



Don't let the “commerciality doctrine” trip up your nonprofit

The commerciality doctrine was created along with the operational test to address concerns over not-for-profits competing at an unfair tax advantage with for-profit businesses. But even business activities related to your exempt purpose could fall prey to the commerciality doctrine, resulting in the potential loss of your organization's exempt status.

Several factors considered

The operational test generally requires that a nonprofit be both organized and operating exclusively to accomplish its exempt purpose. It also requires that no more than an “insubstantial part” of its activities further a nonexempt purpose. Your organization can operate a business as a *substantial* part of its activities as long as the business furthers your exempt purpose.

But under the commerciality doctrine, courts have ruled that some organizations' otherwise exempt activities are substantially the same as those of commercial entities. They consider several factors when evaluating commerciality, including:

- Whether an organization has set prices to maximize profits,
- The degree to which it provides below-cost services,
- Whether it accumulates unreasonable reserves,
- The use of commercial promotional methods such as advertising,
- Whether the business is staffed by volunteers or paid employees,
- Whether it sells to the general public, and
- The extent to which the nonprofit relies on charitable donations. (They should be a significant percentage of total support.)

No single factor is decisive for courts or the IRS.

Possible UBIT issues

There's another risk for nonprofits operating a business. You could pass muster under the commerciality doctrine but end up liable for unrelated business income tax (UBIT).

Revenue that a nonprofit generates from a regularly conducted trade or business that *isn't* substantially related to furthering the organization's tax-exempt purpose may be subject to UBIT. Much depends on how significant the business activities are to your organization as a whole. There are also several exceptions.

Seek advice first

If you're thinking about launching a new business to drum up additional revenues, consult us first. We can help reduce the risk that your organization will run into potential exemption or UBIT issues.

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