt organizations substantially in recent years.

These materials explore some of the key legal rules that govern the conduct of earned income activities by organizations that are exempt from federal income taxes. They begin with a brief overview of the policy behind tax exemption and continue with a discussion of some of the key issues with which exempt organizations must contend. They will conclude with a discussion of the application of some of these principles in the context of various types of joint ventures and other transactional options that social enterprising tax-exempt organizations might consider.

II. BACKGROUND

A. What is a nonprofit?

A nonprofit is an organization that is both (1) organized as a nonprofit corporation under state law and (2) which has been recognized as exempt from taxation by the IRS.

These materials will focus on charitable organizations which are exempt under Section 501(c)(3) of the Internal Revenue Code of 1986, as amended (the "Code") unless stated otherwise.

B. Eligibility. Who is eligible for tax-exempt status?

1. **Basis for exemption.** The basis for tax exemption is found in Code Section 501(a), which states that organizations that meet the requirements of Section 501(c) or (d), or Section 401(a), will be exempt from federal income tax.
2. **Tax-exempt charitable organizations.** This is the designation that is most frequently sought under § 501(c) of the Internal Revenue Code. The basis for this type of exemption is found in § 501(c)(3) of the Code, which is only one of twenty-eight subsections of § 501(c) of the Code that provide for tax-exemption. The basis for the exemption of charitable organization is as follows:

Corporations, and any community chest, fund or foundation, 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 (but only if no part of its activities involve the provision of athletic

functions or equipment), or for the prevention of cruelty to children or animals....

3. **Non-charitable tax-exempt organizations.** There are a number of other bases for tax-exemption under § 501(c) of the Code, all of which have very specific rationales and requirements. Among the more commonly utilized bases for exemption under § 501(c) of the Code are the following:
 - a) Exemption under § 501(c)(4) for (1) civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare; or (2) local associations of employees, (i) the membership of which is not limited to the employees of a designated person or persons in a particular municipality; and (ii) the net earnings of which are devoted exclusively to charitable, educational or recreational purposes.
 - b) Exemption under § 501(c)(5) for labor, agricultural or horticultural organizations.
 - c) Exemption under § 501(c)(6) for business leagues, chambers of commerce, real-estate boards, boards of trade or professional football leagues not organized for profit and no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Those organizations are not eligible for charitable contributions (that are deductible for the donor) and typically not recipients of grants from foundations or government, but they are exempt from paying federal income tax.

C. What does “tax-exempt” status mean to a charitable organization?

1. **Corporate Income Tax.** Organizations that qualify are not required to pay corporate income tax on net income (excess of revenues over expenses) of the corporation. There is also an exemption from federal unemployment taxes.
2. **State Income Tax.** The organization may qualify for an exemption from state income tax on the net income of the organization. Various states have different tests for state tax exemption.
3. **Real Property Taxes.** The organization may qualify for exemption from real property taxes. This exemption is usually the most difficult to obtain.
4. **State Sales Tax.** The organization may also qualify for exemption from any state sales tax.
5. **Eligibility for Tax-Exempt Financing.** Tax-exempt rates are generally significantly less than commercial lending rates.
6. **Grants.** Tax-exempt organizations tend to be frequent recipients of grants from private foundations.

7. **Deductibility of Gifts.** Tax-exempt status allows donors to claim a tax deduction for gifts to the tax-exempt health care organization.
 8. **Reduced Postal Rates.** Tax-exempt organizations are eligible for preferential second and third class postal rates.
 9. **Employee Benefits.** Tax-exempt organizations can take advantage of favorable rules for contributions to certain annuity benefit programs.
- D. Are there any disadvantages to tax-exempt status?** Absolutely. The privilege of not paying income tax brings with it a complex and well-enforced regulatory scheme.
1. **No private inurement.** This is discussed in detail below, but generally, the prohibition on private inurement means that the tax-exempt organization cannot allow any of its net income or net earnings to “inure” to the benefit of private individuals.
 2. **No substantial legislative or political activities.**
 3. **Extensive annual reporting requirements.** Unlike your personal tax returns, this information is in the public record.
 4. **Significant regulatory oversight, and significant penalties for violations of applicable laws and regulations.** There is absolutely no doubt that this trend will continue in the future.
 5. **Unrelated Business Taxable Income (“UBTI”).** As will be discussed below, exemption from federal income tax does not mean that an organization will be exempt from all types of income tax. Instead, some earned income ventures which are not related to exempt purposes — under IRS regulations — are subject to tax as unrelated business taxable income (UBTI).

III. EXEMPTION UNDER CODE § 501(c)(3)

- A. There are two key elements to § 501(c)(3) exemption.** Generally, as noted above, corporations that are organized and operated exclusively for religious, charitable, scientific, literary or educational purposes or for testing for public safety may qualify for § 501(c)(3) exemption. Accordingly, organizations that wish to acquire § 501(c)(3) status must satisfy what are known as the “Organizational Test” and the “Operational Test.”
1. **The Organizational Test.** A corporation is organized exclusively for one or more exempt purposes only if its articles of organization include specific required provisions that limit its activities to those permitted under Code Section 501(c)(3).
 2. **The Operational Test.** The Operational Test looks to the actual operations of the organization and requires constant vigilance to ensure that it is not inadvertently violated. Basically, the Operational Test will be satisfied so long as the following three sub-tests are followed:

- a) **The Primary Purpose Test.** An organization must engage “primarily” in activities that accomplish one or more exempt purposes. Meeting the primary purpose will satisfy the “operated exclusively” language found in § 501(c)(3).
- b) **The Private Inurement Test.** An organization will not be considered to operate exclusively for one or more exempt purposes if its net earnings inure in whole or part to the benefit of private shareholders or individuals.
- c) **The Private Benefit Test.** An organization is not organized or operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest, and it may not be operated for the benefit of private interests such as designated individuals, the creator of the organization or the creator’s family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

B. Elements of the Operational Test Analyzed in More Detail.

1. The Primary Purpose Test.

- a) Basically, an organization will be regarded to be “operated exclusively” for one or more primary purposes only if it engages “primarily” in activities which accomplish one or more exempt purposes, and no more than an “insubstantial part” of its activities are in furtherance of non-exempt purposes. This is because, according to the Supreme Court, “the presence of a single ... [nonexempt] purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly ... [exempt] purposes.” *Better Business Bureau of Washington, D.C. v. United States*, 326 U.S. 279, 283 (1945).
- b) There is no universally accepted definition of “insubstantial.” One court determined that activities that represented less than 10 percent of an organization’s activities would not violate the primary purpose test. *See World Family Corp. v. Comm’r.*, 52 T.C.M. 1093 (1986). Another court found that activities that were not related to an organization’s exempt purpose that resulted in more than one-third of that organization’s income were substantial, and that exemption was no longer appropriate. *See Orange County Agric. Soc’y, Inc. v. Comm’r.*, 55 T.C.M. 1602 (1988), *aff’d* 893 F.2d 647 (2nd Cr. 1990).
- c) Additionally, exempt organizations will pay tax on any income that is derived from any unrelated trade or business; this tax, which is called “unrelated business taxable income” will be discussed in Section IV below.

2. The Private Inurement Test. An organization will not be considered as operated exclusively for one or more exempt purposes if its net earnings inure in whole or part to the benefit of private shareholders or individuals.

- a) Any transactions between exempt organizations and insiders must be demonstrably reasonable. This reasonableness standard focuses essentially on comparisons, that is, the terms of similar transactions by similar organizations. As a general rule, “reasonable” compensation is the amount that a like organization in like circumstances would pay for like services.
- b) It should also be noted that, as will be discussed below, transactions with insiders that could theoretically implicate the private inurement prohibition can also be considered an “excess benefit transaction” and result in the imposition of “intermediate sanctions,” pursuant to a relatively recent modification of the Code, § 4958.

3. **The Private Benefit Test.** As one court noted, the proscription against private benefit “inheres in the requirement that a [charitable] organization operated exclusively for exempt purposes.” *Redlands Surgical Services v. Comm’r.*, 113 T.C. 47, 74 (1999), *aff’d* 242 F.3d 904 (9th Cir. 2001).

- a) As noted above, if a single non-charitable purpose exists that is substantial in nature, this purpose can place at risk an organization’s tax-exempt status. Some private benefit, however, is permitted, so long as it is incidental in both a qualitative and quantitative sense.
- b) If the private benefit is a necessary concomitant—i.e., incidental—of the activity which benefits the public at large, and is insubstantial in amount, private benefit may be permitted. In other words, the benefit to the individual(s) must be such that the public benefit could not be achieved without necessarily benefiting the certain individual(s), and the amount of the benefit to the individual(s) must not be substantial.
- c) Although the concepts of private inurement and private benefit are similar, these two tests differ in two very important ways:
 - i. First, even a minimal amount of private inurement results in disqualification for tax-exempt status. By contrast, if private benefit is a necessary concomitant of the activity and is not substantial in amount, the private benefit will not result in disqualification for exempt status.
 - ii. Second, as noted above, the proscription against private inurement only applies to insiders.
- d) For example, the IRS ruled that an organization formed to keep a commercial classical music radio station in the community was not tax-exempt because of excess private benefits. Even though the community as a whole would also benefit from keeping the station, and the station may have also served an educational role in the community, the fact that the organization’s activities inherently benefited the private owners of the station prevented it from qualifying for § 501(c)(3) status

- C. Application Process for § 501(c)(3) Exemption.** Being organized and operated for a charitable purpose does not automatically bestow tax-exempt status. Instead, it is necessary to seek recognition from the IRS of tax-exempt status.
- 1. Individual Determination Letter.** This starts with filing the appropriate application with the IRS, along with all required supporting material. Organizations seeking § 501(c)(3) exemption must complete Form 1023.
 - a)** The burden is on the organization that is applying to demonstrate that it complies with all required standards. The representations made to the IRS on the Form 1023 form the basis of the organization's tax exempt status. If the IRS is persuaded that an organization qualifies, it will issue a "determination letter."
- D. Requirements for Reporting by § 501(c)(3) Organizations.**
- 1.** Although exempt from federal taxes (aside from unrelated business income tax, discussed below, and certain excise taxes), § 501(c)(3) organizations are nevertheless required to file a variety of forms with the IRS. The policy rationale for this requirement is clear—the IRS wants to make sure organizations that are enjoying the substantial benefit offered by exemption from federal income tax are behaving in a manner that is consistent with their originally expressed basis for exemption.
 - 2.** The specific forms that an organization will need to file will vary based on the particularities of that organization. All forms and instructions are available from the IRS at www.irs.gov/charities. Generally speaking, however, most organizations that are exempt from federal income taxes are required to file Form 990, the "Return of Organization Exempt from Income Tax" form. Additionally, organizations that qualify as "public charities" or "non-private foundations," as discussed above, are required to file Schedule A to Form 990. Organizations that have unrelated business taxable income of more than \$1,000 must also file Form 990-T. Organizations with gross receipts that are less than \$500,000 and total assets that are less than \$1.25 million in value at the end of reporting year 2009 can file the much shorter, and simpler, Form 990-EZ. The IRS is moving towards electronic filing of Form 990.
 - 3.** Certain organizations are exempt from the requirement to file a Form 990; however, these organizations are required to notify the IRS of any changes in the organization's charter, operations, or purposes. Organizations with no more than \$25,000 in gross receipts are exempt from filing a Form 990, but they must now file 990-N ePostcard. Certain churches and related organizations are also exempt. The filing threshold for the Form 990 will be increased from \$25,000 to \$50,000 in gross receipts beginning with the 2010 tax year.
 - 4.** Public Disclosure. The Form 990 and its schedules and attachments, with limited exceptions, are subject to public disclosure by the organization and by the IRS. Form 990s filed with the IRS are all posted on the Internet by an independent organization, Guidestar, at www.guidestar.com.

E. Maintaining § 501(c)(3) Status.

1. **General Rule.** Generally, once an organization obtains tax-exempt status, that status may be maintained so long as the organization does not materially change its character, purposes, or methods of operation. It is necessary to stay abreast of legal developments, however, because a change in the law can also affect an organization's exempt status.
2. **So what is a material change?**
 - a) Unfortunately, there is no consensus as to what type of change is "material." The idea is that exemption is premised on the continued operation by an organization in accordance with its exempt purpose. Thus, any significant deviation from this conduct may constitute a "material" change.
 - b) For example, in a 1981 case, the IRS revoked the exempt status of a § 501(c)(3) entity named Gospel Workers Society because that organization's operations had shifted so dramatically that it no longer had any real tie to its original exempt purpose. *Incorporated Trustees of the Gospel Workers Soc'y. v. United States*, 510 F. Supp. 374 (D. D.C. 1981). The Court found that the organization's exempt purpose—the promotion of religious, educational and missionary activities, including the dissemination of religious literature to charitable and penal institutions—was simply no longer being pursued in a meaningful way. The Court highlighted the high profits, rapid rise in salaries of top personnel and the fact that the entity was in competition with a number of commercial enterprises in support of its conclusion.
 - c) The organization's managers and advisers have the burden of determining whether a change is "material" or "immaterial."
 - d) Material changes are supposed to be communicated to the IRS as soon as possible after the change is made or otherwise becomes effective. Immaterial changes that are part of the natural evolution of the organization should also be reported, but can simply be included in the Form 990. Examples of these would be routine amendments to organizational documents, new program accomplishments consistent with the original tax-exempt purposes of the organization, and new sources of revenue.
3. **Retroactive Revocation.** The IRS will sometimes attempt to retroactively revoke an organization's exempt status. This can happen in three situations:
 - a) If the organization misstated or omitted a material fact in the process of acquiring exemption;
 - b) where the organization operated in a manner materially different from that originally represented to the IRS; and

- c) if the organization engaged in a prohibited transaction.

IV. UNRELATED BUSINESS TAXABLE INCOME (“UBTI”)

Of particular importance to organizations running earned income ventures are the rules related to unrelated business income tax. Net revenues from earned income ventures that are not substantially related to an organization’s charitable purpose are subject to income tax. *The fact that the organization uses the money from a venture to support its charitable activities is not relevant.* It is the activity itself that generates the revenue that must further the organization’s charitable mission.

A. What is UBTI and why does it matter? UBTI is defined as the “gross income derived by an organization from any unrelated trade or business regularly carried on by it.” I.R.C. § 512. An “unrelated trade or business” is defined as any trade or business conduct of which is not substantially related, aside from the need of such organization for income or funds or the use it makes of the profits derived, to the exercise or performance by such organization of its exempt function. I.R.C. § 513. UBTI is permitted; the organization must simply track and report the income, deduct related expenses, and pay applicable taxes.

1. **Why is there UBTI?** The rationale for this level of taxation is that it is unfair to allow tax-exempt entities to compete with for-profit businesses while enjoying the benefits of their tax-exempt status. Thus, UBTI is intended to place the business activities of tax-exempt organizations that are outside the scope of their charitable mission on the same footing as the for-profit businesses with which they compete.
2. **What would the alternative be?** Having UBTI is not uncommon, and income from unrelated business is essentially taxed in the same way that the revenue of non-exempt businesses is taxed. If there were no such thing as UBTI, the policy rationale that disallows tax-exempt entities from competing with for-profit entities because that kind of competition is unfair to the former could result in an even harsher penalty: the complete revocation of exempt status.
3. **Too much UBTI can lead to revocation.** As discussed above, the primary purpose test requires that an exempt organization must be operated primarily for one or more exempt purposes. Accordingly, unrelated business income must be limited to something less than a substantial part of the organization’s activities. Although there is no specific rule, the IRS may deny or revoke an organization’s exempt status when the organization regularly derives more than an insubstantial part of its annual revenues from unrelated activities. *See e.g., Orange County Agricultural Soc’y v. Comm’r*, 893 F. 2d 647 (2d Cir. 1990), *aff’g* 55 T.C.M. 1602 (1988) (exempt status not available where the organization received approximately one-third of its revenue from an unrelated business). There is no bright-line rule for how much UBTI is too much. A good rule of thumb is 10% to 15% of gross revenues, or 10% to 15% of the organization’s overall activities, without regard to revenues generated, is an acceptable level. Activity or revenues in excess of this amount should be reviewed carefully.

B. Related to What?

1. **A prerequisite to understanding whether UBTI exists is to understand fully the nature and scope of the exempt organization's exempt purpose.** This is because, as discussed below, any activity that is “substantially related” to these purposes is exempt from UBTI. *See* IRC § 513(a). In other words, before you can know whether an activity is “substantially related” to an “exempt purpose,” you need to understand exactly what constitutes the “exempt purpose.”
2. **Analysis.** In analyzing this question, the IRS looks first to the organizational documents of the entity in question. These purposes are generally found in an organization's articles of incorporation (for corporations), articles of association (for unincorporated associations), or trust instruments (for charitable trusts). Additionally, an organization's bylaws may offer further detail concerning the entity's exempt purpose. The second level of analysis is the purposes of the organization that were described to the IRS when the organization originally sought tax exemption, as this representation forms the basis for the organization's tax-exempt status.

C. **Elements of UBTI.** To determine whether UBTI exists, the following issues need to be addressed and each is discussed in the following sections of this outline.

- a) Is the activity a “trade or business?” If not, then UBTI will not be imposed on income from the activity.
- b) Is the trade or business “regularly carried on?” If the business is conducted only infrequently, then income from the business is not subject to tax.
- c) Is the business “substantially related” to the organization's exempt purposes (other than its need for funding)? If so, then income from the business is not taxable.
- d) Even if the business is not substantially related, does one or more of the “volunteer,” “convenience” or “donated goods” exceptions apply?
- e) Finally, does one of the special exceptions set forth in Code § 512(b) apply?

1. **“Trade or Business.”**

- a) This term has an exceptionally broad definition, including “any activity which is carried on for the production of income from the sale of goods or the performance of services.” Code § 513(b).
- b) The applicable Treasury Regulations expand this definition even further, sweeping within the ambit of “trade or business” any activity that otherwise has the characteristics of a business as that term is defined in the federal income tax law in the context of business deductions. According to the Supreme Court, the test for determining whether an activity has the characteristics of a business is that the “taxpayer's primary purpose for engaging in the activity must be for income or

profit.” *Comm’r. v. Groetzinger*, 480 U.S. 23, 25 (1987).

A congregation of an apostolic religious order asserted that profit was not the primary motivation for them to engage in farming and therefore their activity should not be considered a trade or business. They argued that farming should be considered a trade or business. They argued that farming was a vehicle for advancing the order’s religious, educational, and charitable purposes and any profit motive was subordinate to that purpose. Further, they ran their operation in a way that did not maximize profit. Their contention was rejected because profit motive does not have to mean profit *maximizing* motive. That the farm was operated for profit was enough to qualify it as a trade or business. See *St. Joseph Farms of Indiana v. Commissioner*, 85 T.C. 9 (1985).

- c) Additionally, the Code clarifies that an activity does not lose its identity as a trade or business solely because it takes place “within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization.” Code § 513(c).

An example of an activity “within a larger aggregate of similar activities” is a hospital pharmacy’s regular sale of pharmaceutical supplies to the public. This activity remains a trade or business even though the pharmacy also supplies the hospital and patients of the hospital in accordance with its exempt purpose. Treas. Reg. § 1.513-1(b).

- d) Accordingly, almost every earned income venture will be considered a trade or business.

2. “Regularly Carried on.”

- a) There is no precise definition of what “regularly carried on” actually means. Instead, the question is to be analyzed on the basis of the unique facts and circumstances of each specific case.
- b) The best guidance as to what “regularly carried on” means comes from the Treasury Regulations, which provide that in making this determination, “regard must be had to the frequency and continuity with which activities productive of the income are conducted and the manner in which they are pursued....” Treas. Reg. § 1.513-1(c)(1). Accordingly, “specific business activities of an exempt organization will ordinarily be deemed to be ‘regularly carried on’ if they manifest a frequency and continuity, and are pursued in such a manner, generally similar to comparable commercial activities of nonexempt organizations.” *Id.*
- c) The regulations provide several good examples of when an activity is regularly carried on, as opposed to when it is not:

- i. The conduct of year-round business activities on one day each week, such as the operation of a commercial parking lot on Saturday of each week, would constitute the regular carrying on of a business.
- ii. Likewise, the conduct of a traditionally seasonal business by an organization for a significant portion of the relevant season would also be considered the regular conduct of a trade or business.
- iii. For example, the sale of holiday cards every December would be regularly carried on, even though it's only carried on one month per year.
- iv. Truly one-time or infrequent events, such as the one-time sale of property, would not be an activity that is regularly carried on.

3. “Substantially Related.”

- a) As noted above, income from a trade or business is not subject to UBTI if the trade or business is substantially related to the organization's exempt purposes. The analysis of whether income is “substantially related” is a facts and circumstances test.

For example, an art museum operating a museum gift shop will not generate UBTI by selling reproductions of its works and educational literature concerning the history and development of art. This activity is substantially related to the museum's purpose of enhancing the public's understanding and appreciation of art. On the other hand, the art museum's gift shop *will* generate UBTI by selling scientific books or souvenirs of the city in which the museum is located. Science books and souvenirs are not substantially related to the museum's exempt educational purpose of promoting art. Rev. Rul. 73-105.

- b) It is the conduct of *activity* of the trade or business which must be substantially related to exempt purposes. The fact that revenue generated is used for exempt activities is not relevant to this inquiry.

Consider two examples where the activity was operating a retail grocery store:

In one case, the organization's purpose was to provide a residence facility and therapeutic program for emotionally disturbed adolescents. The organization operated a grocery store almost entirely staffed by residents at a level that utilized only the number of adolescents residing at the facility. The residents' on-the-job achievements played an important role in determining the privileges they received in the residence and the progress they made toward becoming reintegrated into the community. Developing job skills was secondary to the goal of

emotional rehabilitation through job satisfaction and personal achievement. Operating a grocery store was substantially related to the organization's exempt purpose because it was through this activity that it accomplished its goal of emotionally rehabilitating residents and helping them reintegrate into the community. Rev. Rul. 76-94.

In another case, an organization operated a grocery store for the purposes of providing reduced price food to residents of a poverty area and job training for unemployed residents. Only the job training purpose qualified for exemption. The job training program consisted of lectures, demonstrations of retail techniques and some on-the-job training during the training period. Trainees were then expected to utilize their new skills to find employment elsewhere. Only 4 percent of the store's earnings were allocated for the job training program, and the scope of the store's operations significantly exceeded the scope of the program. In this case, operating the store was not substantially related to the organization's exempt purpose of job training. Rather, the operating the store primarily served the independent and non-exempt purpose of providing a low-cost food outlet to residents of a poverty area. Rev. Rul. 73-127.

- c) The regulations provide that a trade or business is "related to" exempt purposes only where the conduct of the business activities has a causal relationship to the achievement of the exempt purposes (other than through the production of income). Treas. Reg. § 1.513-1(d)(2). Additionally, the trade or business will be "substantially related" only if the causal relationship is a substantial one. *Id.* In particular, the production or distribution of goods or the performance of services involved in the business must "contribute importantly to the accomplishment of those purposes." *Id.*

An organization's operation of a mini-golf course did not "contribute importantly" to its purpose as a charitable organization. The organization's stated purpose was to provide for the welfare of young people through charitable activities, services and facilities that contributed to their social, mental, and spiritual health at low cost or no cost to them. The mini-golf course was open to the general public, staffed by salaried employees, and charged admission fees comparable to similar commercial facilities and were designed to turn a profit. There was nothing to distinguish this mini-golf course from any other commercially operated mini-golf course. Its operation did not contribute importantly to providing free services to young people, and therefore there was no substantial causal relationship between the activity and the organization's charitable purpose. Rev. Rul. 79-361.

Consider also the example of an organization with the charitable purpose of preventing cruelty to animals. The organization operated an animal shelter for stray or unwanted animals, and in order to produce income to support the shelter, offered for-fee boarding and grooming services for

pets. Though 100 percent of the income earned through the services went toward funding the shelter, it was unrelated income. The animals for which the services were provided were neither unwanted nor the victims of cruel or inhumane treatment. The service was an ordinary commercial service to pet owners that did not have a causal relationship to preventing cruelty to animals. Rev. Rul. 73-587.

d) Several general principles can be drawn from this statutory and regulatory language:

i. **Size and Extent.** In analyzing whether activities “contribute importantly” to the accomplishment of an exempt purpose, the size and extent of the activities in question must be compared to the size and extent of the exempt activities that they purport to serve.

- Where income is realized by the exempt organization from activities which are in part related to the performance of its exempt functions, but which are conducted on a larger scale than is reasonably necessary for the performance of such functions, the gross income attributable to that portion of the activities in excess of the needs of the exempt functions constitutes gross income from the conduct of an unrelated trade or business. Treas. Reg. § 1.512-1(d)(3).

For example, an occupational treatment program for people with chemical dependency that runs a manufacturing business to employ and train its clients would likely be substantially related. But, if the same program operated on a scale much larger than necessary for its occupational training program and employed members of the public to staff those expanded operations, the expanded operations would generate UBTI.

The organization that operated a grocery store on a scale far larger than necessary to serve the organization’s exempt purpose of job training, discussed previously, also illustrates this. Rev. Rul. 73-127.

Another example is a residential school for court-referred juvenile males that operated an 18-hole golf course to teach golf course maintenance. Like the school’s other vocational programs, the golf-course maintenance program taught marketable vocational skills and pro-social behaviors. The course was open to the public in order to generate enough actual play to require the maintenance techniques taught in the program, but was closed at times for students to receive instruction in daylight hours. There was no golf pro, nor were there golf instructional packages for the public, and the course was minimally advertised. There were no employees except for

instructors, and the students performed all course maintenance. The scope of the golf-course operation was not larger than the organization's exempt purpose because every aspect of the course's operation was reasonably necessary to accomplish the goal of teaching students vocational and life skills. Priv. Let. Rul. 200151061 (Sept. 28, 2001).

ii. Disposition of Products of Exempt Functions or the “Same Condition” Rule. The regulations provide that ordinarily, “gross income from the sale of products which result from the performance of exempt functions does not constitute gross income from the conduct of unrelated trade or business if the product is sold in substantially the same state it is in on completion of the exempt functions.” Treas. Reg. § 1.513-1(d)(4)(ii).

- However, if a product that results from an exempt function is utilized or exploited in a further business endeavor beyond that reasonably appropriate or necessary for its disposition in the condition it is in following the completion of exempt functions (i.e., if the product is substantially improved or processed further in any way), sale of the enhanced product would generate UBTI.
- Thus, the IRS found that the sale of plasma to commercial labs by an exempt blood bank engaged in collecting and maintaining blood products for use by hospitals is not an unrelated trade or business where the blood bank sells either by-product plasma from which red blood cells have been removed for use by hospitals or plasma salvaged from whole blood nearing the end of its shelf life. However, the sale of plasma derived from donors through plasmapheresis (a process in which plasma is modified through the separation of red blood cells, primarily used for people who have rare antigens) or purchased from other blood banks was found to be unrelated trade or business because it was not a product resulting from the organization's exempt functions, but rather was obtained for resale. *See* Rev. Rul. 78-145.

iii. Income from Performance of Exempt Functions. Additionally, gross income derived from the performance of exempt functions is not considered gross income from an unrelated trade or business. Treas. Reg. § 1.513-1(d)(4)(i). This means that fees an organization generates for services that are in furtherance of its exempt functions—an exempt hospital's charges for room, board and other services provided to patients, for example—are not subject to UBTI.

- Gift shop sales in museums are a good example of this concept. The sale of items related to a museum’s exhibits, such as reproductions of works of art, further the museum’s educational mission and probably do not generate UBTI. Sales of other items like clothing or jewelry unrelated to museum exhibits, or souvenirs of the general locale but not the museum, are likely to generate UBTI.
- iv. Dual Use of Assets or Facilities.** This principle is based on the IRS’s recognition of the fact that sometimes, an asset or facility that is necessary to the performance of exempt functions may also be used in a commercial endeavor. Treas. Reg. § 1.513-1(d)(4)(iii). Income from exempt function uses would not be UBTI while income from unrelated or commercial uses would be UBTI.
- The test is whether the activities that are productive of the income in question contribute importantly to the accomplishment of exempt purposes.
 - The regulations give the example of an exempt museum with a theater auditorium designed for the showing of educational programs during the day. If the theater is used as an ordinary movie theater for public entertainment in the evening, when the museum is closed, income from the evening operations would be UBTI.
 - Another example is special events. A museum that hosts special events, including catering, related to its exhibits would not generate UBTI. Exhibit openings, donor events and book readings or speakers related to an exhibit would fall into this category. Hosting and catering private events, like weddings and corporate events, would generate UBTI if they are carried on with any regularity.
- v. Exploitation of Exempt Functions.** This concept is based on the regulatory recognition that sometimes activities carried on by an organization in the performance of its exempt functions may “generate good will or other intangibles which are capable of being exploited in commercial endeavors.” Treas. Reg. § 1.513-1(d)(4)(iv).
- In these cases, “unless the commercial activities themselves contribute importantly to the accomplishment of an exempt purpose,” the income they produce is UBTI. *Id*

- For example, if an exempt scientific organization that has an excellent reputation in the field of biomedical research exploits that reputation by regularly selling endorsements of various items of lab equipment to manufacturers, these endorsements would not contribute importantly to the accomplishment of the organization's exempt purposes, and any income from their sale would be UBTI.

4. UBTI Can be Created through Services Relationships.

- a) As a general principle, the provision of management services by one exempt organization to another exempt organization (even where both entities have the same tax-exempt status) is not, for that reason alone, a related business.

For example, an organization with the primary purpose of supporting charitable activities through grant-making began performing some of its internal grant-making and administrative functions – researching potential grantees; designing and operating strategic grant-making and scholarship programs; overseeing grants made; and other administrative, accounting, and clerical duties – as a service to other charitable foundations. The organization expanded its purpose to include carrying out the charitable purposes of other exempt organizations by performing support services, and charged fees at the market rate. By providing grant-making services to other charities, the organization was uniquely positioned to coordinate grant-making activities for the benefit of the community, provide advice about unmet charitable needs in the community, and provide advice about how to address those unmet needs. This contributed importantly to the organization's charitable purpose, and the fees from these services were not UBTI. However, providing administrative and clerical services did not contribute importantly to achieving the organization's exempt purpose. The fees for these services were unrelated. Priv. Ltr. Rul. 200832028 (Aug. 8, 2008).

- b) The provision of services by and among exempt organizations that are related to each other, such as being within a corporate family under common control, generally will *not* give rise to UBTI because the IRS considers such services to be an integral part of the exempt activities of the organizations. *See, e.g.*, Priv. Ltr. Rul. 8833002 (May 13, 1988) (provision of laundry services within a health care system is not UBTI), administration support services; Priv. Ltr. Rul. 8822065 (Mar. 7, 1988), (administrative support bill collection and transportation services); Priv. Ltr. Rul. 8736046 (June 10, 1987) (billing and transportation systems). The provision of management services for a fee has also been ruled non-UBTI when it is between two related tax-exempt organizations. Priv. Ltr. Rul. 9533007 (May 8, 1995), 9318048 (Feb. 16, 1993); 9318049 (February 6, 1993); and 8941012 (October 13, 1989) (management services).

- c) Also, if the provision of management services is substantially below cost, and the services are an essential function for the charitable organizations served, UBTI may not be created. In one example, charging 15% of cost for services was considered low enough to avoid generating UBTI. Rev. Rul. 71-529.

An organization that performed management and training services at cost rather than below cost to 501(c)(3) nonprofits lacked the donative element necessary to establish its activity as charitable. Rev. Rul. 72-369.

D. Statutory Exceptions. IRC § 513 contains a number of specific exceptions that exempt certain trades or businesses from classification as an “unrelated trade or business,” even if they would otherwise meet that definition. Some of the more important statutory exceptions are discussed below:

1. **Volunteer Work.** An exception to the definition of unrelated trade or business exists for businesses in which “substantially all the work in carrying on such trade or business is performed for the organization without compensation.” IRC § 513(a)(1). An example of this type of activity would be an exempt orphanage operating a retail store and selling to the general public, where substantially all the work in carrying on such business is performed for the organization by volunteers without compensation. Treas. Reg. § 1.513-1(e)(3).
2. **Convenience Exception.** An exception exists for trade or business that is carried on by a § 501(c)(3) organization “primarily for the convenience of its members, students, patients, officers or employees.” IRC § 513(a)(2). For example, the operation by a college of a laundry for the purpose of “laundering dormitory linens and the clothing of students” is cited as an activity that would be protected by this exception. Treas. Reg. § 1.513-1(e)(3).
 - a) Limited concession sales at a museum also fall under the convenience exception, but a full-scale restaurant in a museum may not.
3. **The Donations Exception.** Unrelated trade or business does not include a trade or business “engaged in the selling of merchandise, substantially all of which has been received by the organization as gifts or contributions.” IRC § 513(a)(3). Applicable treasury regulations make clear that this exception applies to operations such as “so-called thrift shops operated by a tax-exempt organization where those desiring to benefit such organization contribute old clothes, books, furniture, etc., to be sold to the general public with the proceeds going to the exempt organization.” Treas. Reg. § 1.513-1(e)(3).
4. **Low Cost Articles.** Unrelated trade or business does not include “activities relating to the distribution” of low-cost articles by certain organizations eligible to receive tax-deductible contributions if the distribution of these articles is incidental to the solicitation of charitable contributions. IRC § 513(h)(1)(A). “Low cost article” means an article that has a cost of less than \$5 (adjusted for inflation). IRC § 513(h)(2)(A).

5. **Other Exceptions.** There are a number of other exceptions under IRC § 513 that § 501(c)(3) organizations rely on from time-to-time, including:

- a) Businesses of Employees' Associations. *See* IRC § 501(c)(4); 513(a)(2).
- b) Entertainment at Fairs and Exhibitions. *See* IRC § 513(d)(1), (2).
- c) Trade Show Activities. *See* IRC § 513(d)(1), (3).
- d) Hospital Services. *See* IRC § 513(e);
- e) Bingo and Other Games. *See* IRC § 513(f); and
- f) Exchanges and Rentals of Mailing Lists. *See* IRC § 513(h)(1)(B).

E. **IRC § 512(b) Modifications.** These are essentially a second set of exceptions to the rules governing the treatment of income generated from unrelated trade or business. They are different in the sense that they are applied in the computation of UBTI, but their successful application can have the same results that comes from the successful application of the exceptions described above, namely, the exclusion of income from UBTI. The idea behind the modifications or exceptions set forth in Code § 512(b) is that passive income is not the type of conduct UBTI is intended to address; instead, the underlying principle of UBTI is that a level playing field needs to be established for competition between tax-exempt organizations and taxable organizations. Since passive income is not generated by competition, it is not the type of income UBTI addresses.

- 1. **Passive Income Generally.** Passive income such as dividends, interest, royalties, annuities, payment with respect to security loans and gains or losses from the sale of capital assets or property used in a trade or business (other than inventory) are excluded from the definition of unrelated trade or business income, except if the income is connected with debt financed property, or from a controlled corporation. IRC § 512(b). *See* IRC § 514; 512(b)(13).
- 2. **Rents.** IRC § 512(b)(3) provides that rents from real property (including personal property leased with the real property), and all deductions directly connected with such rents, are excluded from UBTI provided that:
 - a) All rents from personal property leased with such real property are an incidental amount, *i.e.*, less than 10%, of the total rents received or accrued under the lease (IRC § 512(b)(3)(A)(ii)), and
 - b) Rent is not determined by income or profits. Rent may be set as a fixed percentage of gross receipts or sales as long as it is not intended to be a method of basing the rent on income or profit (IRC § 512(b)(3)(B)(ii)), and
 - c) Services are not provided to the lessee other than furnishing heat and light, cleaning of public entrances, exits, stairways and lobbies, and collection of trash. *Treas. Reg. § 1.512(b)-1(c)(5).*

- For example, if a historical society leases its facility to the public for special events, the income may be classified as rent and excepted from UBTI. But if the society also provided catering or other services in conjunction with the event, income would not be rent and would not fall into this exception.
3. **Royalties.** IRC § 512(b)(2) provides that royalties, and all deductions directly connected with such royalties, are excluded from UBTI. For this purpose, a royalty is payment for the right to use intangible property. *Sierra Club Inc v. Com.*, 86 F3d 1526 (9th Cir. 1996).
 - a) A royalty is, by definition, “passive” and, thus, cannot include compensation for services. *Sierra Club Inc v. Com.*, 86 F3d 1526 (9th Cir. 1996); *Arkansas State Police Association Inc.*, TC Memo 2001-38 (2001).
 - b) For example, payments received in connection with an endorsement of a product is not considered a royalty but rather payment for the endorsement, a service. *Fraternal Order of Police, Illinois State Troopers, Lodge No. 41*, 87 TC 747, (1986), *aff’d* 833 F2d 717 (7th Cir. 1987); *National Collegiate Athletic Assn*, 92 TC 456 (1989), *rev’d on other grounds*, 914 F2d 1417 (10th Cir. 1990).
 4. **Research.** Several provisions of § 512(b) allow for the exclusion of income derived from research. For example, § 512(b)(7) excludes income from research for the U.S. government, its agencies or instrumentalities or any state government or political subdivision of a state. Similarly, § 512(b)(9) excludes income from research received by an organization operated primarily for purposes of carrying on fundamental research whose results are freely available to the general public.
 5. **Other Modifications found in Code § 512(b).** There are a number of other modifications in Code § 512 that may be applicable, depending on the characteristics of a particular organization. For example, UBTI does not apply to unrelated income generated by religious orders in certain circumstances. *See* IRC § 512(b)(15).
 6. **However, income from Controlled Organizations may be included.** Income which would be excluded from UBTI as “passive income” is includable in UBTI if such income is received from a “controlled entity.” IRC § 512(b)(13). A controlled entity is one in which the exempt organization owns (by vote or value) more than 50% of the stock or beneficial interest or appoints more than 50% of the governing board. Accordingly, certain income, such as rent and interest from a taxable subsidiary, would not be subject to the passive income exceptions. Taxable subsidiaries are discussed further in Section VII below. (Legislation is currently pending before Congress that would treat income from controlled entities the same as income from unrelated entities. Stay tuned.)

V. EXCESS BENEFIT TRANSACTIONS AND INTERMEDIATE SANCTIONS

A. The Principle Behind the Intermediate Sanctions (or Excess Benefit Transactions Rule) and Private Inurement .

1. One of the most recent modifications to the Internal Revenue Code was the enactment of rules pertaining to what are defined as “excess benefit transactions,” along with certain financial penalties that can be imposed in the event of an excess benefit transaction. These penalties are known as “intermediate sanctions.” Under this approach, financial sanctions—in the form of excise taxes—may be imposed on those persons who improperly benefited from impermissible transactions, along with certain organizational managers.
2. The basic idea behind the excess benefit transactions rule is that revocation of exempt status is too harsh of a penalty to impose for many violations of the federal tax laws. Nevertheless, regulators did not want to let violators off the hook entirely. Accordingly, the concept was borne that a set of penalties—significant enough to deter bad conduct, but not so harsh as to automatically lead to revocation—would be developed as a sort of “middle-ground” in the IRS’ arsenal of enforcement tools.

B. Intermediate Sanctions Rule, I.R.C. § 4958.

1. Intermediate sanctions apply to “excess benefit transactions” between all 501(c)(3) public charities and 501(c)(4) organizations and “disqualified persons” with respect to those organizations. The sanctions can be imposed on both disqualified persons and organization managers which includes officers, directors and trustees, acting with knowledge that it was an excess benefit transaction.
2. The tax imposed on the disqualified person is 25% of the excess benefit. Any excess benefit found must be repaid by the end of the year or a 200% (of the excess benefit) excise tax can be imposed on the recipient.
3. A tax of 10 % of the excess benefit (to a maximum of \$10,000) may also be imposed on any organization manager (officer, director, trustee or others with similar powers) who participated on the transaction knowing it was an excess benefit transaction (unless such participation is not willful and due to reasonable cause).
4. The rule is effective for all transactions entered into on or after September 14, 1995. There is an exception for transactions continuing after that date which were subject to a binding contract on that date.

C. Disqualified Persons.

1. A “disqualified person” includes any person in a position to exercise “substantial influence” over the affairs of the organization during any time during the five-year period ending on the date of the transaction involved, members of such person’s family, and an entity in which such a person owns more than a 35% interest.

2. Members of the governing body, president, CEO, COO, Treasurer, CFO, along with voting members of the organization's board, are all automatically considered disqualified persons. *See* Treas. Reg. § 53.4958-3(c). Others, such as other § 501(c)(3) organizations, are automatically deemed not to be disqualified persons. *See* Treas. Reg. § 53.4958-3(d).
3. The regulations set forth a series of facts and circumstances that "tend to show substantial influence." *See* Treas. Reg. § 53.4958-3(e)(2). Additionally, the regulations set forth another set of facts and circumstances that "tend to show no substantial influence." *See* Treas. Reg. § 53.4958-3(e)(3). These competing sets of facts and circumstances are to be used in evaluating whether a person who is not automatically deemed to be or not to be a "disqualified person" is nevertheless a "disqualified person."

D. Excess Benefit Transactions.

1. An "excess benefit transaction" is any transaction in which an economic benefit is provided by an exempt organization, directly or indirectly, to or for the use of a disqualified person, if the value of the benefit exceeds the value of the consideration received by the exempt organization in exchange for providing the benefit. I.R.C. § 4958(c)(1)(A); Treas. Reg. § 53.4958-4(a)(1).
2. The following are examples of excess benefit transactions: (i) excessive compensation; (ii) payment by an exempt organization of greater than FMV for assets in a transaction; (iii) receipt of less than FMV by an exempt organization for its goods and services; and (iv) revenue sharing arrangements which violate the private inurement prohibition.

E. Rebuttable Presumption of Reasonableness.

1. There is a rebuttable presumption of reasonableness that applies to compensation arrangements and other transactions between an exempt organization and disqualified persons in certain circumstances. This presumption is not actually mentioned in the Code; instead, it was created by the legislative history behind this law, and is set forth in the Treasury Regulations that implement Code § 4958. If the rebuttable presumption arises, the burden of proving that the transaction was unreasonable shifts to the IRS. This requires the IRS to develop "sufficient contrary evidence to rebut the probative value of the comparability data relied upon by the [approval] body." Treas. Reg. § 53.4958-6(b).
2. To create the rebuttable presumption of reasonableness, the following three requirements must be satisfied:
 - a) The arrangement must be considered and approved by an independent board of directors (or committee of the board) that is composed entirely of individuals unrelated to and not subject to the control of disqualified persons involved in the arrangement. Treas. Reg. § 53.4958-6(c)(1);
 - b) The approval body must obtain and rely upon appropriate data as to comparability. Treas. Reg. § 53.4958-6(c)(2). For example, the

following comparability measurements might be relied on: compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions; the location of the organization, including the availability of similar specialties in the geographic area; independent compensation surveys compiled by independent firms; or actual written offers from similar institutions competing for the services of the disqualified person; and

- c) The board or committee must adequately document the basis for its determination. Treas. Reg. § 53.4958-6(c)(3).
3. All compensation and financial transactions with all disqualified persons (officers, directors and anyone able to exercise substantial influence over the organization) should be approved according to this process to enable the organization to rely on the rebuttable presumption. To be able to rely on the rebuttable presumption, however, the three conditions must be met before making any payments under the arrangement being considered. Treas. Reg. § 53.4958-6(f).

VI. JOINT VENTURES AND TAX-EXEMPT STATUS

A. What is a Joint Venture?

1. A joint venture may take a variety of forms: it may be a contractual agreement between two or more parties to cooperate in providing services, or it may involve the creation of a new legal entity by the parties, such as a limited partnership, limited liability company or closely held corporation, to undertake an activity or provide services.
2. Where these joint ventures occur between nonprofit and for-profit entities, the nonprofit must proceed with caution to protect its tax-exempt status and manage the creation of UBTI.
3. Additionally, the structure and operation of the joint venture must be examined to determine whether the joint venture does not jeopardize the organization's tax-exempt status. A joint venture that will be a substantial activity or investment must further the organization's charitable purposes. A joint venture which is only a small part of an organization's activities must either be substantially related to the exempt purposes of the organization or its income will likely be taxed as UBTI to the tax-exempt organization.

- B. Key Considerations.** Forming a joint venture between for-profit and nonprofit entities, or among like entities, raises many operational and legal issues including those set forth below. All of these issues must be addressed in the joint venture agreement or organizational document, if a new entity is established. These issues will drive the structure of the joint venture and the ultimate relationship between the parties. It is crucial to consider these issues up front in negotiations with the joint venture partner so each entity understands the limitations under which the joint venture must operate.

1. Operational Considerations.

- a) Scope of joint venture – agreement or new entity;
- b) Relative contributions and strengths of each party;
- c) Governance of joint venture and relative representation by each partner;
- d) Financial relationship between joint venture parties;
- e) Staffing and use of employees of joint venture entities;
- f) Office space;
- g) Accounting between the organizations;
- h) Shareholder interests;
- i) Insurance;
- j) Mission - Is forming a joint venture consistent with all of the organizations' missions and strategic plans? This may be the most important consideration — or biggest roadblock — for the exempt entity participant.

2. Legal Considerations.

- a) There are a variety of legal issues that parties must consider when entering in to a joint venture, including:
 - i. Organizational structure and state laws governing various types of business entities;
 - ii. Control and governance;
 - iii. Real estate issues;
 - iv. Antitrust issues;
 - v. Employment and employee benefits matters;
 - vi. Licensing.
- b) Where the joint venture includes an exempt entity, the exempt organization and the for-profit partner should be aware that the exempt organization's participation in the joint venture is limited by the following issues:
 - i. Effects on tax-exempt status;
 - ii. Private inurement;

- iii. Private benefit;
- iv. Tax-exempt bond financing;
- v. Intermediate sanctions;
- vi. Property tax exemptions.

c) The exempt organization must also determine whether its participation will harm its exempt status or lead to UBTI. The joint venture should be structured, where possible, to be related to the exempt organization's tax-exempt purposes. In addition, the joint agreements creating the joint venture must enable the exempt entity to establish that the joint venture serves a community benefit, creates no private inurement and provides private benefit only incidental to community benefit.

C. **IRS Guidance.** In general, an exempt organization may participate in joint ventures with for-profit partners without adversely affecting its tax-exempt status if the joint venture is carefully structured to ensure the exempt organization's status is protected.

1. **Effect on Tax Exempt Status**

- a) **Division of Profits.** All joint ventures must be structured in a manner to ensure net revenue streams are not divided disproportionately among the for-profit and nonprofit members.
 - i. For example, in General Counsel Memorandum 39,862, the IRS revoked three private letter rulings involving joint ventures between hospitals and their physicians. Each ruling involved the sale of the gross or net revenue stream of a hospital department to a joint venture. The ventures did not involve the establishment of any new facilities or services and involved the purchase for a limited period of time without a sharing of the underlying capital risk of the ventures. The hospital, rather than the ventures, continued to own and operate the underlying facilities and set charges. The stated purpose of the ventures was to maintain physician support and provide incentives to use hospital facilities.
 - ii. The IRS found that the joint ventures jeopardized the tax-exempt status of the hospitals since the arrangements were merely devices between the hospitals and the physicians to share net profits of the hospital. As a result, the transactions resulted in the inurement of the hospital's earnings to the physicians. The private benefit to the physicians were not incidental to the public benefits achieved from the transactions.
- b) **Warning Signs Suggesting Problematic Joint Ventures.** The joint venture relationship must be analyzed to determine whether the terms of the agreements adequately protect the exempt organization's financial

interests and prevent excessive financial benefits from flowing to the non-exempt partners. Inurement may occur through (1) payment of excessive compensation to the nonexempt partners, or a disproportionate allocation of profits and losses to the nonexempt partner (Gen. Couns. Mem. 39,862); (2) the exempt organization making commercially unreasonable loans to the partnership (*Id.*); (3) inadequate or excessive compensation for services provided by the exempt organization (*Plumstead* at 1333); and (4) control of the exempt organization by for-profit partners (Gen. Couns. Mem. 39,862).

- c) **Importance of Organizational Control.** Revenue Ruling 98-15.
- i. This ruling focused on the control of the joint venture between the exempt and for-profit participants. If the joint venture is to be considered related to the exempt entity's tax-exempt purposes, the exempt participant must control certain crucial elements of the joint venture. Although the ruling only discusses joint ventures in which an exempt hospital transfers all of its assets into a new joint venture vehicle in connection with a for-profit entity, in what is known as a "whole hospital" joint venture, IRS officials indicated that the analysis of this ruling is applicable to *all exempt joint ventures*.
 - ii. This ruling set forth two fact situations in which a hospital transfers all of its assets to a limited liability company ("LLC") into which a for-profit corporation also contributes assets. The LLC then owned the hospital and contracts with a management company to manage the facilities. In the first fact situation, the hospital's exempt status is unaffected; the hospital's exempt status in the second factual situation is revoked because the joint venture does not further the charitable purposes of the exempt hospital.
 - iii. **Favorable Factors.** The IRS noted that the following features of the joint venture were consistent with the organization's tax-exempt status:
 - Ownership in LLC in proportion to capital contributed.
 - Exempt entity has a majority of the LLC's board seats.
 - A majority of the board must approve major decision including approving the management contract and changes in services.
 - The LLC has a purpose statement which provides that the LLC has the duty to operate the hospital in a manner which furthers charitable purposes.
 - No officers or directors of the hospital or for-profit were given any inducements or promised jobs to complete the LLC transaction.

- The hospital is managed by a management company which is unrelated to the exempt organization and the for-profit organization.
- iv. **Unfavorable Factors.** The IRS ruled that the arrangement with the following factors jeopardized the organization's tax-exempt status (in addition to not having many of the favorable factors noted above):
- Management company is subsidiary of for-profit partner.
 - The management contract is renewable in the sole discretion of the management company.
 - No charitable purpose statement in LLC documents so LLC has a statutory duty to maximize profits.
- v. **Other key points from Rev. Rul. 98-15.** Governance structure and control over operations must be in the hands of the exempt organization or with legally binding assurances that the venture will be operated in accordance with exempt status.
- d) **Whole Entity Joint Ventures.** These types of joint ventures involve a tax-exempt organization placing its entire operation into a venture with a for-profit entity. Where the tax-exempt organization cedes control over its resources to the for-profit venturer, the IRS' will closely scrutinize the transaction. If this kind of control is ceded, it may be irrelevant if the charitable organization is engaging substantially in exempt activities and if the fees paid by the tax-exempt organization to its for-profit partner are reasonable.
- **Rev. Rul. 98-15 as a vehicle for additional IRS enforcement efforts.** In *Redlands Surgical Services v. Comm'r*, 113 T.C. 47 (1999), *aff'd per curiam*, 242 F.3d 904 (9th Cir. 2001) the IRS challenged a health care venture that resembled the one described in situation 2 of Rev. Rul. 98-15. There, the U.S. Tax Court ruled that an ambulatory surgery center jointly owned by a 501(c)(3) and a physician group did not qualify for 501(c)(3) status itself because Redlands ceded too much control of the center to for-profit interests. Thus, the Court concluded that the center failed to qualify because it was not operated exclusively for exempt purposes, and because it benefited private interests more than incidentally.
- e) **Ancillary Joint Ventures.** One of the most recent pieces of IRS guidance with respect to joint ventures between tax-exempt organizations and taxable partners came in June, 2004, in the form of Revenue Ruling 2004-51.
- Facts of Rev. Rul. 2004-51.** This Ruling involved a § 501(c)(3) university forming an LLC with a for-profit company that specialized in

interactive video training programs. The LLC was owned equally between the two organizations, and each shared equally in distributions, allocations and capital contributions. The LLC offered interactive video training seminars at off-campus locations to enhance the skills of school teachers. The university had the right to approve the curricula, seminar content, training materials, and instructors and to determine the criteria for completing the seminars. The broadcasting company had the right to approve the camera operators and other personnel required to conduct the seminars. Other than these issues, control was divided equally between the members. The IRS determined that the university's participation in the venture did not jeopardize its exempt status because the LLC's activities were not a substantial part of the university's activities and because there was no improper private benefit. The IRS also determined that the income earned by the university was not UBTI because the LLC's seminar activity was substantially related to the university's exempt purpose. This was based on a determination that the university selected the instructors and controlled the content of the program, which was the same as those conducted on campus, and the arrangement extended the university's reach to additional teachers.

- The upshot of this ruling is that, in certain circumstances, an exempt organization can contribute a portion of its assets to, and conduct a portion of its business through, a joint venture with a non-exempt company, while both: (1) retaining its tax-exempt status; and (2) avoiding any UBTI on its share of the income derived from the venture. Accordingly, if an ancillary joint venture represents only an insubstantial part of an exempt organization's activities, venture furthers a tax-exempt purpose of the exempt organization participant, and does not involve private inurement or more than incidental private benefit, exempt status should not be jeopardized.
- Moreover, this Ruling coupled with Rev. Rule 98-15 suggests that numerical voting control of an ancillary joint venture is still required for an exempt organization to maintain that status, and is a critical factor on whether the exempt organization's share of income from the venture will be UBTI.
- This ruling also clarifies that the standard UBTI analysis applies to income from joint ventures the same as for income from activities directly. That is, whether the activity of the joint venture is substantially related to the organization's tax-exempt purposes.

VII. TAXABLE SUBSIDIARIES

A. Why Create a Taxable Subsidiary?

Taxable subsidiaries typically are formed by exempt organizations for one or more of the following business and tax reasons:

1. Insulation of charitable assets from creditors or tort claimants.
2. Segregation of operations for reporting, management or other purposes.
3. Facilitation of collaborations, joint ventures, and expansion.
4. Licensing or regulatory issues particular to the business to be conducted by the taxable subsidiary.
5. Protection of exempt status.
6. Minimizing tax on income from unrelated activities.

B. Business Objectives and Mission.

1. A taxable subsidiary should only be formed in response to a defined business objective. Taxable subsidiaries may be formed simply to maximize revenue for the parent company, to serve as a shield from liability, to enhance operational efficiencies or to serve as a collaborative vehicle for other joint ventures and partnerships.
2. Any exempt organization considering creating a taxable subsidiary must analyze the impact of that decision on the ability of the exempt organization to continue to fulfill its mission. Consider whether the proposed activity conflicts with the organization's current mission.
3. The taxable businesses started by exempt organizations that survive and thrive are those which are consistent in some manner with the mission of the exempt parent. Consider expanding a service currently provided to a larger audience. An organization should be very cautious about entering a business in which it has no experience.
4. Consideration must also be given as to how much revenue the proposed subsidiary will make compared to the increased expenses of operating a more complex corporate structure including additional staffing, duplication of business expenses such as insurance, space and office expenses, as well as the taxation of profits.
5. Finally, creating a separate taxable subsidiary is not always required. An exempt organization may engage in activities which are "unrelated" to its exempt purposes as an insubstantial part of its total activities without jeopardizing its tax-exempt status. As discussed above, however, the revenue from these activities will be considered UBTI and be taxed at regular corporate rates. Many

organizations choose to operate an unrelated business within the exempt organization for a period of time until the financial implications of operating the business are clear.

- C. Key Considerations.** Forming a taxable subsidiary raises many operational and legal issues including those set forth below. All of these issues should be addressed up front as the exempt entity considers the pros and cons of establishing a subsidiary. These issues, as well as the business objectives of the parent, will drive the structure of the subsidiary.

1. Operational.

- a) Define business objective and determine if activity is within mission of organization.
- b) Governance structure of subsidiary – outside or internal operations.
- c) Staffing of subsidiary and use of employees of parent entities.
- d) Office space.
- e) Accounting between the organizations.
- f) Insurance.
- g) Capitalization of subsidiary.

2. Legal. As an exempt organization considers creating a taxable subsidiary, a number of legal issues should be addressed, including:

- a) Effect on tax-exempt status
- b) Private inurement/private benefit
- c) Tax-exempt bonds
- d) Property tax exemption
- e) UBTI
- f) Intermediate sanctions
- g) Licensing
- h) State corporate law
- i) Real estate
- j) Compliance program issues
- k) Choice of corporate form

D. Primary Legal Considerations.

1. Formation of Subsidiary.

a) Choice of Corporate Form.

- i. C-Corporations Most Common Form.** In creating a taxable subsidiary, the parent must determine the most appropriate legal structure for the new entity. A “C” corporation has historically been the most commonly used structure for a wholly owned subsidiary. The parent capitalizes the subsidiary and in return receives 100% of the voting stock of the corporation.
- ii. Business vs. nonprofit corporate form.** A taxable subsidiary created as a “C-Corporation” may be incorporated either as a business corporation or as a taxable nonprofit corporation. Each is taxed at regular corporate rates; however, the structure of a taxable nonprofit corporation does not permit individual equity ownership although under most state laws another nonprofit may have equity ownership. A taxable nonprofit is used where the exempt parent wants control of and investment in the subsidiary to be limited to itself and/or other nonprofits. In addition, dividend distributions by a taxable nonprofit corporation may generally only be made to those members which are themselves nonprofit corporations. Accordingly, a nonprofit should not be used if the subsidiary will or might in the future be a vehicle for a joint venture with a for-profit partner. Some exempt organizations are also attracted to the public relations value of operating a taxable venture in a “nonprofit” entity.
- iii. LLC Option.** An exempt organization may also form a subsidiary as an LLC. LLCs are typically disregarded for tax purposes, and all the income and expenses are treated as those of the exempt parent. Accordingly, if the LLC will be engaged in activities which are unrelated to the exempt parent’s tax-exempt status, the revenue from the LLC will be UBTI to the parent unless the LLC makes an election to be taxed as a corporation.
- iv. L3C Option.** The low-profit, limited liability company, or L3C, is a form of limited liability company that has certain nonprofit characteristics. It is promoted as a “hybrid” of a nonprofit and for-profit organization. The primary benefit of using an L3C rather than a regular LLC is in the name – it enables an organization to show in its very name that the business is operated for a social benefit purpose. It may also provide some convenience as many nonprofit concepts are built into the organizational structure, without having to draft them into the governing documents which would be required if a regular LLC form were used.

The L3C is being promoted as a vehicle to enable private foundation investment in a social-purpose venture and incorporates many of the IRS requirements for such investments, but without IRS acceptance of this notion, the utility of the form over an LLC for this purpose is uncertain.

- v. **B Corp. designation.** A for-profit company can apply to become a “B Corporation,” “B” standing for “benefit. B Corp. is not a legal status of incorporation; rather, it is a designation “certifying” that an organization meets social and environmental standards. B Corp. designation is awarded by a non-profit called B Lab, which has developed a ratings system to evaluate organizations’ social and environmental performance. Like the L3C, the B Corp. designation is useful primarily for marketing. To become a B Corp, an organization must complete the B Lab survey and receive an above-minimum rating; amend corporate documents to add specific language incorporating stakeholder interests; sign a statement of commitment and terms; and pay an annual licensing fee to use the designation. See <http://www.bcorporation.net>.

b) Capitalization of Subsidiary.

- i. **Assets.** Assets of a tax-exempt organization which are used in an unrelated trade or business may be used to capitalize a for-profit subsidiary. The use of charitable assets by an exempt organization to capitalize a for-profit subsidiary is generally analyzed by the IRS on the basis of whether the capitalization is reasonable as an investment of the exempt organization’s assets. As a result, the amount of capitalization should be analyzed by the exempt organization’s governing board to ensure it is of a reasonable size in relation to projected return on investment (both income and capital appreciation). In addition, or as an alternative to, direct capitalization, the parent may consider loaning funds to the taxable subsidiary at a fair market rate of interest. The interest to the parent may be taxable as UBTI to the parent of the activity is unrelated to the parent’s exempt purposes.
- ii. **Control.** Generally, no gain or loss is recognized if property is transferred to a taxable subsidiary by a tax-exempt organization solely in exchange for stock in the taxable subsidiary if immediately after the exchange, the exempt organization is in *control* of the taxable subsidiary. IRC §§ 351; 512(b)(5).

2. Tax-Exempt Status.

a) General Considerations.

3. Unrelated Business Taxable Income.

a) General Considerations.

- i. By placing unrelated activities in a taxable subsidiary, it may be possible to decrease the tax paid on the income from the activity. Computation of the taxable income from unrelated businesses conducted within an exempt organization involves restrictions on deductible expenses that might be avoided when the business is conducted in a taxable subsidiary, which is just subject to standard business tax rules.
- ii. Net income from an unrelated trade or business carried on within an exempt organization may not be offset by net losses from a related business. However, if both activities are conducted by a taxable subsidiary, the net income from one activity may be offset by the net losses from the other.

b) Distributions to the Tax-Exempt Parent.

It is generally desirable to structure distributions by the taxable subsidiary to the tax-exempt parent so that the amount distributed is deductible by the subsidiary and excluded from the UBTI of the parent.

- i. **Dividends.** Dividends are excluded from UBTI of the parent but are not deductible by the taxable subsidiary.
- ii. **Interest, rent, royalties and annuities.** Interest, rents and royalties received from a controlled entity is UBTI to the parent, even though these forms of passive income would be exempt from UBTI if they were received from an unrelated third party. “Controlled” means the parent owns 50% or more of the voting stock, partnership interest, or membership units, or is able to appoint 50% or more of the Board of Directors. (Congress is currently considering legislation that would repeal this rule.)
- iii. **Distributions of appreciated property.** Distributions of property, or transfers of cash after a liquidation of property, may also be taxable to the parent under certain circumstances.

c) Payments Between Parent and Subsidiary.

- i. It is crucial for the exempt parent to remember that its assets cannot be used by the taxable subsidiary without fair market value payment by the subsidiary without jeopardizing the parent’s tax-exempt status even when the for-profit business is controlled by the parent. The parent’s assets have been dedicated to a charitable use and cannot be used in a for-profit business without jeopardizing its continued exempt status. As a result, it is of primary importance to structure the relationship

between the parent and the subsidiary in a manner which ensures the subsidiary is paying the parent fair market value for any benefit it receives from the parent. Likely services include: space, use of employees, use of equipment or supplies, access to capital, management or accounting services.

- ii. The IRS has ruled that revenues received by exempt organizations from *incidental* arm's length sales to related, taxable subsidiaries are not subject to UBTI, except for interest, rent, annuities and royalties received from controlled organizations under Code Section 512(b)(13). However, regularly carried on sales will be subject to UBTI. For example, an exempt entity may enter into a multi-year contract to provide the CEO and CFO for the subsidiary for a fair market rate. The revenue received by the parent will be UBTI to the parent. If the contract provided that the subsidiary would receive these services at no charge, the parent's exempt status would be jeopardized.
- iii. In contrast, if the subsidiary provides CEO and CFO services to the parent, it need not charge the parent for the services provided. However, the deductibility of the salaries of those employees by the subsidiary as ordinary business expenses might be jeopardized. As a result, the business relationship between the entities must be carefully structured to ensure UBTI to the parent is minimized and its exempt status is not jeopardized.

4. Intermediate Sanctions.

The intermediate sanction rules apply both to the exempt entity itself, as well as to the activities of entities which are "controlled" by the exempt parent. Please see Part V, above, for a full discussion of intermediate sanctions and the excess benefit transactions rule.

a) Application to Activities of Taxable Subsidiary.

- i. "Excess benefit transaction" is defined as any transaction in which an economic benefit is provided by a tax-exempt organization directly or *indirectly* to a disqualified person. IRC § 4958(c)(1).
- ii. The Treasury Regulations related to IRC § 4958 provide that a benefit may be provided indirectly through the use of a controlled entity or through an intermediary. Treas. Reg. § 53.4958-4(a)(2).
- iii. Accordingly, compensation and all other financial transactions with insiders, even through a for-profit subsidiary, must be on fair market value terms.

5. Operational Considerations.

a) Governance Structure.

- i. Generally, an exempt parent organization will establish a taxable subsidiary which is wholly controlled by the parent. Where, however, the creation of UBTI is problematic, consideration should be given to having another entity or individuals own at least 50% of the ownership interest of the corporation. If the other owners are not exempt organizations, or are individuals, a joint venture will be created and the relationship between the parties must be carefully constructed.
- ii. Operational decisions will also need to be made regarding the authority over the day to day operations of the subsidiary. To the extent employees of the parent will be given such authority, they should be made employees of the subsidiary or the parent will need to be compensated for their time. This may, of course, create UBTI to the parent. Alternatively, the employees could have a dual employment arrangement. Either arrangement should be carefully considered with respect to employee benefit purposes.

b) Facilities. Although an in-depth analysis is beyond the scope of these materials, it should be noted that the use of facilities that are financed through tax-exempt bonds will impose certain additional requirements.

- i. If the taxable subsidiary will operate in any facilities owned by the parent which have outstanding tax-exempt bonds, such use will be considered to be a private business use of such facilities under IRC § 145. If such use is greater than 5% of the bond proceeds, it may disqualify the tax-exempt nature of the bonds.
- ii. If the taxable subsidiary will operate on property that is tax-exempt for property tax purposes, such use may cause a portion, or all, of the property to be taxable, depending on local regulations.
- iii. If the subsidiary will operate in any property or facilities of the exempt parent, it must be pursuant to a FMV lease. Due to the bond financed facility issues as well as property tax exemption considerations, the subsidiary may consider purchasing the necessary facilities from the parent, at FMV price, or leasing from an unrelated party.

c) Form 990 Reporting. The new Form 990 requires a substantial degree of disclosure regarding related entities, including subsidiaries. As with all information reported on the Form 990, information regarding subsidiaries is public information and freely available on the internet.