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NOT-FOR-PROFIT ENTITY ACTIVITIES AND INCOME:
CHALLENGES TO CONTINUING TAX- EXEMPT
STATUS

by
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Richard J. Kraus**

INTRODUCTION

Many places of worship and other community organizations today wish to continue the purposes for which they were founded. But they lack contribution income sufficient to continue their religious, literary, educational, artistic or charitable purposes. These not-for-profit entities must find methods of using resources available to them for the maintenance of their missions without creating threats to their tax-exempt status.¹

Not-for-profit corporations and other entities organize and market themselves, as do for-profit businesses. Not-for-profit organizations, however, seek to serve a public or mutual benefit purpose other than the pursuit of accumulated profit. The United States Congress and state legislatures recognize the fact that certain traditionally charitable or religious enterprises are tax exempt because of the public purposes they pursue.²

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A not-for-profit enterprise is not prohibited from obtaining funds by contribution or even by sale or rental of personal or real property.³ Legislatures, of course, describe the purposes for which these funds may be used. If a not-for-profit organization engages in fund producing activities, unrelated to its purposes, the entity's tax-exempt status may be revoked.⁴

This article proposes to describe the formation of not-for-profit entities for tax-exempt purposes, cautions concerning the activities of those organizations and some methods for keeping the tax-exempt status of a not-for-profit despite the existence of unrelated business income and even substantial related income.

FORMATION OF THE TAX-EXEMPT ENTITY:
PLANNING AND ACTING WITH CAUTION

The Formation Articles

The Internal Revenue Code clearly states that a not-for-profit organization may submit an IRS Form 1023 and organizational articles stating its not-for-profit purpose and structure. The organizational articles will describe the particular entity by articles of incorporation, articles of association or trust agreement.⁵

The organizational articles of the not-for-profit will describe how the organization is not created for profit and that no part of its earnings will yield benefit to any private shareholder or other interested person. The articles will indicate that the organization is formed for religious, scientific, literary, educational, artistic or charitable purposes that benefit the public at large. No substantial portion of the not-for-profit's activities may be used to influence legislation. The organization may not participate in political campaigns

whether by active endorsement or by substantial donations. Illegality and violations of fundamental public policy cannot occur.⁶

In October 1975, Aid to Artisans, Inc., for example, organized itself as a not-for-profit Massachusetts organization.⁷ The organizers wanted to promote and sell the handicraft output of disadvantaged artisans in developing societies of the world, so as to improve and expand that output. Its Articles of Organization were part of its completed Form 1023 "Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code". These Articles, as amended, used language from the Code in listing its purposes:

The prosecution of charitable, scientific and educational purposes, with no part of the net earnings of the Corporation to inure to the benefit of any private individual, nor any substantial part of the activities of the Corporation to be the carrying on of propaganda, or otherwise attempting, to influence legislation, and with no participation in, or intervention in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office, and, in particular, the promotion, improvement and expansion of the handicraft output of disadvantaged artisans in developing societies of the world by providing assistance and support in the areas of marketing, quality control standards, financing and related areas.⁸

The organization described a number of types of assistance to the artisans. The corporation would market the handicrafts to museums and other not-for-profit agencies for sale to interested buyers. United States exhibitions and newsletters concerning the work would solicit need for support.

If the corporation began to experience any profit, that money would be used to provide technical and material support to the artisans.

The Internal Revenue Service refused to grant the organization tax exempt status because it was not satisfied with the organization's definition of "disadvantaged artisan" nor that the artisans themselves were in fact members of this category. Aid to Artisans contended that its activities served public rather than private interests, were undertaken for charitable purposes and, therefore, qualified it as a tax exempt organization.

The United States Tax Court agreed with Aid to Artisans. The Court reasoned that the operational test applied to the entity indicated that the organization's primary activities and purposes were tax exempt and further one or more tax exempt purposes; that a substantial part of the organization's activities do not further non-exempt purposes nor do they serve private interests. The court indicated rather that the organization sought alleviation of economic distress, artistic and cultural education, preservation of authentic handicraft and economic stability in disadvantaged communities. Aid to Artisans, therefore, was entitled to an exemption from income tax pursuant to IRC 501(a).⁹

Aid to Artisans cautions any legal or tax advisor. An exhaustive review of Section 501(c)(3) of the Internal Revenue Code with the client will help the practitioner determine the exact organizational purposes that benefit the public. The application for tax-exempt status will then be clear and concise. The practitioner will select the correct type of tax exempt entity.¹⁰

A considerable number of entities are treated as not-for-profit organizations; the Code treats these organizations as tax-exempt because of that designation. Those entities most ordinarily associated with the not-for-profit status are religious, charitable, scientific, literary, educational, artistic, healthcare and animal cruelty prevention organizations. Civic leagues operated for social welfare purposes, agricultural organizations, chambers of commerce, boards of trade, fraternal clubs and veterans associations, credit unions operated for mutual purposes and without profit, legal services and trusts for public benefit are also tax-exempt. Social philanthropy, expressed through care for culture and others, forms the framework in which such organizations are treated as operating on a not-for-profit basis and through which tax-exempt status is offered to them¹¹.

It is also important to advise the client to keep the not-for-profit purpose of the organization continually in mind. Clients should minimize activities that would impair the not-for-profit tax exempt status. For example, the organization's compensation and private benefit policies require close scrutiny; substantial lobbying efforts and political campaign contributions must be avoided.

Caution Concerning Salaries and Benefits to Insiders

The IRS will scrutinize excessive salaries which do not reflect a difference between a not-for-profit entity's salaries and those in the for-profit sector. The Service may revoke the tax-exempt status of the organization for this violation¹². In addition, excessive benefits to inside individuals may result not only in a loss of tax-exempt status, but also in the imposition of considerable excise taxes ranging from five to one hundred percent. The Service will scrutinize transactions in which the value of the benefit given to an insider exceeds the value of the

consideration which the not-for-profit receives from that insider or others. It will also penalize dealings in which the revenues of the not-for-profit determine the insider's economic benefit as if a partnership existed between the insider and the entity¹³

Forbidden Private Benefits

Not only can the entity's activities not benefit an insider; the private interests of any individual or organization may not be served. The organization must benefit individuals recognized as objects of charity (for example, the poor or distressed) or the entity may promote religion, science, literature, education, health, art or fellowship for the benefit of the public at large. Private benefit to a non-insider, however, is not forbidden in all cases¹⁴. The private benefit must be a substantial part of the entity's business in order to jeopardize its tax-exempt status.

Penalized Substantial Lobbying Efforts

The substantiality test applies to the entity's lobbying attempts – such a portion of the organization's activities may not be to influence legislation. Legislation includes any action by the Congress and any state or local governing bodies to pass bills or resolutions. It does not include attempts to influence decisions by executive, judicial or administrative bodies. The entity may not contact, or urge the public to contact, members of a legislative body for the purpose of proposing or opposing legislation. The organization itself may not advocate the adoption or rejection of legislation. An organization, however, may conduct educational meetings and prepare materials in an educational manner without jeopardizing its tax-exempt status. If the organization violates this prohibition, the IRS may levy an excise tax against the entity, equal to five (5%) percent of its

lobbying expenses for the year in which it ceases to qualify for exempt status. In addition, organization managers may be liable for an additional five (5%) percent of those expenditures¹⁵.

The Service also makes available an option under IRC Section 501(c) to use the expenditure test. The organization may lobby without jeopardizing its tax exempt status provided the expenditures do not exceed a proportionate amount of its income not to exceed one million (\$1,000,000) dollars. An organization which engages in excessive lobbying must pay an excise tax equal to twenty-five (25%) percent of the excess expended in its lobbying efforts¹⁶. Cases continued to examine the meaning of "proportionate amount". In any event, caution should be practiced in this area.

Dangerous Political Campaign Activity

The Internal Revenue Code absolutely forbids not-for-profit organizations from directly or indirectly participating in any political campaign through private contributions or public statements. The organization may, however, engage in educational and voter registration campaigns, so long as it neither favors nor opposes any candidate. An individual member of the organization is free to endorse any candidate as long as it is clear that the endorsement is not that of the organization. The entity must afford equal opportunity for all candidates to participate in any public forum sponsored by the organization. Any participation in a political campaign jeopardizes the tax-exempt status of the entity. Any political expenditures are subject to an excise tax of ten (10%) percent in regard to the organization and two and a half (2.5%) percent against its managers. If the expenditures are not corrected through their recovery to the extent possible, the Service may levy an additional tax equal to one hundred (100%) percent of

the expenditures against the organization and fifty (50%) percent of the expenditures against its managers¹⁷.

The practitioner must advise the client to file the required documents in order to form the proper type of organization. The client must not engage in the explicitly forbidden activities described above. But if contributions begin to dwindle, the continued existence of the enterprise may be in jeopardy. Many tax-exempt organizations have already begun to tap unrelated business income sources in order to maintain themselves. The next section of this paper explores the Code regulation and taxation of unrelated business income. The tax-exempt organization may also be exempt from tax upon funds obtained from these sources.

METHODS FOR KEEPING THE TAX-EXEMPT STATUS OF A NOT-FOR-PROFIT DESPITE THE EXISTENCE OF UNRELATED BUSINESS INCOME AND SUBSTANTIAL RELATED INCOME

Unrelated Business Income

UBIT Regulation:

The Internal Revenue Code and the Tax Regulations permit tax-exempt organizations to engage in income producing activities unrelated to their tax-exempt purposes. These activities, however, are subject to income tax liability if the following three conditions are met: the activity constitutes a trade or business; the trade or business regularly occurs; the trade or business is not substantially related to the entity's tax-exempt purposes. The entity, furthermore, may lose its tax-exempt status if the unrelated activities are a substantial part of the organization's activities¹⁸.

In 1947, New York University acquired the Mueller Noodle Company in order to obtain income which would assist its tax-exempt educational purposes. The pasta manufacturing business was certainly a regular business and bore no relationship to the educational purposes. Its income, therefore, is taxable and not exempt, at least under present law. NYU could even have lost its tax-exempt status if it operated the Company, and the business was a substantial part of its activities¹⁹. If NYU however, operated a student cafeteria, its income would be substantially related to its purpose and would be tax exempt. Mueller Company dividends, as passive income from an NYU investment, would also be tax-exempt. Donations from the Company to the University to create an endowed tax chair would not qualify as taxable because such gifts are always exempt²⁰.

Many other forms of business activity are subject to the unrelated business income tax if the business activity is not substantially related to the exempt purpose of the organization. Income from the sale of advertising constitutes unrelated trade or business income²¹. Most forms of gaming are considered unrelated trade or business. Bingo games, however, have a special tax-exempt exception, as long as the bingo game (1) is conducted in its traditional form and not as an instant lottery, (2) does not compete with for-profit organizations in the area, and (3) does not violate any local law. The sale of merchandise and publications may be considered an unrelated business, but only if the items do not have a substantial relationship with the exempt purposes of the entity²².

The practitioner may recommend that unrelated business activities be conducted by a separate for-profit organization by way of contract, parent-subsidiary relation or joint venture so as to not dilute the not-for-profit purposes of an entity. No control over the business activity resides in the

exempt organization. Arrangements between the parties must emphasize the business activity's exempt benefits to the exempt entity's mission²³. The business corporation or other enterprise may then be able to contribute its net income to the not-for-profit organization. New York University and other charitable entities have chosen this path. Most contemporary social entrepreneurs, however, have not chosen this alternative, but have instead framed their enterprises to fit within the exceptions listed by the Code and Regulations concerning the unrelated business income tax (UBIT).

Exceptions to UBIT Regulation:

The Code and the Tax Regulations allow that income from the activities of a not-for-profit entity may escape income tax liability if the income production meets one of the following exceptions: the work is performed by volunteers; the activity primarily assists its own members; the sale of donated merchandise occurs²⁴. The law also permits rents from real property, royalties, capital gains and interest and dividends to be exempt from the unrelated business income tax unless any of these activities are financed with borrowed money²⁵. Such a financing arrangement is commercial in nature and will be taxed because the income from the rentals or other activities must be used to repay the outstanding loan.

The rental fees must constitute actual rentals from passive real estate, rather than payment for services provided to outsiders. The Internal Revenue Service has ruled that a University communications tower permanently affixed to its property could rent excess capacity on its satellite dish to a paging company without being subject to income tax on unrelated business²⁶. An exempt organization may rent out its meeting hall, providing utilities and janitorial services, without tax liability²⁷. An entity may lease parking lot space for

customary parking service in relation to the tax exempt purpose, but not rent to tenants²⁸. The Service has also indicated that rental charges to maintain the real property such as attendance, security, and clean-up are not subject to tax, whereas services for the renters' benefit such as set-up of chairs, tables and public address systems are not exempt²⁹.

Related Business Income

Court and IRS rulings have indicated that certain not-for-profit activities will be exempt from tax and will not affect the tax-exempt status of the organization if the activity is substantially related to the exempt purposes of the organization. As already noted above, an organization which sold artifacts produced by poor artisans from other countries was permitted to keep its tax-exempt status and its tax-exemption because its profits were used for the entity's charitable purposes³⁰.

A religious publisher has been permitted, furthermore, to continue its work as a tax-exempt and not-for-profit organization despite the significant profits earned by the religious press³¹.

In 1931 three Presbyterian ministers obtained a corporate charter for the Presbyterian and Reformed Publishing Company in order to

...state, defend and disseminate (through every proper means connected with or incidental to the printing and publishing business) the system of belief and practice taught in the Bible, as in that system is now set forth in the Confession of Faith and Catechisms of the Presbyterian Church in the United States of America...³²

The corporate charter required that any income was to be used to improve its publications, to extend its influence and to support Presbyterian institutions. In 1939, the Internal Revenue Service granted the publishing Company tax-exempt status indicating that the corporation's works were religious in nature and that its activities, therefore, were exempt from income tax

From 1931 through 1969, Samuel, Charles and Bryce Craig, operated the Company without any compensation for themselves. Two of the three brothers made loans to the Company in order to keep it functioning. Editing, packing and shipping tasks and clerical work were done by volunteers. In 1969, the business experienced an increase in financial activity because of a series of best sellers written by a minister and published by the Company. This increased economic success enabled the company to pay its workers, repair its equipment and to make contributions to affiliated religious organizations. In accord with disclosure requirements, the Company filed annual reports. In 1980, the Internal Revenue Service revoked the Company's tax-exempt status. The Service reasoned that the Company was not now "operating exclusively for purposes set forth in 501(c)(3)" and was "engaged in a business activity which is carried on similar to a commercial enterprise."³³ The Service applied the revocation retroactively to January 1, 1969.

The publishing company appealed the revocation to the United States Tax Court which upheld the IRS decision but ruled that the retroactivity portion of the decision was an abuse of discretion³⁴. The Tax Court did, however, set a revocation date at 1979. The Company's substantial commercial activities since that date, evidenced by greatly increased profits, undermined the exempt purpose of the organization. The Company additionally was distributing its books in part through a commercial publishing house, thereby competing with commercial publishers. The Company had in effect

converted itself to a commercial enterprise by marketing its books to obtain more readers, by paying workers, by its substantial royalties, by its formal contracts with authors and by its failure to formally affiliate itself with any church organization³⁵.

In 1984, the United States Court of Appeals for the Third Circuit reversed the Tax Court decision; it decided that the successful operation of a tax-exempt organization does not transform its business into a commercial enterprise³⁶. The Court of Appeals reasoned that increased economic activity should not automatically forfeit the tax-exempt status of an enterprise. The Publishing Company continued to operate for tax-exempt purposes and the benefit from the company's operation did not inure to the benefit of any private shareholder or individual.

The Court indicated that the Company certainly continued to operate for tax-exempt purposes. The Court noted the legislative history of the tax exemption Code provisions. The original sponsor of Section 501(c)(3) in the United States Senate described the religious publishing house as a primary example of a tax-exempt organization:

The corporation which I had particularly in mind as an illustration at the time I drew this amendment is the Methodist Book Concern, which has its headquarters in Nashville, which is a very large printing establishment, and in which there must necessarily be profit made, and there is a profit made exclusively for religious, benevolent, charitable, and educational purposes, in which no man receives a scintilla of individual profit. Of course if that were the only one, it might not be a matter that you would say we would be justified in changing these provisions of law to meet a

particular case, but there are in greater or less degree such institutions scattered all over this country. If Senators will mark the words, the amendment is very carefully guarded, so as not to include any institution where there is any individual profit, and further than that, where any of the funds are devoted to any purpose other than those which are religious, benevolent, charitable, and educational.³⁷

The company was organized exclusively for the exempt purpose because it had no commercial motive but sought, through its activities and its management decisions, to remain closely affiliated with the Orthodox Presbyterian Church. The company used its substantial profits for a religious purpose. This religious purpose was not diluted by the accumulation of funds to purchase or build an office or warehouse so that the mission of the company might even be expanded³⁸.

The company's profits did not inure to the benefit of any private individual or shareholder. No person was to receive a ten (10%) percent portion of the Company's gross income instead of a salary, as occurred in the case of L. Ron Hubbard, the founder of the Church of Scientology³⁹. The Company paid salaries which rose from \$550 in 1972 to about \$57,600 in 1979, but no one person received a salary greater than \$15,350 and five individuals were paid under \$6,250. The Court observed that, in the circumstances, the salaries "were relatively modest."⁴⁰

The practitioner then may rely on the *Presbyterian and Reformed Publishing Company* decision to advise a client concerning business activities substantially connected to the client's charitable purpose. A Service General Counsel's memorandum which antedates the decision reinforces this conclusion: a not-for-profit organization should be able to

operate a business if that business is substantially connected to its charitable purpose.

For some time now it has been increasingly apparent that our earlier approach to the problem of permissibility or non-permissibility of business activities of charities has been based on misconception that somehow in the enactment of the provisions for exemptions of charities from income tax, Congress intended an implied restriction on the extent of their engagement in business activities. In the years past, the Service sought by ruling and by litigation to deny the right of charities to engage in business, insisting that somewhere, somehow in the enactment of the exemption provisions Congress must have intended to limit the classifications of exempt charities to those charities not engaged to any substantial extent in commercial endeavors⁴¹.

The Internal Revenue Service and Court decisions, however, continue to scrutinize the substantiality test in both of its applications: the income, whether from an unrelated or substantially related business, must be exclusively used for a charitable purpose and may not inure to the benefit of any private individual; if the income stems from unrelated business activity, the income should not be a substantial part of the charity's operation. Court decisions seem to permit substantial operations to be tax-exempt and not to affect an entity's tax-exempt status so long as the income is exclusively used for charitable purposes, but the Service continues to examine any substantial business activities in which an exempt organization engages.

CONCLUSION

The Internal Revenue Code and its court and Service interpretations require that the practitioner exercise considerable caution in advising not-for-profit clients. Clients must follow the Internal Revenue Code formation articles strictly. The charitable organization must be organized for charitable purposes and not improperly compensate its employees or board members through salaries or private benefits; substantial lobbying efforts and political campaign contributions need to be avoided. Clients must understand the definition of unrelated business income and exceptions to the rule of UBIT regulation such as the sale of donated merchandise, real property rentals, royalties, capital gains, interest and dividends. Finally, the practitioner needs to clearly describe related business income and the present controversy concerning its taxability in accord with the substantiality test. The formation of separate for-profit entities which contribute business profits to the tax-exempt entity may be the most acceptable alternative at this time to the related business income problem addressed by the *Presbyterian* decision but still resurrected by the Internal Revenue Service.

ENDNOTES

¹ Places of worship and other community organizations in New York City, for example, possess land and even buildings. Many of these entities, however, lack the liquid assets necessary to the continuation of their missions.

² See, for example, the acknowledgement of this fact in the discussion of charitable exemption problems held before the Senate Finance Committee and the House Ways and Means Committee in early 2005, available at <http://waysandmeans.house.gov/hearings.asp?> and at <http://finance.senate.gov/sitepages/hearing0305.htm>.

³ See the discussion of charitable tax exemptions for income obtained not only from contributions but also from investment income which follows.

⁴ The Internal Revenue Service continually confronts situations in which not-for-profit organizations obtain profits from business, but the business purports to use income for charitable purposes. See, for example, *Presbyterian & Reformed Publishing Company v. Commissioner*, discussed infra.

⁵ IRC 501(c)(3), 26 U.S.C. Section 501(c)(3).

⁶ Id.

⁷ See *Aid to Artisans, Inc. v. Commissioner*, 71 T.C. 202 (1978).

⁸ Loc. Cit. at 203.

⁹ Loc. Cit. at 215.

¹⁰ U.S.C. Section 501(c)(3) lists organizations eligible for tax-exempt status: Corporations, and any community chest, fund or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation, and which does not participate in, or intervene in, (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.

¹¹ This description merely amplifies by example the organizations already listed in Section 501(c)(3).

¹² Id.

¹³ Id.

¹⁴ Id.

¹⁵ 26 U.S.C. Section 503.

¹⁶ Id.

¹⁷ Id.

¹⁸ See Treasury Regulation 1.501(c)(3)-1(e)(1).

¹⁹ See Law School to Get Company's Profits, N.Y. Times, Oct. 3, 1947 at 27 quoted in the article of Ethan G. Stone, *Adhering to the Old Line: Uncovering the History and Political Function of the Unrelated Business Income Tax*, 54 Emory Law Journal 1475 at 1556.

²⁰ Loc. Cit. at 1482.

²¹ See Treasury Regulation 1.501(c)(3)-1(e)(1).

²² Id.

²³ See Plunkett and Christianson, *Exempt Organization Law: The Quest for Cash: Exempt Organizations, Joint Ventures, Taxable Subsidiaries and Unrelated Business Income*, 31 WILLIAM MITCHELL 1 (2004).

²⁴ Id.

²⁵ Id.

²⁶ Private Letter Ruling 98-16027.

²⁷ Revenue Ruling 69-178.

²⁸ Private Letter Ruling 93-11024.

²⁹ Private Letter Ruling 98-35001.

³⁰ See *Aid to Artisans, Inc. v. Commissioner*, 71 T.C. 202 (1978).

³¹ See *Presbyterian & Reformed Publishing Company v. Commissioner*, 743 F. 2d 148 (3d Circuit, 1984).

³² Loc. Cit. at 150.

³³ Loc. Cit. at 151.

³⁴ See *Presbyterian & Reformed Publishing Company v. Commissioner*, 79 T.C. 1070 (1982).

³⁵ Loc. Cit. at 1078.

³⁶ See *Presbyterian & Reformed Publishing Company v. Commissioner*, at 152 ff.

³⁷ Loc. Cit. at 153.

³⁸ Loc. Cit. at 156-157.

³⁹ See *Founding Church of Scientology v. United States*, 397 U.S. 1009 (1969).

⁴⁰ See *Presbyterian & Reformed Publishing Company v. Commissioner*, at 154.

⁴¹ General Counsel Memorandum 34,682 (Nov. 17, 1971).

An Effect of the Revision to the
New York Mental Hygiene Law
on General Contract Law

by

Winston Spencer Waters*

INTRODUCTION

This article examines the common law doctrine of contracts involving persons deemed to be adjudicated and non-adjudicated mentally incompetent. It reviews the current case law in New York as it relates to contracts of persons deemed to be "incapacitated" pursuant to Article 81 of the Mental Hygiene Law. The article attempts to outline the similarities and differences between general contract law and the Mental Hygiene Law as they relate to contracts of the "incompetent person" and the "incapacitated person." The burden of proof required to establish "incapacity" pursuant to the Mental Hygiene Law and mental capacity required to enter into a contract is also discussed.

I. TRADITIONAL CONTRACT LAW

Early New York Court of Appeals cases clearly established the contract rules regarding adjudicated and non-adjudicated incompetents. A contract made with a person duly adjudged incompetent and for whom a committee has been appointed is void¹ and a contract of a non-adjudicated

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