



# Legal Minute

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## What Nonprofits Need to Know About the Tax Consequences of Economic Development Activities

Nonprofits across Texas that are working to improve the quality of life in lower-income communities are engaged in a broad range of economic development activities, from developing affordable housing to building shopping centers in distressed neighborhoods. Some 501(c)(3) nonprofits, however, assume that just because an activity falls within the nonprofit's mission statement, any income generated from the activity is tax-exempt. This is not always the case—and if a nonprofit engaged in economic development activities is not careful, the nonprofit can even lose its tax-exempt status from the IRS.

### What are the potential tax consequences for a 501(c)(3) nonprofit that engages in economic development activities?

A 501(c)(3) nonprofit must pay taxes on all income over \$1,000 generated from “**unrelated business activity**.” Moreover, a nonprofit that engages in “**unrelated business activity**” to a “**substantial degree**” can lose its tax-exempt status. If a nonprofit is subject to unrelated business income tax (“UBIT”), the nonprofit must file Form 990-T with its annual Form 990 return and may have to file quarterly estimated payments of the nonprofit's UBIT.

Even economic development activities that fall within a nonprofit's mission may be considered by the IRS to be unrelated business activity. In order to determine whether a specific economic development activity will affect the tax-exempt status of a nonprofit, a nonprofit needs to answer the following four questions:

- (1) Is the activity consistent with the charitable mission of the organization?
- (2) Is it a business activity?
- (3) Is it a related or unrelated business activity?
- (4) If it is an unrelated business activity, will the nonprofit engage in the activity to a substantial degree?

### What is a “business activity?”

A business activity is an income-generating activity that is “regularly carried on.” A business activity does not include fundraisers such as an annual golf tournament or annual banquet or income derived from passive activities earned from dividends, interest, royalties, capital gains, and dividends from taxable subsidiaries. A business activity also does not include any activity in which:

- the work is performed completely by volunteers;
- the activity is carried on for the convenience of members of the nonprofit; or
- the nonprofit sells donated merchandise.

### What is a “related business activity?”

A related business activity is a business activity that is related to the exercise of the nonprofit's charitable purpose. In determining whether an activity is related to a charitable purpose, the IRS considers many factors including the following:

- how the income is earned;
- what the fee structure is;
- which clients are served by the activity; and
- whether the nonprofit operates the business in a manner similar to for-profit businesses.

## Examples of *related* business activities include:

- providing corporate services to another tax-exempt organization at less than cost;
- operating a consignment shop to provide sales opportunities and job training for welfare clients;
- constructing and operating a golf course in conjunction with a vocational program;
- operating a job training program in which trainees manufacture an item sold at a profit;
- operating a daycare center to help low-income persons maintain employment.

## Examples of *unrelated* business activities include:

- providing services to charitable organizations at cost;
- operating a grocery or pharmacy in a distressed neighborhood;
- general business promotion in a distressed community; and
- providing property management services for low-income housing owned by the city for a standard commercial fee.

Examples of unrelated business activities may also include: advertising, selling a nonprofit's mailing list, corporate sponsorships, and hyperlinks to other websites.

## What is a substantial degree of activity?

To determine whether a nonprofit is engaged in an activity to a substantial degree, the IRS will look at gross revenues, net revenues, employee hours, and percentage of space. Usually not more than 15% of income or effort can be expended on an unrelated business activity or the IRS will consider the activity to be substantial.

## Can a nonprofit earn income from commercial real estate activities?

Yes. Commercial real estate activities are considered related business activities in the following circumstances:

- leasing to other nonprofit organizations if the lowest feasible rent is charged;
- leasing to businesses owned by the poor or minorities in blighted areas if the owners would otherwise have difficulty finding suitable space;
- leasing to businesses with lease provisions requiring job training and employment of disadvantaged area residents; and
- using rental income to make grants to other nonprofits or to reduce the rent of other nonprofit tenants.

## Should a nonprofit consider using other corporate forms to engage in some activities?

Yes. If a nonprofit is concerned about some activities subjecting the nonprofit to unrelated business income tax, the nonprofit should consider forming a for-profit subsidiary or limited liability corporation, or participate in partnerships or joint ventures with for-profit companies. In addition to tax consequences, there are other reasons for a nonprofit to consider other corporate forms when entering into new economic development activities.

***Cautionary Note: The decisions by the IRS on related and unrelated business activities are very complicated and affected by many different factors. The fact that the IRS previously found that an activity is a related business activity does not mean that the activity would always be categorized as being related. Nonprofits should contact a lawyer before engaging in economic development activities. Moreover, because the operations of the business will change over time, a nonprofit should consult with a lawyer regularly to determine whether the activities remain related business activities.***

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