Accountability in the Non-Profit Community:
A Look at the Potential for 501(c)(3) Tax Evasion and Misused Donations
By April Fabregat-LeBlanc

Currently, there are millions of Internal Revenue Code Section (“Section”) 501(c)(3) tax-exempt public charities in the United States. A substantial number of these charities are committed to what would be classified as community economic development (“CED”) work. A growing concern among government regulators is the potential for tax evasion schemes involving Section 501(c)(3)’s that take advantage of their tax-exempt status and unfairly compete with private, tax-paying corporations. The Internal Revenue Service (“IRS”) has generated a list of frequent tax-evasion scams. Included on the IRS tax-scam list is the practice of non-profit organizations erroneously invoking the unrelated business income tax provisions to avoid paying taxes on certain income. Due to the IRS tax-scam list, individual donors should also be concerned about whether or not their donations to a Section 501(c)(3) organization are being spent on the Section 501(c)(3) organization’s stated exempt purpose.

501(c)(3) TAX EVASION: THE UNRELATED BUSINESS INCOME TAX

Given that state and federal tax agencies, such as the IRS, do not have sufficient resources to effectively enforce tax laws, including § 501 of the Internal Revenue Code, and given the growing number of tax-exempt organizations, there is a great potential for tax evasion.

A tax-exempt organization, such as a CED organization, is subject to unrelated business income taxes (“UBIT”) when the activity that is generating income (1) is not substantially related to the organization’s charitable purpose, (2) is regularly carried on, both in frequency and continuity, in a manner similar to that of comparable commercial activities of non-exempt organizations, and (3) constitutes a trade or business. All three prongs must be met in order for the organization to be taxed.

A tax-exempt non-profit must pay tax on income only if the income-generating activity is not substantially related to its charitable purpose. An activity is not substantially related to the non-profit’s purpose when the money itself, being earned from the activity, is the motivation for the activity. In other words, the end goal of the income-generating activity must be to support the charitable purpose or mission that is specified in the CED organization’s incorporating documents. If the charity does not spend the donated funds on its charitable purpose, the income
must be taxed for obvious reasons. This also raises questions for donors about how they can make sure that their donations are going to a charitable cause.

This requirement is demonstrated in *St. Luke’s Hospital of Kansas City v. U.S.* St. Luke’s Hospital, a 501(c)(3) non-profit, provided pathology tests for local doctors in exchange for a fee. St. Luke’s mission was to train new doctors. St. Luke’s argued that it needed the collected cell samples from the pathology tests, specifically the cancer cells, in order to properly train the new doctors in the classroom. The U.S. District Court ruled that by producing the needed samples, the hospital was promoting its tax-exempt mission and therefore the service revenue received was not taxable.

In the event that multiple activities are being undertaken by the CED organization, each income-generating activity is treated separately and all activities, or the funds derived therefrom, must contribute importantly to the CED organization’s purpose in order to be exempt from UBIT.

Second, a CED organization is subject to UBIT only if the income-generating activity is regularly carried on, both in frequency and continuity, in a manner similar to that of comparable commercial activities of non-exempt organizations. In the landmark case, *National Collegiate Athletic Association v. Commissioner of Internal Revenue*, the IRS argued that the NCAA March Madness Basketball Tournament was a regularly carried on business and was therefore subject to unrelated business income taxes. The NCAA successfully argued that the tournament was only produced and marketed for a few weeks each year, as opposed to the for-profit activities of the similar organization ESPN, which works year-round to produce its product.

Third and finally, a non-profit, tax-exempt organization must pay UBIT only if the income-generating activity constitutes an unrelated trade or business. An unrelated trade or business is characterized as one in which (1) there is a profit motive, (2) substantially all of the work is performed with compensation, (3) the sold goods or services were not goods received as a gift or donation to the organization, and (4) a substantial amount of participation is performed by the non-profit directly or indirectly through control of another organization.

In *Portland Golf Club v. Commissioner of Internal Revenue*, a Golf Club had participated in two activities (investing capital for profit and food sales to non-members). The Golf Club was successful in earning income from investing, but incurred a net loss in food sales to non-members. The Golf Club’s investment gains were subject to UBIT because it was regularly
and actively carried on by the Golf Club’s members, unrelated to its purpose, the income was not received as a gift, and there was a profit motive. The Golf Club claimed that the food sales were also taxable because the customers were non-members and therefore, the activity was not substantially related to its purpose. The Golf Club wanted the net loss in food sales to be taxable so they could deduct the loss against the investment gains, claiming both as taxable income. The Supreme Court ruled in favor of the IRS’ argument which stated that because the Golf Club was selling the food below the wholesale variable cost paid for the food, it had to be assumed that the Golf Club did not have a profit motive. Without a profit motive, the food sale activity did not constitute a trade or business and therefore, it was not taxable.

If income is generated in a passive manner, the income is not taxed because the non-profit is not actively engaging in the alleged trade or business. The recognized forms of passive income are interest earnings, dividends, royalty payments, rents from real property, and revenues from the sale of property. For example, in Sierra Club Inc. v. Commissioner of Internal Revenue, the Sierra Club was paid by a credit card company for use of its mailing list. The IRS unsuccessfully argued that the credit card marketing transactions constituted a regularly carried on business and, therefore, were taxable. The court sided with Sierra Club, holding that the payments it received constituted royalty payments, as defined by Black’s Law dictionary, were therefore passively earned by Sierra Club, and not taxable.

**INDIVIDUAL TAX EVASION THROUGH A 501(c)(3)**

In recent years, the IRS has caught on to a very specific type of tax-evasion. According to the IRS, in its 2010 Dirty Dozen Tax Scams list, one of the most common methods of tax evasion is through a Type III supporting organization, which is donor advised and therefore not controlled by the charity that it supports. The donor organization or individual gives money to a tax-exempt organization (created by the donor) and then gets the supposed donation back, tax-free, through offshore investments or interest-free loans to family, who eventually return the funds to the original donor. Effectively, an individual’s taxable income is laundered through the tax-exempt charity so that the donor can evade paying taxes on personal income. The funds may also simply be used by the donor as a board member of the charity. For example, a person may set up a Section 501(c)(3) tax-exempt charity in the U.S. and open a bank account for the charity. The person may then donate large amounts of personal income to the charity that he or she created and deduct the donations on personal income taxes. The money is then used by the
person, who is of course authorized to use the charity funds, for personal purposes, but reported as being used for charitable purposes on the Section 501(c)(3)’s 990 tax form. The I.R.S. does not provide information regarding specific organizations that have been caught during audits. Private inurement can cost a non-profit, tax-exempt organization its tax-exempt status, but only if the organization is caught. There are a number of organizations engaging in this type of illegal activity however, as previously mentioned, there are not enough state and federal tax enforcement resources to catch and punish organizations engaging in these types of illegal activities.

MISAPPROPRIATED PUBLIC DONATIONS

The second major concern for regulators and donors is that, as the public is donating to CED charities, there is no one checking to make sure that these organizations are really spending the donations on their purported charitable purposes or any charitable purpose at all.

Two years ago, a public charity called Ahava Kids, whose purpose was to help child victims of human trafficking and AIDS by operating a hotline and safe houses, was sued by Connecticut Attorney General Richard Blumenthal. Blumenthal claimed that Ahava Kids’ founder used roughly $100,000 in public donations for personal or inexplicable expenses at restaurants, department stores, grocery stores and sporting goods stores. An investigation revealed a safe house did exist, but that it was rarely used. In another example, the Gloria Wise Community Center (“GWCC”) received $875,000 from New York City’s Department of Youth and Community Development, Department for the Aging, and Department of Education, to be used for services for children and the elderly. Instead, GWCC improperly loaned the money to Air America Radio for non-exempt purposes. GWCC must now return $625,000 to the city.

SOLUTIONS

One possibility for accomplishing an accountability check to alleviate both of the aforementioned concerns is the creation of a formal accreditation body, similar to a legal advisory and certification board that can provide non-profit, tax-exempt organizations with a legal compliance and financial audit review as well as a certificate of transparency to better protect donors and to curb tax evasion.

Accreditation bodies such as the National Collegiate Athletic Association, the American Bar Association, and Commission on the Accreditation of Rehabilitation Facilities, were all created by willing participants, volunteers, and government organizations that saw a need for
organization and standards within each respective sector. The non-profit community also has such a need for accreditation standards that will increase financial transparency and enforce ethical and legal standards. Community economic development may be best served by an accreditation process that will act as both a marketing vehicle for non-profits who want to attract donors and assurance for donors.

Another similar, but potentially more feasible, solution may already be underway. Guidestar, a non-profit resource website founded in 1994, has opted for a less formal, but still potentially effective, approach. It has launched a program called the Guidestar Exchange Program and is in the process of encouraging its 2 million plus charities to participate. This free, optional program requires participating non-profits, including community economic development organizations, to provide an independent financial audit along with other general information. A charity who receives a Guidestar Exchange Seal by successfully completing the program increases its chances of receiving donations through the Guidestar website and acts as an incentive for other non-profits who have not achieved the higher starred status. Donors who regularly visit the website will now be able to screen out charities that have not opted for transparency and accountability.

The potential for tax evasion and misappropriation by Section 501(c)(3) organizations will grow as the number of these organizations grows if a solution is not implemented. All affected parties (regulators, donors, and competing private businesses) should be aware of the lenient reporting standards to which Section 501(c)(3) organizations are currently held. As donors become more aware of this problem, more accountability and transparency will be demanded of Section 501(c)(3) organizations and, in return, provide more piece of mind to donors.

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3 Id.
5 Id. All 3 prongs of the test must be met.
7 Id. at 86.
8 Id.
9 Id. at 86, 88.
10 Id. at 89.
11 Nat’l Collegiate Athletic Ass’n v. Comm’r of Internal Revenue, 914 F.2d 1417 (1990).
12 Id. at 1421.
13 Id. at 1422.
14 Treas. Reg. § 1.513-1(e)(1-3).
16 Id. at 157.
17 Id. at 158.
18 Id.
19 Id.
20 Id. at 171.
21 Id.
22 I.R.C. § 512(b)(13).
23 I.R.C. § 512(b)(1) – (3).
24 Sierra Club Inc. v. Comm’r of Internal Revenue, 86 F.3d 1526 (1996). See also Arkansas State Police Ass’n, Inc. v. Comm’r of Internal Revenue, 282 F.3d 556 (2002).
25 Id. at 1530.
26 Id. at 1527, 1529.
28 Id.
30 Id.
31 Id.