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Community Arts Q&A Series

**Income-Generating Activities, Part Two:
Sales of Food & Merchandise by Community Arts Organizations**

As part of its Community Arts initiative, Lawyers Alliance is providing a series of Q&As to help community arts organizations better understand the legal issues that arise from their income-generating activities. This Q&A is the second in that series. The first, on Ticket Sales and Admission Fees, may be found [here](#). For additional in-depth information on these topics, please see our publication entitled [Advising Nonprofits](#) or check out our ongoing live webinar and workshop series [here](#).

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Community arts organizations often stage performances, art exhibits, or other fundraising galas and special events at which they sell refreshments or merchandise. This memo explores some of the legal issues that arise from such sales, focusing primarily on (a) tax deductibility, (b) unrelated business income tax, (c) New York State sales tax and (d) internet sales. Of course, legal counsel should carefully review the specific facts and circumstances of any income-generating activity a nonprofit conducts to assess potential tax liability. Nevertheless, we hope that this memo, which is not intended as legal advice, will provide some helpful general information.

This memo addresses common questions relating to sales of food and merchandise at performances and events:

- Are purchases of food, beverages, or merchandise at their fair market value deductible?
- Are purchases of food, beverages, or merchandise at prices above their fair market value deductible?
- Does the nonprofit need to provide anything to the purchaser so he or she can take a deduction on goods or services purchased at above their fair market values?
- Does the amount the nonprofit spends on providing the goods or services determine their fair market value?
- Is the entire charitable donation still deductible when the nonprofit gives the donor a low-cost gift or benefit in exchange for the donation?
- When is an exempt nonprofit community arts group subject to UBIT?
- Is revenue that volunteers generate for a nonprofit taxable?

- Is income from the sale of goods that a nonprofit produces taxable when those goods are created in connection with the nonprofit's tax-exempt purpose?
- What tax rules apply when a nonprofit sells merchandise on the Internet?
- Is income derived from fundraising activities taxable?
- If a nonprofit is subject to federal UBIT, do additional New York State taxes apply, too?
- Is income a nonprofit generates from the sale of food, beverage, or merchandise subject to New York State sales tax?

Issue #1: Tax Deductibility of the Price of Food, Beverage, or Merchandise

Question 1A: Are purchases of food, beverages, or merchandise at their fair market value deductible?

Answer 1A: As a general rule, people who purchase food and beverages or other merchandise, such as CDs, T-shirts, posters, etc., at community arts events may not deduct the sales price of any such goods as a charitable contribution. In other words, if the nonprofit charges fair market value for these items, the price paid is not considered a charitable gift, but instead represents a payment for value and is not deductible.

Example: A tax-exempt community orchestra holds a concert. During the intermission, a patron purchases a CD of the orchestra's top recordings. The CD's fair market value is \$10, which is what the patron pays. The patron cannot deduct the CD's cost as a charitable contribution.

Question 1B: Are purchases of food, beverages, or merchandise at prices above their fair market values deductible?

Answer 1B: If a person pays more than fair market value for the food and beverages or other merchandise, a portion of the price paid may be deductible as a "quid pro quo" contribution. The IRS clearly states that if a person receives a benefit as a result of making a contribution to an exempt organization he or she can deduct only the amount of the contribution that is more than the value of the benefit received. This means that if a person pays more than fair market value to an exempt organization for goods or services, the excess may be considered a charitable contribution. For the excess amount to qualify, the person must pay for the goods or services with the intent to make a charitable contribution.

Example: A donor pays \$40 for popcorn and soda at a special showing of a movie for the benefit of a nonprofit music school. Printed on the ticket is "Price-\$40." If the regular price for the popcorn and soda is \$8, the donor's actual tax-deductible contribution is \$32 (\$40 payment – \$8 regular price).

Question 1C: Does the nonprofit need to provide anything to the purchaser so he or she can take a deduction on goods or services purchased at above their fair market value?

Answer 1C: If a person pays more than \$75 for food and beverages or other merchandise and that payment is partly a donation and partly in exchange for those goods or services, the nonprofit must provide the individual with a written statement that (i) the purchaser can only deduct the amount of the payment that exceeds the fair market value of the goods or services received and (ii) provides a good-faith estimate of the fair market value of those goods or services. The nonprofit should deliver this written statement at the time it solicits the payment and again when it receives that payment, in the event those times differ. Beyond this written statement, the nonprofit should not attempt to advise donors as to the deductibility of their contributions.

Example: A person pays \$80 for popcorn and soda at a special showing of a movie for the benefit of a nonprofit music school. The school provides the person with a written statement (i) informing the purchaser that he or she can only deduct the amount of payment exceeding the fair market value of the popcorn and soda and (2) estimating, in good-faith, that the fair market value of the popcorn and soda is \$8. (In this case, the person can deduct \$72; \$80 payment – \$8 fair market value.)

Question 1D: *Does the amount the nonprofit spends on providing the goods or services determine their fair market value?*

Answer 1D: The nonprofit's cost to provide the goods or services is not relevant when determining fair market value for deductibility purposes. Instead, it is the fair market value of the goods or services that governs. When there is no available market value for the goods or services provided, the nonprofit should make a good faith effort to estimate value, using a measure other than cost. However, if the goods or services are generally not available on a commercial basis, then no value need be provided.

Example: A CD has an established value of \$10. That value must be used, even if the actual cost to the nonprofit of producing the CD is substantially lower or higher.

Question 1E: *Is the entire charitable donation still deductible when the nonprofit gives the donor a low-cost gift or benefit in exchange for the donation?*

Answer 1E: The IRS provides a “safe harbor” under which the *full amount* of a donor's contribution is deductible when, in exchange for a charitable donation, a charity offers a donor a low-cost gift—or “token benefit.” But the safe harbor only applies if the donor receives merely an “insubstantial benefit” in return for the donation. An item or benefit is “insubstantial” if it falls within one of the following guidelines:

- the fair market value of all the benefits received is not more than 2% of the contribution or \$97, whichever is less; or
- the contribution is \$48.50 or more *and* the only benefits received by the donor are token items bearing the charity's logo, which cost, in the aggregate, less than \$9.70.

Example 1: A person makes a \$100 donation to a community choir. In return, the choir sends the person a CD of its highlight recordings from the past year. The CD's fair market value is

\$1.50, which is only 1.5% of the contribution. The CD is a token benefit, therefore the entire \$100 contribution is deductible.

Example 2: A person makes a \$50 donation to a nonprofit dance school. In return for the donation, the school sends the person a backpack and hat, both with the organization's logo stitched on them. The backpack costs \$6 and the hat costs \$2.50, therefore the person's entire \$50 contribution is deductible because the aggregate cost of the benefits he or she received is less than \$9.70 (\$8.50) and the contribution was more than \$48.50.

Issue #2: Unrelated Business Income Tax ("UBIT") on Sales of Food, Beverages, or Other Merchandise

Question 2A: *When is an exempt nonprofit community arts group subject to UBIT?*

Answer 2A: Even though a community arts organization is recognized as tax exempt, it may still need to pay unrelated business income tax ("UBIT") on certain income. An organization's UBIT liability will differ depending on the circumstances of each event. For most organizations, an activity is considered an "unrelated business", and therefore subject to UBIT, if the activity (i) is a trade or business,¹ (ii) is regularly carried on,² and (iii) is not substantially related to furthering the exempt purpose of the organization.³

The key element in analyzing sales of food, beverages, or merchandise by community arts groups for UBIT purposes will often be whether the activity is "substantially related" to the nonprofit's exempt purpose. The IRS indicates that an activity will be considered "substantially related" only when it both produces income for the organization and contributes importantly to the achievement of the organization's exempt purpose. In analyzing this element, the IRS looks at the size and extent of the activities in relation to the nature and extent of the exempt function that they intend to serve.

Example 1: A museum operates eating facilities, which help attract visitors, permit visitors to spend more time viewing the exhibits, and allow museum employees to remain in the museum throughout the day. Therefore, the facilities contribute importantly to the accomplishment of the museum's exempt purposes and are not unrelated trade or business.

¹ A trade or business generally includes any activity carried on for the production of income from performing services or selling goods.

² Activities of an exempt organization ordinarily are considered regularly carried on if they show a frequency and continuity, and are pursued in a manner similar to, comparable commercial activities of nonexempt organizations.

³ A trade or business is related to an organization's exempt purposes only when the conduct of the business activities has a causal relationship to achieving the organization's exempt purposes. In other words, the activity must not only produce income for the organization, it must also substantially contribute to the achievement of the organization's exempt purpose. To be substantially related, the activities that generate the income must contribute importantly to accomplishing the organization's exempt purposes.

Example 2: A museum operates a gift shop. The IRS will analyze each line of merchandise separately to determine if gift shop proceeds are subject to UBIT. For instance, selling reproductions of works from the museum's own collection is not considered an unrelated trade or business, but selling souvenirs of the city where the museum is located, which have no causal relationship to art or artistic endeavor, will be subject to the tax.

Example 3: A museum operates a gift shop, where it sells greeting cards featuring reproductions of works from *other* collections and museums. The greeting cards list artist names and other details about the images, like the names of the collections or museums where the works can be found. The sales are not subject to UBIT because they enhance public awareness of art, which contributes importantly to the achievement of the museum's mission.

Question 2B: Is revenue that volunteers generate for a nonprofit subject to Unrelated Business Income Tax?

Answer 2B: The tax code excludes from the definition of unrelated trade or business any trade or business in which substantially all the work for a particular activity is performed for the organization without compensation.

Example 1: A volunteer-operated bake sale held to benefit a community arts nonprofit will most likely not be taxable.

Question 2C: Is income from the sale of goods that a nonprofit produces taxable when those goods are created in connection with the nonprofit's tax-exempt purpose?

Answer 2C: The IRS excludes income from selling products that result from performing exempt functions if the products are sold in substantially the same state as when the exempt functions were completed.

Example: An exempt organization's exempt function is to rehabilitate disabled people using music therapy. As part of the rehabilitation process, these people produce recordings. The organization then sells the recordings. The organization is not engaged in an unrelated trade or business because the recordings are produced when the organization performs its tax exempt function.

Question 2D: Is income derived from soliciting support taxable?

Answer 2D: Although support soliciting activities may satisfy all three prongs of the UBIT test (trade or business, regularly conducted, unrelated to the organization's mission), the IRS normally does not subject income generated from fundraising activities to UBIT. The argument may be made that soliciting donations is not a trade or business because nothing is given in exchange for the donations. That said, the IRS could change its position on this issue at any time and legal counsel should be sought whenever questions arise regarding the applicability of UBIT to any income-generating activity.

Example: An exempt organization operates a fundraising department, charged with raising funds for the organization. Even though the department's activities may meet all the elements of the UBIT test, the IRS has historically refused to tax the funds the department raises.

Question 2E: *If a nonprofit is subject to federal UBIT, do additional New York State taxes apply, too?*

Answer 2E: In New York, organizations that are subject to federal UBIT are taxable under New York State Tax Law Article 13. Specifically, if an organization conducts trade or business in New York State that is unrelated to its mission, it must file Form CT-13 (Unrelated Business Income Tax Return) and pay any tax due regardless of the amount of income generated from the activity.

Example: A museum operates a gift shop where it sells souvenirs of the city where it is located. Because the souvenirs are not related to the museum's exempt function of raising public awareness of art (among others), proceeds generated from the souvenirs are subject to federal UBIT. In New York, these proceeds are taxable, too. Accordingly, the museum must file Form CT-13.

Issue #3: Sales Tax in New York State

Question 3A: *Is income a nonprofit generates from the sale of food, beverage, or merchandise subject to New York State sales tax?*

Answer 3A: Organizations that have secured exemption from New York State sales and use taxes will be exempt from paying New York State sales tax on items such organizations purchase, but not from collecting taxes on items the organization sells, to the extent such items are generally subject to New York State sales tax.

Example: ABC Theater purchases 100 coffee mugs with the logo "ABC Theater" and a picture of a stage on them. If ABC Theater has secured exemption from New York State sales and use taxes it is not required to pay New York sales tax on that purchase. However, when ABC Theater sells those mugs to attendees at its shows, it must collect New York sales tax on the sales (unless the purchaser is exempt from New York State sales tax).

Issue #4: Internet Sales

Question 4A: *What tax rules apply when a nonprofit sells merchandise on the Internet?*

Answer 4A: The same principles that apply to the sale of merchandise in a nonprofit's physical location govern the taxability of any merchandise the nonprofit sells on the Internet. Like revenue from sales made in-person, online revenue's taxability is based on the unique facts and circumstances of the Internet sales. Essentially, the taxability of merchandise sales is determined regardless of where the New York nonprofit sells the items.

Example: A nonprofit community ballet school sells ballet shoes to further public awareness of ballet and fund its activities. If the income from ballet shoe sales is exempt when the sales are

made in-person, then income derived from any online shoe sales will be exempt, too. Similarly, if sales tax is generally collectible on shoe sales, the nonprofit must collect sales tax on shoes sold on its website (unless the purchaser is exempt from New York State sales tax).

The question of whether a nonprofit's activities are exempt from sales tax is complex; always consult tax or legal professionals for specific questions or concerns.

This memo is meant to provide general information only, not legal advice. Please contact Judith Moldover at Lawyers Alliance for New York at (212) 219-1800 x 250 or visit our website www.lawyersalliance.org for further information.

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