

Unrelated Business Income Tax: Volunteer Labor Exclusion

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Having too much “unrelated business income” (UBI) is right up there with four other sure-fire ways to sink your valuable 501(c)(3) tax exemption: engaging in political-campaign activity, doing too much lobbying, setting up operations and activities that produce too much private benefit, and forgetting to file Form 990s.

The Unrelated Business Income Rules

In *The Fourth Way to Sink Your Tax Exemption: Too Much Unrelated Business Income*, we introduced the UBI concept along with the tax (UBIT) that results when you run afoul of the rules. We explained that many 501(c)(3)s are fully (or mostly) funded by donations from the general public or grants from the government or foundations. Some exempt organizations, though, generate income from activities that are “business-like” – for instance, selling products or services. Sometimes it’s ok; sometimes it’s not.

If an activity is “substantially related” to the group’s exempt purposes, the revenue won’t be taxed even if the money-making program otherwise looks like a business. On the other hand, if a 501(c)(3) operates a “**trade or business**” that is “**not substantially related**” to its stated exempt purposes, then the federal government may impose a special tax called the unrelated business income tax. This UBI tax applies even if the organization uses all of the generated revenue to carry out its goals and mission.

An organization thinking about extra revenue sources must know and understand the UBI rules. The bottom line: The proposed activity generates UBI subject to taxation if it meets *all three* of these tests:

- It is a “trade or business;”
- It is “regularly carried on;” *and*

- It is “not substantially related” to furthering the exempt purpose of the organization.

Each prong has its own definitions developed over the years by the IRS and the courts. If a 501(c)(3)’s proposed venture meet all three tests according to these established rules, there’s no wiggling out of it. That’s that, and the group will have to pay the unrelated business income tax. In addition, if it looks like the 501(c)(3) has far too much UBI, then the tax exemption is in serious jeopardy.

Happily, though, there are a few exceptions: Fit into one of these safe-harbor rules, and there’s no UBI tax. In this post, we explore the Volunteer Labor Exception.

Volunteer Labor Exception

The “volunteer labor exception” relates to the first prong of the UBI test; that is, whether there is a “trade or business.” If “substantially all the work in carrying on such trade or business is performed for the organization without compensation,” then you don’t have to worry about the next two prongs of the statutory test. *Internal Revenue Code section 513(a)(1)*.

The devil is in the details, though, including how the government applies the some of the terminology used in this statute. There’s some helpful guidance from a number of sources, including *Treasury regulation 1.513.1(e)* and IRS *Publication 598*, Tax on Unrelated Business Income of Exempt Organizations, as well as selected IRS revenue rulings and court decisions.

Consider these examples where there is **no** UBIT:

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Example 1. A 501(c)(3) orphanage operates a retail store with substantially all volunteer labor. (*Reg. Section 1.513-1(e)*)

Example 2. A tax-exempt, volunteer fire company holds weekly dances open to the public. Admission is charged, but unpaid volunteers perform the work. (*Rev. Rul. 74-361*).

Compare them to examples with the opposite result on a claimed volunteer-labor argument:

Example 3. A 501(c)(3) organization engaged in leasing activity. Although the work performed in connection with this activity is done without compensation, the volunteer labor exception does not apply because the performance of services is not a “material income-producing factor in carrying on the business.” (*Rev. Rul. 78-144*)

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Example 4. Workers at a casino operation of a tax-exempt organization receive tips “in lieu of salary.” The volunteer labor exception does not apply. (*Exec. Network Club. v. Comm., T.C. Memo 1995-21*)

But see –

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Example 5. At a monastery, the monks have taken a vow of poverty. They receive no “compensation” though they are given “food, clothing, shelter and medical care.” But all of the monks have these basic needs taken care of whether or not they work on the farm. “Ninety-one percent of the labor was performed by the Brothers without compensation and the volunteer labor exception applied.” *St. Joseph Farms of Ind. Bros. of Congregation of Holy Cross, Sw. Province, Inc. v. Comm.*, 86 TC 9 (1985), *nonacq.* 1986-2 CB 1. By the way, that “nonacq. 1986-2 CB 1” means that the following year, the IRS issued a revenue ruling indicating it doesn’t like the Tax Court’s *St. Joseph Farms* ruling. (In the words of the response by the Tax Court if it had made a comment, which it never does: “too bad.”)

The Usual Problem with Tax Statutes: Vagueness

As with many parts of the federal tax code, important words and phrases are thrown around without pinning down what they actually mean. The Fifth Circuit Court of Appeals correctly points out a problem with the “volunteer labor exception” to the unrelated business income tax: The term “substantially all” is not defined in Internal Revenue Code section 513(a)(1) or in any Treasury regulation. (The purpose of the Treasury Department issuing tax regulations is to fill in gaps and uncertainties into a statute written by Congress.)

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When analyzing all the facts and circumstances it is helpful to identify and compare the number of hours worked by people who work without pay and the number of hours worked by people who are compensated to determine if substantially all the work is carried on by unpaid volunteers. However, the existing court cases do not apply a set percentage test and the “substantially all” test is to be applied in a general manner. See Waco Lodge No. 166, Benevolent & Protective Order of Elks v. Comm., 696 F2d 372 (5th Cir. 1983)

Other terms in the UBI are similarly vague. “De minimus” amounts are not compensation, but there is no set definition of when an amount (or a payment in kind, like food or drinks) is “de minimus.” See *Waco Lodge, supra*. The term “compensation” itself appears to be interpreted expansively, which also creates problems of uncertainty:

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It may include payments to bartenders, waitresses, snack bar staff, maintenance workers, security, and other workers, as well as the tips that any workers receive....A worker who obtains goods or services at a reduced price in return for his services may also be considered to be compensated. See Waco Lodge, supra. At the same time, there must be a “but-for” connection between the payment and the services, such that the payment would not otherwise be received but for the provision of services. See St. Joseph Farms, supra.

Conclusion

The “volunteer labor exception” is an important safe-harbor rule for some organizations to escape paying the unrelated business income tax on key revenue-generating activities important to funding these groups’ missions and goals. But some additional clarity as to which activities qualify or not would certainly be helpful.