Unrelated Business Activities: Strategies for Coping

How much is too much? Options for Dealing with Unrelated Activities as They Become Substantial, including spinoff or organization of an unrelated activity, equity and other forms of compensation, and ongoing relations

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H. Unrelated Business Activities

A section 501(c)(3) organization can engage in activities unrelated to its exempt purpose as long as it is primarily engaged in activities in furtherance of its exempt purposes.

1. How Is Unrelated Activity Level Measured?

In this regard, the *amount of income* generated by the unrelated trade or business has been ruled not to be the sole factor in determining whether or not the exempt status is jeopardized. The Internal Revenue Service (the "Service") looks at all the facts and circumstances, including the amount of the organization's *expenses* allocable to the activity. Priv. Ltr. Rul. 8038004 (May 28, 1980). In this regard, Priv. Ltr. Rul. 7849003 (Aug. 17, 1978) concluded that the appropriate measure of business activity is *gross income* (rather than gross receipts).

2. How Much Is Too Much?

The organization in Priv. Ltr. Rul. 7849003, which was exempt under Section 501(c)(6) of the Internal Revenue Code of 1986, as amended (hereinafter all section references are to the Code), derived 40% of its gross income and incurred 40%

of its expenses on unrelated business activities, and was held not to lose its exempt status as a result. In Priv. Ltr. Rul. 8038004, a Section 501(c)(3) organization whose unrelated business activities ("UBI"), sale of prosthetic devices to the public, constituted 46% of its gross income and activities was held to retain its exempt status. Also, where as much as 66 to 70% of an organization's gross income and 52 and 66% of the organization's expenses relate to unrelated business activities, the Service has taken the position that the organization is not primarily engaged in activities directed toward the fulfillment of its exempt purpose. Priv. Ltr. Rul. 7902006 (Sept. 22, 1978).

See also *Orange County Agricultural Society, Inc. v. Commissioner*, 893 F.2d 529 (2d Cir. 1990); Rev. Rul. 57-313, 1957-2 C.B. 316; *Indiana Retail Hardware Association, Inc. v. United States*, 366 F.2d 998 (Ct. Cl. 1966); *People's Educational Camp Society, Inc. v. Commissioner*, 331 F.2d 923 (2d Cir. 1964); and G.C.M 35480 (Sept. 17, 1973). In the *Orange County Agricultural Society* case, a section 501(c)(3) organization lost its tax-exempt status because one-third of its revenues were derived from unrelated business income. For approximately two weeks a year, the Society operated a racetrack and concession during its annual fund-raiser fair as a qualified public entertainment activity. During the rest of the year, the racetrack and concession activity is unrelated to the exempt purpose of the society. The revenue comprised one-third of the Society's revenues. In affirming the Tax Court, the Court of Appeals held that because the activity was substantial and was not in furtherance of its exempt purpose, the Society was not exempt. The court also found that interest-free loans from the Society to a corporation, whose shareholders were the Society's majority shareholders, constituted inurement of earnings to the private corporation receiving the loans.

In G.C.M. 35480, a cemetery's exempt status was revoked where it regularly offered and sold plants and flowers grown in its greenhouse to the general public. The memorandum states that UBI of greater of 15% of gross income could be used as an "administrative rule of thumb" for determining UBI as being "substantial," thereby threatening an organization's exempt status.