Training & Events

SkillBuilders

Raising Funds with an Auxiliary Business

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Does your organization need to diversify its revenue sources? If so, this half-day SkillBuilder is for you! You'll leave this session with the information and inspiration you need to launch a profit-making enterprise to fund – and perhaps directly further – your organization’s mission. The focus will be on legal and practical considerations.

This SkillBuilder will include:

- Discussion of structuring options, including whether a new entity might be needed
- Conversations with nonprofit officials who have developed successful auxiliary businesses
- An overview of federal tax implications, including preservation of tax-exempt status and the unrelated business income tax (UBIT)

Who Should Attend: Executive Directors and Board members

Presenter(s): Leonard Cole
Panelist(s): Stephen Bolton, Donald Gean
Date: Thursday, August 12, 9:00 am - Noon
Fee: Member: $50, NonMember: $100
Location: Iris Network, Portland
Address and Directions
Google Map
Course ID: FR-79

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Raising Funds with an Auxiliary Business

Presented by:
Leonard Cole, PretiFlaherty
Stephen Bolton, Habitat for Humanity of Greater Portland
Donald Gean, York County Shelter Programs, Inc.

Maine Association of Nonprofits, August 12, 2010

What is an “auxiliary business”?

An activity conducted by a nonprofit organization which:

- is conducted primarily for profit (*business*) and
- is not the organization’s primary activity (*auxiliary*).

→ Not a legal term.

AGENDA

Scope: legal and practical considerations

- Success stories
- Non-tax legal issues
- Federal tax issues
- Questions & sharing of ideas

Non-tax legal issues: Corporate structure

Some reasons to form a new legal entity:

- To isolate liability
- To avoid UBTI

  (more on “unrelated business income tax” later)

- To use the subsidiary in a partnership

Non-tax legal issues: Corporate structure

Some reasons ***not*** to form a new legal entity:

- To preserve *property tax exemption*
- To reduce income tax liability by deducting allocable portion of nonprofit's overhead
- To avoid the expense of an additional entity: administrative, legal, accounting
- To avoid the hassle of an additional entity: governance, reporting, doing business

Non-tax legal issues: Corporate structure

If we need a new entity, what are the best options?

- Corporation
  - for-profit or nonprofit
  - ***Must be a corporation to qualify for ME property tax exemption***
- LLC
  - Versatile tax status – check-the-box regime
  - Can be disregarded for ***income*** tax purposes
- Partnership

Non-tax legal issues: Business-related issues

Employment-related issues

- Unemployment insurance
- Workers Comp insurance
- Others

Non-tax legal issues: Business-related issues

General business issues

- Licensing and registration requirements
- Insurance
  – Casualty and liability
  – Director & Officer
  – Other
- Contracts

Federal tax issues:

Primary federal tax issues:

- Will conducting a business affect the organization's tax-exempt status?
- Will profit from the business be subject to income tax?

Federal tax issues: Related or unrelated?

Several tax issues hinge on whether the business is

RELATED or UNRELATED

to the organization's "exempt purposes,"

i.e., the purposes for which exemption is granted.

Federal tax issues: Related or unrelated?

An organization's business is UNRELATED if it is

- not *substantially related* (other than through the production of funds) to the exempt purposes.

Federal tax issues: Related or unrelated?

A business is not *substantially related* unless:

- the conduct of the business activities has a ***substantial causal relationship*** to the achievement of exempt purposes (other than through the production of income); and

- the business ***contributes importantly*** to the accomplishment of those purposes.
  - Facts-and-circumstances determination

Federal tax issues: Effect on tax exemption

First tax question:

Will conducting a business affect the organization's tax-exempt status?

- Generally, the organization's tax-exempt status will not be affected if the business is conducted by a subsidiary corporation.
  - Attribution and the importance of corporate formalities
  - Private foundations: excess business holdings

Federal tax issues: Effect on tax exemption

If the business is conducted directly by the organization and is RELATED:

- **no negative effect on tax-exempt status** . . .

  . . . unless the business involves prohibited activity other than merely conducting a business, such as
  - Political campaign activity
  - Excessive lobbying
  - Actions contrary to strong public policy

Federal tax issues: Effect on tax exemption

If the business is conducted directly by the organization, is UNRELATED, and is the organization's PRIMARY PURPOSE:

- **501(c)(3) status is lost!**

Section 502 "feeder" organization: "An organization operated for the *primary purpose* of carrying on a trade or business for profit shall not be exempt from taxation under section 501 on the ground that all of its profits are payable to one or more organizations exempt from taxation under section 501."

Federal tax issues: Effect on tax exemption

If the business is conducted directly by the organization, is UNRELATED, and is *not* the organization's primary purpose:

- **no negative effect on tax-exempt status**, but
- the income may be subject to

unrelated business income tax (UBIT).

Federal tax issues: UBIT basics

Second tax question:

Will profit from the business be subject to income tax?

- If the business is conducted by a taxable subsidiary, the profits will generally be taxed.
- If the business is conducted by the tax-exempt organization, the profits may be taxed under UBIT.

Federal tax issues: UBIT basics

The unrelated business **income tax** (UBIT):

- a tax on unrelated business **taxable income** (UBTI)
  - at regular corporate income tax rates: <u>Federal and Maine</u>
  - Combined tax rates start at 18.5% and quickly go up to 33%
- applies to most all 501(c) organizations

Federal tax issues: UBIT basics

Unrelated business **taxable income** (UBTI) equals:

- gross income from an *unrelated business* (more later)

MINUS

- allowable deductions that are directly connected with the unrelated business.

Federal tax issues: UBIT basics

Federal UBIT rates:

0 – $50,000	15%
$50,000 – $75,000	25%
$75,000 – $100,000	34%
$100,000 – $335,000	39%
$335,000 – $10,000,000	34%

. . . etc.

Federal tax issues: UBIT basics

Maine UBIT rates:

0 – $25,000	3.50%
$25,000 – $75,000	7.93%
$75,000 – $250,000	8.33%
over $250,000	8.93%

Federal tax issues: UBIT basics

Payment and reporting:

- Quarterly estimated tax payments
- Annual tax return: Form 990-T
  - Public document

Federal tax issues: UBIT - regularly carried on

In addition to be "unrelated," to be subject to UBIT a business must be *regularly carried on*.

- Business activities will ordinarily be deemed to be regularly carried on if they
  - manifest a *frequency and continuity*,
  - and are *pursued in a manner*,

  generally similar to comparable commercial activities of nonexempt organizations.

Federal tax issues: UBIT – "Modifications"

The following income is excluded from UBTI:

- dividends, interest, royalties, and most rents
  - ***except*** such items of income from a controlled entity that are generally deductible to the controlled entity
- gains and losses from sales of investment property
- certain income from research performed
- certain amounts from controlled entities
- others

BUT: Income from debt-financed property is UBTI.

Federal tax issues: UBIT – Exceptions

The following are not unrelated businesses:

- Volunteer operations: A business in which *substantially all* the work in carrying on such trade or business is performed for the organization without compensation.
- Convenience operations: A business of a 501(c)(3) organization primarily for the convenience of its members, students, patients, officers or employees.
- Thrift shops: A business which is the selling of merchandise, substantially all of which has been received by the organization as gifts or contributions.

Federal tax issues: Taxable subsidiary issues

Generally, a taxable corporation owned by a tax-exempt organization is taxed the same as a corporation owned by one or more other taxable entities and/or individuals.

- Taxation of corporations and shareholders is beyond the scope of this presentation.

Federal tax issues: Taxable subsidiary issues

A tax-exempt shareholder is generally not taxed on dividends from its subsidiary and gain from the sale of its stock in the subsidiary.

- However, dividends are not public support for 501(c)(3) organizations that qualify as a public charity under a public support test.

Questions?

Leonard Cole
lcole@preti.com
(207) 791-3223