

Nonprofits may encounter tax consequences

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Lauren Suttell often reminds clients pursuing nonprofit status that in the tax world, the ultimate gift is an exemption.

As such, they should do whatever they can to protect that gift, said the business and corporate attorney at Jaeckle Fleischmann & Mugel.

“That’s usually how I frame it to my clients,” said Suttell, who also concentrates on tax and not-for-profit matters. “Because you are getting a gift from the Internal Revenue Service, there are certain rules you have to be aware of and follow, and dotting your i’s and crossing your t’s are very important.”

Rules have been enacted by the federal government to avoid a nonprofit taking advantage of tax-exempt status by engaging in traditionally commercial-based activities or pursuing unrelated business income for the purpose of addressing for-profit endeavors.

The IRS rule for Unrelated Business Income Tax, or UBIT, affects all revenue-generating activity of exempt organizations. Their earned revenue is exempt from tax only if the activity that produces the revenue sufficiently furthers their mission.

There can be tax consequences and other penalties levied on tax-exempt organizations engaging in business transactions unrelated to their mission.

“Just because you’re tax exempt doesn’t mean you don’t pay taxes on anything because you have UBIT hanging in the wings,” she said.

There’s a fine line between an activity that furthers the purposes of a tax-exempt organization and one that crosses into something more commercial, according to Kelly Marks, a partner and tax attorney at Phillips Lytle.

“The reason Congress adopted these rules, at least in part, was a concern that tax-exempt organizations have a distinct advantage over for-profits that operate in the same space and industry so that the tax-exempt organizations couldn’t unfairly use their tax-exempt advantage to do something that is truly a commercial enterprise,” she said.

It has become more of an issue for nonprofits because they are being squeezed financially, and as a result they try to come up with ways to find more revenue, said Bruce Goldstein, senior partner at Goldstein Ackerhalt & Pletcher in Buffalo. As a result, a growing number of nonprofits are looking for business-making opportunities, he said. He practices not-for-profit corporation law.

“There are nonprofits making conscious decisions to do profit-making ventures for the purpose of developing revenues to help fund the areas that are more related to the mission for which there are insufficient revenues,” he said. “It’s the only way the nonprofit may be able to remain in existence because it can’t get enough donations, contributions or revenue for its mission activities. When you’re doing that, you have to realize that just because you’re a nonprofit doesn’t mean you don’t pay taxes.”

Also, the public has come to expect that certain nonprofits make more of an effort to help grow the economy and provide jobs, as well as find novel ways to achieve their exempt purposes, according to Marks. She said that can be seen in the university context and research institution setting, where incubator programs have been set up to develop certain startup businesses.

“In today’s world, where a lot of folks have concerns about the big savings that exempt organizations are getting by not paying taxes, they’re looking for them to contribute to the community,” Marks said. “And at least in certain sectors, you’re seeing this issue become more prevalent because organizations are being forced to think outside of the box, in terms of achieving their purposes and growing their income.”

Tax consequences

The consequences could include having to pay tax on income of \$1,000 or more from unrelated business transactions, Suttell said.

If so, the organization must file a special form to go along with its annual return. If more than \$500 is owed, the organization is required to make estimated tax payments throughout the year.

Taxed owed by an organization would be levied at the standard corporate rate, Marks said a rate of 35 percent is applied when the unrelated business taxable income exceeds \$10 million. The rate is 34 percent when that same income is greater than \$75,000. The organization could face penalties and interest, as well.

The rules are complex, according to Suttell. She said it is very important that an organization closely examine any new venture from which it would earn income.

“It’s not a very high threshold and a lot of organizations don’t know that there are tax implications until they sit down with their accountant at the end of the year or, God forbid, the IRS ever contacts them and then they’re being audited on the issue,” she said.

In the worst-case scenario, if an organization crosses the line it could see its tax-exempt status revoked.

“When you start threatening that, it’s a much bigger consequence that organizations need to think about heavily before they consider entering into a transaction,” Suttell said.

There is no “bright-line test” for where that point may lie, Marks said. Various practitioners have different opinions about what may give them concern, she added.

“In some ways, you can look at the unrelated business income tax as almost like an intermediate sanction,” Marks said. “First they’re going to tax your income from that unrelated trader business before the IRS comes in and revokes your tax-exempt status.”

Any nonprofit may be affected

No nonprofit is immune from these regulations, Suttell said, no matter the size: It could be a mom-and-pop organization running a scholarship or a large organization such as the United Way. It becomes a balancing act between what an organization is currently doing and what it wants to do, she added.

Yet the sophistication of the nonprofit does matter, Goldstein said. Smaller nonprofits may be more susceptible to running into problems because these types of issues can slip by them, while larger ones that employ accountants in-house may recognize pitfalls ahead of time.

“If you have any inkling that you might be dealing with UBIT, you want to bring in an accountant who knows what they’re doing,” he said. “This is really an accounting issue, even more than a legal issue.”

Suttell said her firm tries to deal with it in the planning stages of a nonprofit. From the outset, the organization’s activities are included in a long tax-exempt narrative.

She asks them to list all that they could potentially take part in and then notify the IRS if an organization is changing the activities it is to pursue. An attorney can help make a determination if a tax-exempt entity is getting into something that could cross a threshold, Suttell said.

“What happens down the road is that if you do something that has not already been scrutinized and passed the IRS’ luster, in terms of your tax-exempt application, you have to notify them and let them know and hope that they issue you another determination letter saying it’s OK. If you don’t, that’s potentially getting you into unrelated business transactions. The further you stray from your original business purposes, the more risky it gets.”

Some examples

Marks said an example of a situation that would not raise eyebrows is if an educational institution with a performing arts curriculum produces plays in which the students participate and charge admission. It would be considered furthering the educational curriculum of the organization and its performing arts curriculum.

However, if a trade association was publishing a member magazine and selling advertisements similar to other magazines, it would be treated as unrelated trader business activities, she said.

Organizations can get tripped up by assuming that as long as they put proceeds from that unrelated transaction toward one of their charitable ends that it makes the activity consistent with the charitable purpose, according to Suttell. She cited an example in which an organization that provides for the homeless holds a fundraiser in which it sells baked goods to the public.

“It doesn’t make my bake sale related to my charitable purpose,” she said. “That income, unless you fall within an exemption or exclusion, could still be subject to tax because my charitable service is not to be selling baked goods to the public.”

Compliance issues also come into play if the organization owns an interest in joint ventures with another organization such as an LLC or S-Corp, Marks said. She sees charitable organizations engaging in joint ventures with for-profit entities. The terms of those arrangements must take into account these types of issues, she added.

“It’s something that organizations need to be cognizant of and cognizant that it can arise not just in the direct conduct of unrelated trader business but in indirect ways, as well,” Marks said.

Tax-exempt bonds issued to 501(c) organizations such as hospitals, private colleges, religious organizations and social service agencies face compliance rules, as well. Any facility financed with these proceeds must be predominantly used to further its tax-exempt purposes, she said.

If a pivotal change is being made in an organization's mission or services, it requires some legal analysis, which may necessitate amending the organizations' certificate of incorporation, Suttell said.

"It is something that each of these organization needs to keep in mind," she said.