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SOCIAL ENTREPRENEURSHIP: CONSIDERATIONS FOR A NONPROFIT ORGANIZATION PURSUING AN “UNRELATED BUSINESS”

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Many nonprofit organizations are looking at the possibility of supplementing their income by pursuing one kind of business venture or another. Some of these are related to their principal charitable mission; others are business ventures completely unrelated to that charitable mission. While there is nothing wrong with a charitable, tax-exempt organization entering into any business, whether or not related to its mission, there are considerations of which all leaders of charitable entities should be aware. These considerations are summarized below.

1. You must determine whether the business venture is “related” or “unrelated” to the charitable purpose for which your tax exempt entity is organized. This seems like an easy determination to make, but is not. You must check with your accounting firm or a lawyer knowledgeable in the law and regulations governing charitable organizations. One example may illustrate the difficulty of predicting “relatedness.” A hospital can operate a pharmacy at which its patients can fill their prescriptions, and the “business” of operating the pharmacy is “related” to the hospital’s charitable mission; if the same hospital operates a pharmacy at which it also fills prescriptions for people not patients of the hospital, that portion of the “business” is considered unrelated.

2. Determining whether the business venture is “related” or “unrelated” is very important, because net income or profits from a related business is not taxed, while net income or profits from an unrelated business is taxed. If, after consulting with your accountant or attorney, you learn that the Internal Revenue Service will consider the business venture under consideration as “unrelated” to your organization’s tax exempt or charitable purpose, you must plan to pay taxes on the profit your organization earns from this business. Profits from such a business is called “unrelated business taxable income.”

3. The amount of unrelated, taxable income must be monitored closely because, if the venture is very successful, its operation can threaten your organization’s tax exemption. The IRS requires that a tax exempt, charitable organization be operated exclusively for the charitable purposes for which it is organized. If the unrelated business income (“UBI”)

described in #2 above becomes too large, the IRS may conclude that this requirement is not met, and revoke the tax exempt status of your organization. How much UBI can a charitable organization have without threatening its tax exempt status? There is no clear answer, but most observers agree that, if UBI grows to be 15% or more of the organization's gross revenues, the organization should become concerned. If UBI is below that figure, there is not likely a problem, although your organization will be required to pay taxes on the unrelated income.

4. What should a charitable organization do with an “unrelated” business which produces or may produce enough UBI to threaten the organization’s tax exemption? Many organizations which have successful, unrelated businesses choose to put that business in a separate, for profit corporation, operated as a subsidiary of the tax exempt, charitable organization. If the businesses are operated separately, the for profit subsidiary can operate the unrelated business, pay taxes on the net income, and contribute all or some of the remaining net income to the charitable organization which may be its “parent.”

Some charitable organizations set up for profit subsidiaries even though the net income from the unrelated business will not threaten the charitable organization's tax exemption. Why do this? The board of the exempt organization may believe that the particular business in question can be operated more efficiently in a separate corporation, or it may desire to make sure that liabilities of the unrelated business do not become liabilities of the exempt parent, or it may wish to avoid the restrictions on tax exempt corporations by pursuing this venture in a separate for profit corporation.

5. Are there any risks associated with establishing a for profit subsidiary to operate an unrelated business? The answer is yes, and you should discuss this entire subject with your legal advisor. First, the for profit subsidiary must be operated separately, with separate books, separate board meetings, separately paid management, and separate tax returns. The failure to do so threatens the charitable organization's attempts to insulate itself from liabilities of the for profit subsidiary. Second, the organization must calculate the costs in maintaining the separateness of the for profit subsidiary.

This publication is intended to provide general information, and is not a substitute for legal advice. If you have additional questions about this issue, contact Community Legal Resources at 313/962-3171.

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