

# Issue Podcast Script - When Are Commercial-Type Activities a Substantial Nonexempt Purpose?

Text version for assistive readers who prefer a text version of this course

## Page 1- Welcome

Hi everyone! Welcome to the issue podcast on When Are Commercial-Type Activities a Substantial Nonexempt Purpose. We have a few announcements before we get started.

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This program is being recorded and will be maintained in accordance with federal record keeping laws.

Now let's get started.

Some organizations, such as churches and schools, engage in activities that are by its very nature inherently religious, educational, or charitable.

Some organizations may be engaged in activities that are **not** inherently religious, educational or charitable and some of those activities may appear to be of a commercial nature; such as providing managerial, consulting, investing or other services. From time to time, we encounter in our cases organizations that are engaged in a trade or business.

## Page 2 – Operated for an Exempt Purpose

As stated in *Airlie Foundation, Inc. v. U.S.*, when an organization's activity can be carried out for either exempt or nonexempt purposes, we must examine the manner in which those activities are conducted to determine their true purpose.

The impact on tax-exempt status of engaging in a trade or business depends on the primary purpose served by the organization's operation of the trade or business.

When an organization operates for a substantial nonexempt purpose, it does not qualify for tax-exemption under Code section 501(c)(3). We are going to be discussing in this issue podcast when commercial-type activities serve a substantial nonexempt purpose.

## Page 3 - Operated for an Exempt Purpose

Section 501(c)(3) of the Code states that organizations must be operated exclusively for religious, charitable, scientific, or educational or other stated **purposes**.

Treasury Regulations 1.501(c)(3)-1(c)(1) states that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more exempt **purposes** specified under Code section 501(c)(3). An

organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

The law requires Code section 501(c)(3) organizations to operate exclusively for one or more tax-exempt purposes.

#### **Page 4 - Operated for an Exempt Purpose**

As we said earlier, the impact on tax-exempt status of engaging in a trade or business depends on the primary purpose served by the organization's operation of the trade or business.

The Tax Court in *B.S.W. Group Inc. v. Commissioner*, provided that:

the fact that [an organization's] activity may constitute a trade or business does not, of itself disqualify [the organization] from classification under 501(c)(3), provided the activity furthers or accomplishes an exempt purpose...

...the critical inquiry is whether [the organization's] primary purpose for engaging in its sole activity is an exempt purpose, or whether its primary purpose is the nonexempt one of operating a commercial business... And if the conduct of a business with an apparently commercial character is the organization's sole activity, that fact weighs heavily against exemption.

#### **Page 5 - Operated for an Exempt Purpose**

Treasury Regulations 1.501(c)(3)-1(e)(1) states an organization may qualify for tax exemption under Code section 501(c)(3) although it operates a trade or business as a substantial part of its activities,

- if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes
- and also if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business, as defined in section 513.

#### **Page 6 - Operated for an Exempt Purpose**

As indicated on this slide, in *Better Business Bureau of Washington, D.C., Inc. v. U.S.*, the United States Supreme Court found that an important, if not the primary, pursuit of the organization was to promote not only an ethical but also a profitable business community. The organization was not operated exclusively for an educational purpose under Code section 501(c)(3).

The United States Supreme Court provided that "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."

#### **Page 7 – Operated for an Exempt Purpose**

The Tax Court in *B.S.W. Group Inc. v. Commissioner* also said, "Under the operational test, the purpose towards which an organization's activities are directed, and not the nature of the

activities themselves, is ultimately dispositive of the organization's right to be classified [under Code section 501(c)(3).]"

So, within the context of the operational test, an organization is exempt on the basis of its *purposes* and not its activities. (However, an organization's primary purpose may be inferred from its activities.)

The issue as to what an organization's purposes are is to be resolved in light of all of the facts presented in the administrative record in a particular case.

## **Page 8 – Operated for an Exempt Purpose**

For illustration purposes, fundraising is an activity that can be carried out for an exempt as well as a nonexempt purpose.

The primary purpose served by the fundraising activities depends on the facts and circumstances involved.

- For example, the primary activity of a PTO is to fundraise on behalf of a public elementary school. The fundraising is conducted by volunteers of the PTO. Although the fundraising activity is not an inherently charitable activity, the PTO nevertheless, serves a tax exempt purpose under Code section 501(c)(3) through the provision of financial support to a charitable recipient.

## **Page 9 – The Five Major Factors**

*Airlie Foundation, Inc. v. U.S.*, described the major factors the courts look for in determining whether a trade or business is carried on for an exempt purpose or a substantial nonexempt commercial purpose.

The five major factors the courts look for are listed on this slide. We'll go over each of these five factors in this podcast.

## **Page 10 – Competition with For Profit Agencies**

The first factor to consider is whether the organization is in competition with for profit businesses or entities.

- Is the activity normally carried on by commercial, profit-making businesses and does the organization directly compete with for-profit businesses?

In *Living Faith, Inc. v. Commissioner*, the court provided that "It is significant that Living Faith is in direct competition with other restaurants."

## **Page 11 – Extent of Below Cost Services**

A second factor to consider is the extent and degree of below cost services provided and the organization's pricing policy for its goods and services.

- To what extent does the organization offer goods and services free or below cost to charitable recipients?

In Rev. Rul. 76-244, an organization that provided home delivery of meals to the elderly on a sliding scale or free, depending on the recipient's ability to pay, was serving a charitable purpose.

However, the court provided in *Easter House v. U.S.*, that adoption services did not in and of themselves constitute an exempt purpose and receiving support primarily from fixed fees from adoption services was indicative of a nonexempt purpose.

## **Page 12 – Reasonableness of Financial Reserves**

Another factor when considering whether the organization is operated for an exempt or a substantial nonexempt purpose is the reasonableness of the organization's financial reserves.

The accumulation of large amounts of money or payments of large amounts to insiders and outsiders, without using the money to further charitable goals, is evidence of a possible nonexempt purpose.

According to the holding in *Incorporated Trustees of the Gospel Worker Society v. U.S.*, an organization that accumulated profits long after all religious work had ceased was **not** operated for an apparent charitable purpose.

## **Page 13 – Uses Commercial Promotional Methods**

A fourth factor to consider is does the organization use commercial promotional methods such as advertising?

- Organizations that do not budget money for charitable activities, apart from advertising, is signaling a possible nonexempt purpose.

In *Airlie Foundation, Inc. v. U.S.*, exemption was denied because the organization's conference center activity did not have significant indicia of charitable purpose. The court noted that the organization maintained a commercial website and paid *significant advertising* and promotional expenses. It promoted its facilities, including elegant events, aggressively without reference to any public purpose.

## **Page 14 – Receives Charitable Donations**

Lastly, the fifth factor to consider is the extent to which the organization receives charitable contributions and donations.

- Is the organization supported by public contributions?

In *B.S.W. Group, Inc. v. Commissioner*, the lack of solicitation of contributions and sole support from fees were factors cited disfavoring exemption.

## **Page 15 – Scenario 1**

Let's take a look at a couple of scenarios and see if the commercial-type activities engaged in by these organizations serve an exempt purpose or a substantial nonexempt purpose.

Here are the facts to Scenario 1:

- The organization's sole activity is to purchase used laptops, refurbish the laptops when necessary, and sell the laptops to low-income students to use at school
- The laptops are provided to the students on a sliding fee basis contingent on the student's family income and ability to pay
- Income after expenses are used to purchase additional used laptops and to expand the laptop program
- The organization informs the public of the availability of the laptops through the distribution of brochures and flyers at and visits to area public schools, public libraries and local community centers
- A majority of the organization's income is from gifts, grants and contributions

### **Page 16 – Charitable vs. Substantial Nonexempt Purpose**

Is the organization in Scenario 1 formed for a charitable purpose or a substantial nonexempt purpose?

I would say that based on Treasury Regulations 1.501(c)(3)-1(e)(1), the organization's operation of a trade or business (the sale of laptops) as a substantial part of its activities, meets the requirements of Section 501(c)(3) because the operation of the trade or business furthers the organization's exempt purpose of providing laptops for low-income students.

I agree. Also, when considering the five major factors provided in *Airlie Foundation, Inc. v. U.S.*, the organization on the whole is not operated for a substantial nonexempt purpose:

- The organization's sale of laptops does directly compete with for-profit businesses
- However, the organization prices the laptops based on the students ability to pay
- The organization also uses its reserves to expand the laptop program
- The organization does not use commercial promotional methods and does not incur any advertising expenses
- The organization is supported by gifts, grants and contributions from the public

I agree with you both. Based on the facts in this scenario and applying the factors provided in *Airlie Foundation, Inc. v. U.S.*, the organization is operated for a charitable purpose.

### **Page 17 – Scenario 2**

Now, let's take a look at Scenario 2.

Here are the facts for Scenario 2:

- The organization's stated purpose is to ensure low-income students have access to laptop computers to use at school

- The organization provides that it believes **only** low-income individuals would actually buy used laptops
- The organization's sole activity is to purchase name brand used laptops, refurbish the laptops when necessary, and sell the laptops over the internet to anyone willing to pay the asking price
- Reserves are used to pay board member compensation
- A substantial portion of the organization's income is devoted to advertising of laptops for sale on various internet sites where likely buyers might visit
- All of the organization's income is from laptop sales revenues; no solicitation for public donations will be made

### **Page 18 - Charitable vs. Substantial Nonexempt Purpose**

How about Scenario 2? Is the organization in Scenario 2 formed for a charitable purpose or a substantial nonexempt purpose?

I would say that in the case of Scenario 2, based on Treasury Regulations 1.501(c)(3)-1(e)(1), the primary purpose of the organization appears to be the operation of an unrelated trade or business as defined under Code section 513 and therefore, the organization does not qualify for exemption under Code section 501(c)(3).

I agree. When considering the five major factors provided in *Airlie Foundation, Inc. v. U.S.*, the organization is operated for a substantial nonexempt purpose:

- The organization directly competes with for-profit businesses selling used laptops over the internet
- The organization sells the laptops at fair market price and does not limit laptop sales to low-income students
- The organization uses its reserves to pay board member compensation rather than on charitable programs
- The organization uses commercial promotional methods and incurs substantial fees for advertising
- The organization is supported by laptop sales revenues and does not solicit for public donations

### **Page 19 – Supplemental Resources**

Although the list is not all inclusive, on this slide are some supplemental resources on this topic. Thank you for your participation!