<u>The Tax Implications of Earned Income</u>

Taxes. Everyone hates the subject, but "tax" is how we register and regulate nonprofits in the U.S. When a tax-exempt organization decides to start an income-generating venture, there are possible tax implications. This chapter is a tax planning primer.

The purpose of this chapter is to help nonprofit managers decide whether to seek professional tax counsel from a CPA or tax attorney, by giving an overview. Some of the details are mind numbing. We will try to discuss each issue generally and then provide a real-world handle. These real-world handles are marked with a symbol: 🔑. Unrelated business income is a subject that is constantly evolving; the laws change yearly. In this chapter, we will discuss broad principles, specific applications, and areas of current regulatory enforcement and scrutiny. These include areas of open dispute between the nonprofit sector and the IRS. Especially in such areas, the laws could change very soon; this chapter should be taken as a basic primer, accurate as of early 2001, but subject to change. One of the benefits of simply hiring expert legal counsel is that such experts keep abreast of changes in law and strategy.

This chapter is not legal advice, and the author is not a lawyer. Every set of facts is different. Giving legal advice is applying the law to a set of facts. The purpose of this chapter is to outline the tax questions involved to help the reader determine when it is prudent to spend money on legal counsel.

Who cares about tax laws affecting nonprofits and commercial activity? In this chapter, the word "nonprofit," unless otherwise qualified, means a U.S. tax-exempt organization, most likely organized as a nonprofit corporation in one of the fifty states, with officially-recognized exemption from Federal and State income tax. *All* tax issues discussed in the chapter affect publicly supported 501(c)(3) organizations. Issues discussed around *public support* relate <u>only</u> to 501(c)(3) organizations that are publicly supported charities. Issues discussed around *unrelated business income* and *commerciality* affect all 501(c) organizations. If your organization is Canadian, skip this chapter and get legal advice from a Canadian lawyer. If your organization is a private foundation, you may wish to read this chapter for insight about your grantees, but private foundation rules are especially tricky and require qualified counsel. If your organization is not incorporated, there may be liability issues to consider before starting a venture; the purpose of being incorporated is to help protect individuals from liability.

Finally, the use of "tax exempt" or "exempt" in this chapter is a reference to corporate income tax, not to exemption from sales, property or other taxes, which rules vary greatly from state to state and city to city.

Background:** the **Commerciality Standard** and the **Notion of Unrelated Business Income. Since 1950, there has been a principle in this country that a tax-exempt organization earns its exempt status based on how it is *organized* <u>*and*</u> *operated*, not based on what it does with its profits. For example, if you operate a pizza parlor, but give all your profits to charity, that does not confer tax exemption on your pizza parlor, no matter how well intentioned the operation. The reason is that it would not be fair to the person down the street who is operating a traditional pizza parlor in an effort to make a buck like any other person in business. The reason it would not be fair is that your nonprofit, enjoying more favorable tax treatment, would be in a position to undercut the competition on price. If a given venture resembles ventures ordinarily engaged in by for-profit organizations, then it is important to take a very careful look at the tax issues raised. It is important to be able to provide information on how the activity is different from commercial competition.

For example, if your nonprofit's proposed pizza parlor uses organically grown produce grown in gardens on formerly vacant lots in the inner city, and the gardens in turn expose low-income kids to gardening and science, and the pizza parlor employs women leaving domestic violence shelters and building job skills, then the pizza parlor may be operated sufficiently differently from commercial pizza parlors to merit tax exemption.

Another well-known example of this tension is the relationship of YMCA gyms to for-profit health clubs. In many jurisdictions, private health clubs have challenged the local property tax exemption enjoyed by YMCA gymnasiums, arguing that the Y has become nothing more than a health club competitor and should be taxed accordingly. Inquiry into this issue is also going on in Congress related to exemption from Federal income taxes, and most State exemptions follow the Federal rules. The Ys, of course, counter that fitness is part of public health and improvement of the citizenry and consistent with the Y's exempt purposes. In response to these pressures, many Ys have had to add scholarship and outreach programs in an effort to distinguish their fitness operations from competing businesses.

This was not always the law. For the first half of the 20th century, all receipts were tax-free to a charity, whether derived from contributions or from the conduct of business, so long as those funds were destined for expenditure or other use to further the exempt purposes of the charity. This so-called *destination test* held sway until 1950. By that time, the charitable sector had grown large enough to be perceived as a competitive threat by the business sector. The number of secular organizations exempt under the predecessor to Section 501(c)(3) increased from 12,500 in 1940 to 50,000 in 1950. In response, the business sector mounted a powerful lobbying campaign to limit tax benefits to charities. Also, charitable organizations were pushing the envelope on the destination test. For example, the School of Law of New York University received as a gift all of the stock of the Mueller Macaroni Company. The result was that the macaroni business paid no income tax on its pasta business profits that were contributed to the School of Law at NYU, which also paid no tax on that income.

Largely in response to business pressure and the NYU/Mueller problem, Congress enacted the Unrelated Business Income Tax in 1950. The gist of the tax is clear: a charity should pay income tax on income from any commercial business it carries on if that business is unrelated to the charitable purpose. The main issues are also apparent: What is a business? When is it related and when unrelated? What are the implications of the concept of "carrying on"? There are, of course, lots of exceptions, exclusions, and other complications.

Finally, if a given commercial venture is very large, compared to the rest of the activity of a nonprofit, it raises a question: Is the overall organization really a tax-exempt nonprofit with some commercial activity, or is it really a for profit business that does some charitable work? Nonprofits that manage to build larger ventures often operate those ventures out of taxable subsidiary corporations to avoid this larger commerciality concern.

Scale of the Venture. The first thing to think about when assessing the need for professional tax advice is the scale of your planned venture. For example, if the venture might account for $5,000 of a $200,000 budget, these issues are not likely to matter very much one way or the other, and even if mistakes are made in tax reporting, the downside risk in a tax audit is small. If larger sums of money *or* a larger percentage of your budget are involved, then you need to be strategic about the tax issues from the beginning.

Use this chapter to get a general idea of the issues involved, and then go get started on your idea! If it takes off and grows, and *actually makes a profit* (no small task), *then* you can hire counsel, do any tax reporting, and reorganize if necessary. The worst case is another tax return to prepare and file, and some tax to pay out of the profits on your new venture. There is no legal activity that is forbidden to a nonprofit. Even if you manage to start a business that grows to be huge and successful, your nonprofit can set up a taxable for-profit subsidiary corporation to hold the business and pay taxes on it like any other commercial venture. Your nonprofit can own 100% of the stock in this subsidiary. So get started! See if your idea makes money. You can sort out the details later.

Caveats: At the start-up stage, if you feel certain the commercial activity might end up in a for-profit subsidiary, put it there now. Otherwise, it may be difficult later to transfer the commercial activity from the nonprofit. Second, if your nonprofit needs to broaden its purposes so that the activity is related, this should be done at the outset. These topics are discussed below. Read on.

Revenue and Support. The first distinction to make is the difference between *revenue* and *support*. Support is money your organization receives as a gift, grant or contribution to further your purposes. Revenue is money your organization receives because the payer receives something in return. Sometimes a single check can be partly revenue and partly support. For example, if you charge $50 to a dinner and dance with live music, and the fair market value of such an event is $20 then the $50 payment is $20 revenue and $30 support. Only the $30 support is deductible to the payer if your organization is a 501(c)(3). This chapter, and the others in this book, are all about generating *revenue*.

Types of Revenue. For tax purposes, there are three types of revenue: 1) *exempt function income*, 2) *passive investment income*, and 3) *unrelated business income*. Unrelated business income is taxable (after deducting related expenses); the other two types are not.

Passive investment income includes revenue earned as interest and dividends on your bank and investment accounts, gains on sales of investments, royalty income, and rental of real property which is not debt-financed (mortgaged). Passive investment income is a specific exclusion from the legal definition of unrelated business income.

Exempt function income includes fees derived activities that are primarily engaged in to further charitable or other tax-exempt purposes, and not primarily to earn revenue, as well as certain revenues excluded from the definition of unrelated business income. It is often called *program service revenue*.

Unrelated business income is income earned from a *trade or business* that is *regularly carried on* and is *unrelated* to the exempt purpose of the nonprofit. Most of this chapter will be devoted to a discussion of unrelated business income (UBI) and unrelated business income tax (UBIT). Any profits made from an unrelated-business-income-generating activity are taxable as if the venture were commercial. Your goal in tax planning is to operate and account for any venture in a way to avoid paying UBIT if possible.

Because of this complexity, professional help is necessary if, as we said right off the bat, the scale of the venture is large in dollars or percent of your budget.

Whether earned income is taxable revolves around the *commerciality standard* so as a nonprofit manager, you can start by asking yourself: "Does this look and feel like for-profit ventures?" Alternatively: "Do we have any for-profit competition for this venture?" If the scale is small, or if you can confidently answer NO to both of those questions, you probably do not need counsel.

Passive Investment Income. The easiest revenue to classify as passive is simple interest and dividends. Royalties and rental income can pose more complicated questions.

Royalties. If your organization allows an unrelated commercial venture to use its goodwill or logo or to publish work that your nonprofit has written, in exchange for a stream of payments, and the nonprofit does nothing to promote the commercial venture, then the revenue is passive royalty income. Royalties are a big area of dispute between the IRS and nonprofits as of this writing.

Royalties from subsidiaries. If the payer of the royalty is a subsidiary entity that the nonprofit owns, the royalty payments will be taxable unless the nonprofit owns less than 50% of the subsidiary.

Royalties: Mailing List Rentals & Affinity Credit Cards. The best-known dispute about royalty income has centered on "affinity" credit cards. In affinity credit card arrangements, a big nonprofit organization allows a bank to use its mailing list to market a credit card which carries the logo of the nonprofit, and which provides a stream of income to the nonprofit, typically based on a portion of the annual fee as well as a very small portion of every transaction charged on the card.

Section 513 of the Internal Revenue Code defines UBI and specifically exempts income from mailing list rental earned when an exempt organization rents its mailing list to another exempt organization, regardless of how related the mission. In other words, the Internal Revenue Code says an environmental charity can rent its mailing list, passively, to Mothers Against Drunk Driving and not have the income counted as taxable. The IRS takes the position that this implies that Congress intended rental of mailing lists to commercial entities to be taxable as unrelated business income. Nonprofits argue that revenue earned by renting a mailing list to any entity is passive royalty income to the renting nonprofit, and is therefore excluded from UBI as passive investment income. The IRS counters that services provided by an exempt organization in maintaining the mailing list (keeping the names up-to-date) leads to at least part of the revenue stream being non-passive and therefore taxable as UBI.

In an appropriately passive affinity credit card deal, typically the nonprofit does two things in exchange for the revenue it earns. First, it allows the bank to use its mailing list one or more times. Second, it allows the bank to use its name, logo, and goodwill on the bank's credit cards and promotional literature. (If the nonprofit were to engage in activities promoting the card, the revenue might become UBI because it is not passively generated, but this is not the primary subject of the current tax dispute around affinity cards.) The IRS takes the position that revenue, at least from the rental of the mailing list to the bank, is taxable as UBI.

So far, the IRS has lost in court on this issue, but it has not been litigated to the Supreme Court, so nothing is final. The history is that the Sierra Club, based in San Francisco, had an affinity credit card arrangement. The IRS took the position that at least a portion of the income from the affinity card was taxable, and the Sierra Club sued. So far, the Sierra Club has won, up through the Ninth Circuit in June 1996, but the IRS has not given up. Most observers think that the IRS is waiting for a case with a better fact pattern to arise, in a different circuit with a judicial panel more favorable to the Service's position. If it can litigate and win in a different circuit, then the Supreme Court will be forced to rule on the issue, because there will be a split between circuits.

> If your organization is considering renting your mailing list and the use of your name and/or logo to a non-exempt organization, and the dollars involved are large, you should seek counsel. There are tactical steps you can take to minimize tax exposure. First, you can structure the deal as two separate deals to minimize the portion of the revenue stream that the IRS would tax if it eventually prevails. Second, you can accurately report the arrangement on annual Forms 990 so as to start the statute of limitations running, and thereby limit how far back the IRS can look to your nonprofit for tax if it prevails in the courts.

Rental of real property. If your organization owns real property outright and rents it out without providing services or renting a bunch of personal property (such as furniture and equipment) in addition to the real property, the revenue is excluded from UBI. If the property is debt-financed (mortgaged) then a portion of the income may or may not be taxable UBI, depending on whether the tenant is mission-related to your organization. The idea here is that borrowing money to buy a property and then paying off the mortgage with rental income derived from tenants is a fundamentally commercial activity.

> If your organization earns large-scale revenue from renting real property to tenants that are not mission-related, then you should seek counsel.

Exempt Function Income. There are many ways for a charity to earn revenue from the very activities that promote its exempt purposes. For example, consider an art museum that is organized for public benefit to promote appreciation of art, and is operated to attract as many people to appreciate art as possible. For such a museum, the admission charge would count as an *exempt function income*, which in no way would be taxable, even though it is a purely earned income, and the person buying admission is not entitled to any deduction for a charitable contribution. Exempt function income is very often called “program service revenue”; the words are synonymous.

Passive investment income is fairly easy to define and to spot. Determining whether other types of revenue are *exempt-function income* or *unrelated business income* can be much more complex. Virtually every type of revenue-generating activity that resembles activities also carried on by businesses has some sort of criteria or rules developed by Congress or the IRS to evaluate whether the activity is UBI. These rules can be obscure and based on various levels of law including the Internal Revenue Code (passed by Congress), Regulations (adopted by the Department of the Treasury), Revenue Rulings and Procedures (issued by the IRS), Private Letter Rulings (issued by the IRS to decide a specific case without creating binding precedent but indicative of the IRS’ viewpoint), General Counsel Memoranda (issued by IRS in-house lawyers), and court cases from Tax Court or Federal District Courts on up through the US Supreme Court.

Unrelated Business Income.

Unrelated business income (“UBI”) is defined with a three-part definition: income earned from a *trade or business* that is *regularly carried on* and is *unrelated* to the exempt purpose of the nonprofit. Each of the three parts of the definition may provides an opportunity for tax planning. Why is this important? It is important because net income from UBI (after deducting related expenses) is taxable at the corporate rate, about 1/3. Tax planning may allow a venture to be organized and operated in a way which avoids this 1/3 tax. (Unrelated business income tax is abbreviated as “UBIT,” and net UBI, which becomes unrelated business taxable income is known as “UBTI.”)

UBI Question #1: ***Related or Unrelated****?* The exempt purposes of your nonprofit are shown, in order of precedence: 1) in its Articles of Incorporation, 2) possibly in its Bylaws, 3) in its original application for recognition of exemption on IRS Form 1023 or 1024, 4) in any further correspondence with the IRS on the subject, 5) in its annual Forms

990, and 6) in various internal documents such as a mission statement or programmatic brochures.

For example, imagine that your organization operates a daycare center for children, and it decides to sell a fancy--but educational--Babysitters' Guide for $30 as a fundraising item. If the Articles of Incorporation and the tax-exemption application say that you are organized to "provide daycare to children," then selling the Guide generates unrelated business activity, and profits (if any) would be taxable. If, however, your Articles and application say that the organization intends to work in a variety of ways for the welfare of children, including provision of daycare, publishing of materials, and educating the public, then selling the Guide would generate exempt function income.

After considering a new venture, and your purposes as currently stated, you may decide that it would be best to amend your Articles of Incorporation to broaden your mission, and to notify the IRS on Form 990 that your activities have changed, and explain the new broader charitable mission. If your nonprofit's purposes and activities have changed substantially, you may wish to formally request IRS recognition that the new purposes and activities qualify as exempt.

Special ***Fragmentation Rule***. It is important to keep in mind that when the IRS looks at a complex venture such as a college or museum gift store or bookstore, it will break the venture into small components, or fragments, before applying the UBIT rules. This means it will determine that revenue from the sale of certain individual items is exempt function income or falls otherwise into one or more exemptions from UBI, while revenue from the sale of other individual items is taxable UBI. For example, the museum referred to above, which exists to promote appreciation of art, might sell a variety of items in its gift store such as local tourist guidebooks, that are not particularly related to art and art appreciation. The IRS would take the position that revenue from those tourist guides is UBI and net income from those guides is taxable, while it would leave alone the sale of art prints and art books.

> In order to assess a new revenue generating venture, you should begin by reading your organization's Articles of Incorporation and Bylaws, and tax-exemption applications, as well as other materials mentioned above, to get a picture of your nonprofit's exempt purposes as currently stated. If your venture is likely to be large-scale, you may decide that it is necessary to amend your Articles or report to the IRS on Form 990 that your activities have evolved.

UBI Question #2: What is a ***trade or business****?* This gets to the very heart of the commerciality standard discussed above. Certain activities have been specifically exempted from the definition of taxable UBI since they are by definition not equivalent to commercial ventures. These exemptions are for:

- ✓ revenue from activities substantially conducted by volunteers
- ✓ revenue from the sale of merchandise, substantially all of which has been donated

- ✓ revenue from activity which is carried on, by a 501(c)(3) organization, primarily for the convenience of members, students, patients, officers or employees
- ✓ revenue from the distribution of low-cost items (defined as $____ in 2000)
- ✓ revenue from bingo games, defined very specifically
- ✓ revenue from certain public entertainment activities such as festivals or county fairs
- ✓ revenue from certain specific types of conventions and tradeshows

Obviously, if your activity might use one of the first three exemptions listed, the question now arises as to the definition of "substantially" or "primarily," which are subjects for you to seek counsel about, if the scale of your venture is large.

In addition to the good news about *exemptions* from UBI based on the definition of "trade or business" there is bad news: certain activities that the IRS considers inherently commercial and unrelated to exempt purposes. These inclusions in UBI are:

- ✓ revenue from advertising
- ✓ revenue from certain sponsorships
- ✓ revenue from debt-financed property

Advertising is a subject on which the IRS has tried to draw a bright line. In nearly all cases, regular advertising revenue (such as in a quarterly newsletter) is reportable as UBI (if gross UBI revenue—before expenses—is over $1,000). In extremely rare cases, organizations have been able to demonstrate that their advertising itself achieves an exempt purpose. For example, a medical journal might be able to qualify its advertising as exempt from UBI if the advertising is closely related to the journal's articles, is itself truly substantive in content, and educates the reader about new medical and scientific products on the market. There is a discussion below of the Form 990-T on which UBI is reported and tax paid.

In the case of advertising, the calculation of income and expenses becomes very complicated. First of all, the rules allow for deduction of the proportionate cost of publication and distribution relating to the proportion of the material that is devoted to paid advertising (in other words, advertising space as a percentage of total publication space equals the percentage of production, printing and distribution cost that may be deducted). However, in some cases the rules require the reporting nonprofit to count as UBI a portion of subscription income (which may be called "membership dues" depending on the facts and circumstances) as well as the advertising income. If your organization has learned how to generate revenue over $1,000 from advertising, you need to learn the accounting rules and think through your record keeping very carefully. Start with Form 990-T instructions, and IRS Publication 598 "Tax on Unrelated Business Income of Exempt Organizations."

Corporate sponsorships , unless properly structured, run the risk of being treated as advertising. With corporate sponsorships, such as the Mobil Cotton Bowl, a business agrees to provide funds to events such as sports competitions, parades and public festivals. In exchange for the funds, the sponsor is provided promotional benefits characterized as "acknowledgement," often including the renaming of the event or facility. In 1993, the IRS made an attempt to tax this revenue as advertising and therefore UBI. It was particularly focussed on bowl games. The IRS position is understandable, since most of the businesses paying for sponsorships are counting the payment as a promotional expense rather than as a charitable gift. The sports and festivals lobby, however, was strong enough that it got Congress to pass new Code language (Section 513(i)) and trumped the IRS. The Code now specifically exempts sponsorship payments from UBI, so long as the "acknowledgement" does not include "advertising [the sponsor's] products or services (including messages containing qualitative or comparative language, price information, or other indications of savings or value, an endorsement, or an inducement to purchase, sell, or use such products or services)." The Code also limits the exemption if the sponsorship payment is contingent on the number of people attending the event or otherwise exposed to the acknowledgement. There are also limitations on the exemption for certain convention and trade show sponsorships and for publication of sponsorship messages in regularly scheduled and printed material that is not distributed in connection with a specific event.

Merchandise for Sale. Watch out for merchandise. If your organization regularly sells tee shirts, tote bags, baseball caps and the like, emblazoned with its logo, this revenue may be considered UBI by the IRS if it is examined. If the item were sold in 1998 and cost less than $7.10 it would be exempted as a "low-cost" item, but otherwise the item needs to do more than simply promote the organization itself, as far as the IRS is concerned. However, if your name (e.g. "Citizens to Prevent Toxic Waste"), your logo, or the item itself promotes your mission by carrying a message such as "reduce, reuse and recycle," then the revenue would be exempt function income. In any case, very few groups report occasional sale of a few tee-shirts as UBI, but on audit, the IRS might have a different view, depending on the merchandise, who sells it (volunteers?), what it says, and how regularly it is sold.

If your new venture is volunteer run, or involves the sale of donated items, or is truly for the convenience of your members, students, patients, officers or employees, then you can treat it as exempt function income. If your new venture involves advertising or large-scale corporate sponsorships, you should learn more about the subject before structuring your accounting system or drafting sponsorship agreements.

UBI Question #3: What is ***regularly carried on***? Nonprofits and the IRS have argued this issue in many specific cases. In general, an activity done only once a year is not "regular" for this purpose. For example, some organizations have an annual banquet, member meeting, and "program books" in which they sell advertising but do not otherwise sell ads. Such an organization might be able to count the advertising revenue as exempt from UBI. However, the IRS took the position that activities of the NCAA in selling advertising in its annual college basketball tournament program book were activities regularly carried on because the program book was so substantial that there was, in fact, a year-round sales effort and advertising staff. The IRS lost to the NCAA in court, but may be waiting for a better set of facts to pursue this issue.

If your venture will be conducted once a year or less, it is likely exempt from UBI. If it is large-scale and will be conducted more often than once per year, but still only on an occasional basis, get counsel.

Form 990-T: reporting Unrelated Business Income and paying Unrelated Business Income Tax. If an organization has gross unrelated business income of $1,000 or more, it must file the Form 990-T, due annually at the same time as the Form 990. The 990-T starts with the gross unrelated business income, and allows deductions for costs associated with the production of that income to determine the net UBTI—unrelated business taxable income. If a nonprofit owes UBIT, it must pay quarterly estimated tax payments. Please also see the discussion of cost allocations below.

Current areas of scrutiny, enforcement, and dispute. As we said earlier, there are a number of areas that are currently being debated or carefully enforced by the IRS:

- ✓ corporate sponsorships
- ✓ fitness facilities
- ✓ mailing list rentals
- ✓ affinity credit card arrangements
- ✓ fragmentation
- ✓ travel tours
- ✓ associate member dues
- ✓ cost allocations

Issues already discussed include corporate sponsorships, fitness facilities, mailing list rentals and affinity credit card arrangements, and the fragmentation rule. Other areas of current attention include travel tours, associate member dues, and cost allocations.

Travel tours being sponsored by colleges, universities, churches, museums and other nonprofits continue to be challenged by for-profit tour groups, who claim unfair competition. Having a real, formal, educational program (as opposed to merely exposing participants to educational surroundings) that is emphasized in the solicitation materials and occupies participants substantially all the time, is the easiest way for any organization desiring to put on such a tour to avoid UBI.

Associate member dues arise as a UBI issue when a nonprofit organization, with specific membership benefits such as an insurance plan, attracts non-voting members who join solely to access the benefits, but are not otherwise part of the program or constituency of the nonprofit.

Cost allocations. The IRS has made it clear that it believes many organizations are overstating the expenses associated with generation of unrelated business income, deducting the expenses and thereby reducing the amount of tax paid. If your organization reports unrelated business income, you may wish to obtain help with accounting for the costs, particularly so that you take full advantage of allowable deductions.

> If your venture is large in scale and involves corporate sponsorships, fitness facilities, mailing list rentals and/or affinity credit card arrangements, sale of many different items variously related and unrelated to your mission, travel tours, or associate member dues, or you are reporting UBI and filing Form 990-T, then you should keep abreast of rapidly changing laws and enforcement standards.

Public Charity Status: the public support tests. This is a very complicated subject, not for the faint of heart. If your organization is a 501(c) organization other than a 501(c)(3), you can skip this section.

Most 501(c)(3) organizations are defined as "not a private foundation" because they receive their support from sufficiently diverse sources. We call these charities "public charities." A 501(c)(3) organization is either a *private foundation* or a *public charity*. The law restricts and regulates private foundations very carefully, because they are typically charities that have received funding from very few sources and may therefore not be as likely to benefit public interest rather than the private interests of the key donor or donors. The law assumes a charity is a private foundation unless it is a certain type of organization such as a hospital, church, or school, or unless it can continue to prove that it meets one of two *public support tests*, on a rolling four-year basis. The two types of publicly supported organizations are defined in Code Section 509(a)(1) (by reference to Section 170(b)(1)(A)(vi)), and Section 509(a)(2). These Sections, and their defining Regulations, describe the complex public support tests.

Section 509(a)(1) public charities (the most common type) are required to be 1) at least 1/3 publicly supported *or* 2) at least 1/10 publicly supported as well as meeting a "facts and circumstances" test. Notice that the fraction is the key; a fraction has both a numerator (top) and a denominator (bottom). For this test, the larger the fraction the better. In calculating this fraction, the numerator includes at least a portion of all gifts (*support*) but does not include any of the three types of *revenue*. The denominator includes all income except exempt function income. Therefore, this creates another tax incentive for a 509(a)(1) charity to structure its ventures so that the revenue qualifies as exempt function income. Exempt function income drops out of both the numerator and denominator, but the other types of revenue only drop out of the numerator.

Section 509(a)(2) public charities are required to be 1) at least 1/3 publicly supported *and* 2) no more than 1/3 supported by passive investment income plus unrelated business income. In calculating the public support fraction in this case, the definitions are even more complex. The numerator contains portions of most gifts (*support*), the greater of $5,000 or 1% of total *exempt function income* from any single source (with certain exceptions), but does not contain exempt function income above that amount from any one source, nor does it include passive investment income or unrelated business income. The denominator includes all three revenues (net of UBIT). Therefore, as with 509(a)(1) charities, this creates a tax incentive for a 509(a)(2) charity to structure its ventures so that the revenue qualifies as exempt function income, and so that the revenue is collected from many small payers rather than a few large ones.

> *Exempt function income* is treated more favorably for the public charity support tests than any other form of *revenue*. Once again, the scale of the project matters: if your organization has many small contributors and a relatively small scale earned income venture, it will not create a public support issue.

Creating a taxable subsidiary corporation. When an unrelated business venture takes off and grows, nonprofits sometimes "spin off" the venture into its own corporation. It is proper (in most cases) for the nonprofit to own 100% of the stock in the subsidiary, and receive all the after-tax profits. These profits are not treated favorably to the charity for the purposes of the public support test, but using a subsidiary can solve other issues:

- ✓ assuming it is a bona fide corporation, the subsidiary corporation may shield the parent organization from liability arising from the venture
- ✓ if unrelated business activities grow to the point that they are very large in relation to the amount of charitable activity, moving the unrelated business activities into a separate organization prevents a challenge to the parent charity based on whether it is really a commercial organization
- ✓ it is easier to account for income and expenses in a separate entity and therefore calculate accurate net income for purposes of calculating tax
- ✓ profit-making ventures sometimes do best run by staff who are themselves more interested in making money than in doing good; a nonprofit may find it easier to spin off a venture so that the venture can develop its own profit-minded entrepreneurial culture separate from the nonprofit's own public-benefit-minded culture

> If you successfully create and grow a venture which generates unrelated business income, there are a number of tactical reasons why your nonprofit might decide to spin off the new venture into a separate for-profit corporation which your nonprofit owns.

Now that you're overwhelmed with the complexity of the tax rules, remember what we said at the beginning of the chapter:

> Use this chapter to get a general idea of the issues involved, and then go get started on your idea! If it takes off and grows, and *actually makes a profit* (no

small task), *then* you can hire counsel, do any tax reporting, and reorganize if necessary. The worst case is another tax return to prepare and file, and some tax to pay out of the profits on your new venture. There is no legal activity that is forbidden to a nonprofit. Even if you manage to start a business that grows to be huge and successful, your nonprofit can set up a taxable for-profit subsidiary corporation to hold the business and pay taxes on it like any other commercial venture. Your nonprofit can own 100% of the stock in this subsidiary. So get started! See if your idea makes money. You can sort out the details later.

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