



Providing Services for Pay: What Charitable §501(c)(3)s Can and Can't Do?

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Mission of Pro Bono Partnership of Atlanta:

To provide free legal assistance to community-based nonprofits that serve low-income or disadvantaged individuals. We match eligible organizations with volunteer lawyers from the leading corporations and law firms in Atlanta who can assist nonprofits with their business law matters.

Pro Bono Partnership of Atlanta Eligibility & Other Information

- In order to be a client of Pro Bono Partnership of Atlanta, an organization must:
 - ✓ Be a 501(c)(3) nonprofit organization.
 - ✓ Be located in or serve the greater Atlanta area.
 - ✓ Serve low-income or disadvantaged individuals.
 - ✓ Be unable to afford legal services.
- *Visit us on the web at www.pbpatl.org*
- Host free monthly webinars on legal topics for nonprofits
 - ✓ To view upcoming webinars or workshops, visit the Workshops Page on our website

Legal Information:

- This workshop presents general guidelines for Georgia nonprofit organizations and should not be construed as legal advice. Always consult an attorney to address your particular situation.
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Threshold Issues under the Internal Revenue Code

- Qualifying as a charitable organization
 - ✓ Purposes test
 - ✓ Organizational test
 - ✓ Operational test
 - Commerciality doctrine
 - ✓ Public support test (private foundation v. public charity)
- Unrelated Business Taxable Income (“UBTI”)
- Private Benefit Prohibited

§501(c)(3) Nonprofit Corporations

➤ Purposes Test:

- ✓ Organization exists for the benefit of the public
- ✓ Activities must be consistent with the stated tax-exempt purpose

➤ Organizational Test:

- ✓ Directed and managed by directors, operated by officers, and no owners or shareholders to distribute profits to (may have members to vote for directors)
- ✓ Organized for the benefit of a broad community and complies with one of the exempt purposes in §501(c)(3) of the IRC
- ✓ Upon dissolution all assets must be distributed to another §501(c)(3) nonprofit corporation

The “501(c)(3)” Organization

- Exempt Activities – charitable, educational, religious, scientific, literary, fostering national or international sports competition, preventing cruelty to children or animals, and testing for public safety
- *Charitable*: includes relief of the poor, the distressed, or the underprivileged; advancement of religion; advancement of education or science; erecting or maintaining public buildings, monuments, or works; lessening the burdens of government; lessening neighborhood tensions; eliminating prejudice and discrimination; defending human and civil rights secured by law; and combating community deterioration and juvenile delinquency

§501(c)(3) Nonprofit Corporations

➤ Operational Test:

- ✓ An organization's activities *must (exclusively)* further its charitable purpose
- ✓ Cannot have any part of its net earnings to inure to the benefit of any private shareholder or individual
- ✓ Cannot be an action organization
- ✓ Commerciality Doctrine – cannot compete with for-profit businesses

Considerations for §501(c)(3)s Conducting Social Enterprise Activities

- Social enterprise activities involve the sale of goods or services that may or may not be in furtherance of a §501(c)(3)'s charitable purpose/mission
- Under the IRC §501(c)(3) operational test, an organization's activities *must (exclusively)* further its charitable purpose
- Potential legal consequences for §501(c)(3)s engaging in business activity include **taxation, penalties, and loss of tax-exempt status**

Charging for Charitable Services

- §501(c)(3)s can charge for services if the service is charitable – assists with accomplishing charitable purposes
 - ✓ Only concern is whether the charges detract from the provision of such services in one of two ways:
 1. Deprive a major part of the charitable community access to the organization and its programs or
 2. The organization derives a profit from the activities beyond that necessary to conduct its exempt function.
 - ✓ If 1 or 2 is true, the payment for the services may make it no longer charitable.

Commerciality & §501(c)(3)s

- §501(c)(3)s can conduct a commercial trade or business if:
 - ✓ It is in furtherance of its exempt purposes AND
 - ✓ The primary purpose is NOT to engage in an unrelated trade or business
- **Making money to support the exempt mission is not related**
- IRS may impose a penalty or revoke or deny tax-exemption if the organization operates a commercial trade or business that is unrelated to the organization's purposes & requires substantial attention from the organization.
- Key Question: Are you competing with a commercial for-profit business?
- Meeting the public support test is essential but just one component

Commerciality Factors

- Living Faith Case
- Org associated with Seventh-day Adventist Church that operated vegetarian restaurants and health food stores
- Court held: “Competition with commercial firms is strong evidence of a substantial nonexempt purpose.”
- 9 Commerciality Factors:
 1. Org sold goods and services to the public (“presumptively commercial”) and did not limit services to certain classes of people
 2. Org in “direct competition” with for-profit restaurants/stores
 3. Prices set by org were based on pricing formulas common in the retail food business (“profit making structure looming large”) and not having “below cost pricing”

Commerciality Factors (cont.)

➤ 9 Commerciality Factors (cont.)

4. Org utilized promotional materials and “commercial catch phrases” to enhance sales
5. Org advertised services and food
6. Org’s hours of operation were same as for-profit enterprises
7. Guidelines of org required management to have a “business ability” and training
8. Org didn’t utilize volunteers but paid salaries
9. Org did not receive charitable contributions

Below Cost Services or Goods

- When the **services are commercial in nature**, such activities (or organizations conducting only such activities) may be considered charitable if:
 - ✓ The organization is providing goods and services to other §501(c)(3) orgs at substantially below cost equating to the provision of a grant-making charity assisting recipient organizations to carry out their charitable programs.
 - ✓ The organization is providing necessary goods or services to the poor at substantially below cost thereby relieving the poor and distressed

Below Cost Services or Goods (cont.)

✓ Definition of Substantial Below Cost:

- IRS doesn't provide bright line tests but:
 - At cost has no donative intent, not sufficient
 - 15% is not substantially below cost

✓ Examples of Substantially Below Cost Factors:

- Receipt of donations and grant money to meet costs
- No commercial business willing to do it at that price
- Not economically feasible business

✓ Serving the Poor:

- Must relieve poverty at least nominally but the more the better –
- If price affects ability for the poor to gain services – is price restrictive?

Risks of Commercial Activity

- When a §501(c)(3) is conducting some commercial activity, it must worry about:
 - ✓ Whether it will jeopardize public charity status?
 - ✓ Whether it will create UBTI?
 - ✓ Whether it will jeopardize tax-exemption?

Public Charity/Private Foundation Status

- § 501(c)(3) organizations are classified as either:
 - ✓ **Public Charities** (including special categories of supporting organizations)
 - Statutorily Classified – churches, schools, organizations that provide medical or hospital care, IRC §§509(a)(1) and 170(b)(1)(A)
 - Publicly Supported – generally must receive more than 1/3 of its support from gifts, grants and contributions from a broad group of contributors, IRC §§509(a)(1) and 170(b)(1)(A)(vi)
 - Service Provider Publicly Supported - generally must receive more than 1/3 of its support from gifts, grants, contributions and receipts from admissions, merchandise sold, or services provided and limited gross investment income IRC §509(a)(2)
 - ✓ **Private Foundations** - any § 501(c)(3) not qualifying as a “public charity” – doesn’t meet IRC §§509(a)(1), (2), (3) or (4) (generally have limited sources of support, e.g., single individual, family, or corporation); could also be a private operating foundation.

Jeopardizing Tax-Exempt Status

- 501(c)(3) organizations cannot engage in unrelated business activities that are substantial in relation to their charitable purpose
 - ✓ What is “unrelated”?
 - “making money for our organization” doesn’t count as “related”
 - ✓ What is “substantial”?

Unrelated Business Taxable Income

➤ The Test:

- ✓ Trade or business
 - Activity carried on for production of income from sale of goods or services
 - ✓ Regularly carried on; and
 - Regularity and continuity
 - Carried on in same way as a comparable commercial activity
 - ✓ Not substantially related to mission
 - No causal relationship to exempt purpose
- *Note: The mere fact that the income produced will be used to carry out the mission is not a sufficient causal relationship. The activity must be related.*

Modifications & Exclusions to UBTI

- Volunteers
- Training Program
- Contributed Property
- Passive Income
 - ✓ Dividends, Interest, Annuities, Royalties
 - Cause Marketing Royalty
 - For-Profit Subsidiary Dividend
- Rents from Real Property
- Sale of Property
 - ✓ e.g. Capital gains
 - Note: Does not apply to inventory or property held in ordinary course of business



Unrelated Business Income – Other Resources

- *View a webcast on unrelated business income:*
 - ✓ <http://www.pbpatl.org/resources/unrelated-business-income>
- *Read the following articles or publications:*
 - ✓ <http://www.pbpatl.org/wp-content/uploads/2011/12/ubit1.pdf>
 - ✓ <http://www.pbpatl.org/wp-content/uploads/2011/12/AlternativeFundraising1.pdf>

Private Benefit

- Substantial Private Benefit = Loss of Tax-Exemption
 - ✓ A tax-exempt organization must serve a public not private interest
 - Organization cannot benefit a charitable class that is too small
 - ✓ Can apply to disinterested or interested parties
 - ✓ Incidental private benefit
 - ✓ Examples of Potential Substantial Private Benefit
 - Co-Venturer agreements (§43-17-6 Charitable Solicitation Act)
 - Other arrangements with individuals or taxable entities
 - Contracts with Professional Fundraisers/Grantwriters

Creative Solutions for Nonprofits

- Some approaches to avoiding potential loss of tax-exempt status and UBTI include:
 - Training Programs
 - For-profit subsidiaries

Training Programs

- First two requirements for Training Program to be considered related to organization's mission:
 1. "Clear and distinct causal relationship" between the work activity & training of individuals.
 2. Scale of training program must not be larger than what is reasonably necessary to accomplish the organization's charitable purpose.

Training Programs (cont.)

- Plus training program must have a combination of the following in order to be related to mission & NO UBTI:
 - ✓ Program clients/trainees are the primary employees, except for individuals providing training and supervision of the program participants/trainees
 - ✓ All work involved in the business activity is performed by the program clients/trainees and those who provide training and supervision
 - ✓ Work or employment in program is transitional employment to gain certain skills or competencies in accordance with the program objectives
 - ✓ The program clients/trainees may only work in the program's employment for a limited period of time
 - ✓ Any net profits gained from the commercial business activity training program operations are applied toward the organization and its mission
- <http://www.pbpatl.org/wp-content/uploads/2013/06/UBIT-Is-Income-Generated-by-Your-Training-Program-Taxable.pdf>

For-Profit Subsidiaries

- Put business in separate corporation or LLC that is owned by the 501(c)(3) and treated as C-Corp for tax purposes.
- Income from for-profit business go to 501(c)(3) as dividends = passive income = no UBTI
- Four Important Factors:
 - ✓ Director/Officer/Employee overlap – (c)(3) should not have complete control over subsidiary
 - ✓ (c)(3) Parent doesn't participate in day-to-day management of subsidiary
 - ✓ Arm's Length transactions between parent and subsidiary
 - ✓ Bona fide business purpose for taxable subsidiary

For More Information:

If you would like more information about the services of Pro Bono Partnership of Atlanta, contact us at:

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