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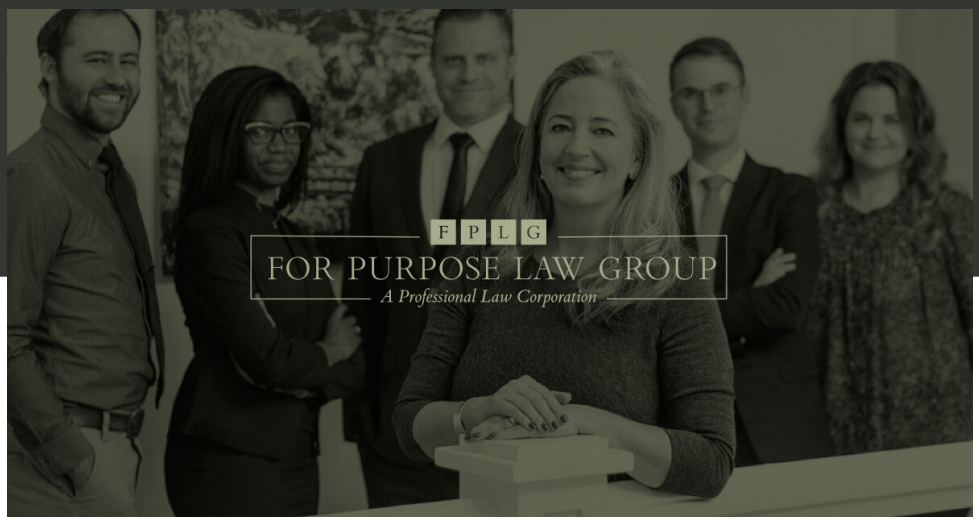
All Profits to Charity?: Not a 501(c)(3)

02.23.16 | Linda J. Rosenthal, JD



From time to time, folks come into our office with the idea of doing something like Newman's Own; that is, starting a business and donating all the proceeds to charity. They ask us to help them set up a 501(c)(3) organization.

They are often surprised to learn that Paul Newman and his partner set up that salad-dressing and pasta-sauce business as a for-profit company. It gives all *after-tax* profits to the Newman's Own Foundation, which in turn distributes the money to various charities.

Why Can't It Be a 501(c)(3)?

Section 501(c)(3) status is a tax exemption for nonprofit organizations that are organized and exclusively for charitable purposes.

Simply put, a business is organized and operated to make profits – even if the funds are eventually put to philanthropic purposes. A business that gives its profits to charity is called a "feeder organization."

Decades of legal precedent makes this clear. See e.g., *Piety, Inc. v. Commissioner*, 82 T.C. 193 (1984) [a company that holds bingo games and contributes profits to charities is operated for the primary purpose of carrying on a trade a business, and *not* operated exclusively for an "exempt" purpose under section 501(c)(3)]

A brief historical note: Before 1950, these types of operations "were exempt from paying income tax, much like a nonprofit" and "this kind of operation was permitted a charitable tax exemption." But the business community started howling about the unfair competitive edge these firms enjoyed, and Congress passed a statutory ban of this practice. That's how we got the predecessor to Section 502 of the Internal Revenue Code:

Feeder Organizations: The Rule

Section 502(a) spells it out in about 90% plain English:

> *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.*

If an entity is organized 100% to carry out a trade or business for profit – but gives profits to charity – there's no wiggle room; it can't be a 501(c)(3) exempt organization.

If the business operation is less than 100% of the entity's focus, then the "primary purpose" test may come into play. The definition of "primary" in the tax exemption laws is squishy; there's no fine line:

> *There is no absolute dividing line for deciding the primary purpose of an organization; instead, it's decided case by case. If your nonprofit runs a small business, it may come down to how much of the nonprofit's activity is business and how much is tax-exempt work.*

So there may be a tax exemption under section 501(c)(3), but the profits will likely be subject to the unrelated business income tax.

A bingo company or any other firm that conducts business as its *sole* activity is a "feeder organization" and that's that.

But – as usual – there are a few exceptions spelled out in Section 502.

Feeder Organizations: The Exceptions

Under section 502(b), "the term 'trade or business' shall not include":

- passive rental income;
- "substantially all" the work in carrying on the trade or business is volunteer; or
- a trade or business that sells merchandise, "substantially all of which has been received by the organization as gifts or contributions."

  Some common examples of these are certain thrift shops run by charities, but only if "most of the goods for sale come from donations, or if the staff is almost entirely volunteering for no ways. People who donate the clothing can take a tax deduction; shoppers at the store are getting something for the price, so they *can't* take a tax deduction – even though those funds, too, help

support the charities' mission.

Another example is a business operation that further's a charity's goals; for instance, "a business that hires the homeless to teach them marketable job skills might qualify as tax-exempt."

Businesses that are created to provide services to a "parent charity" may also be exceptions to the "feeder organization" rules. "A company you create –

> *to provide electricity to your charitable group, for example, could qualify as tax-exempt, even though it shows a profit. This only works if the service goes entirely to your charity, or to several affiliated charities. If the company provides service to unrelated charitable groups or the general public, it's just a for-profit business like any other.*

Conclusion

Hope springs eternal, and folks out there still keep trying to crawl out of the "feeder organization" designation.

In our next post, we'll tell you about a creative – but, alas – unsuccessful effort decided by the United States Tax Court, and then eventually, last year, shot down by the Ninth Circuit Court of Appeals.