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What Nonprofits Should Consider Before Opening a Thrift Store

Even though 501(c)(3) nonprofits are created for a charitable purpose, they are still allowed to make a profit with certain activities. As nonprofits search for new revenue streams, they may consider certain business activities, including, for example, the operation of a thrift store. Thrift stores can be a 'win-win' enterprise as the clothes and other goods sold are donated to the nonprofit organization, the operation of the store can help the nonprofit organization's bottom line, and the community benefits by getting access to low-cost goods. Engaging in a thrift store business to raise revenue while also contributing to a good cause may seem simple, but there are some considerations in how to engage in this business.

This Legal Alert answers common questions that a nonprofit organization may have when considering engaging in a thrift store business.

Is the Thrift Store Related to the Nonprofit Organization's Charitable Mission?

A nonprofit organization may not operate for a substantial purpose outside of its purposes clause. In general, a thrift store should be considered only if it has some conceivable connection to the charitable purpose of the nonprofit organization (e.g. workforce training for store workers or reduction of waste). If a thrift store was not contemplated in a nonprofit organization's initial application for tax exemption or is not related to the current charitable purpose, it should be approached with caution.

Is Operating the Thrift Store Going to Create Unrelated Business Income Tax? [1]

The answer is generally no.

The IRS defines an "unrelated business activity" as business activities that are not substantially related to an organization's charitable purposes.[2] In order to be "substantially related," there must be a significant and direct causal connection between the business activity and the organization's tax-exempt purpose, a*side from the need to generate income for its exempt purpose.* While the IRS determines whether or not a business activity is unrelated based on the specific facts and circumstances of each case, the regulations specifically exclude two relevant types of business activities:

- if the business involves selling merchandise, substantially all of which has been donated to the organization; or
- if substantially all the work related to conducting the business is performed without compensation.

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[1] For more information, see:
Basics of the Federal Unrelated Business Income Tax on Nonprofits Legal Alert.pdf (lawyersalliance.org)

[2] *Id.*

Therefore, there are a few ways a nonprofit organization can avoid taxation on its thrift store activities:

(1) If the thrift store receives mostly donated merchandise (it is not buying wholesale and then selling at retail).[3] For the donated merchandise exception to be allowed, substantially all the goods sold must be donated to be exempt from the tax on unrelated business income. The IRS has found that this rule applies if at least 85% of the items sold are donated.[4]
(2) If the entire thrift store is run by unpaid volunteers (e.g. there are no paid employees). This can be a challenge to maintain a fully operational retail store.
(3) Some thrift stores may qualify for the convenience exception. The IRS has found that activities carried on for the convenience of an organization's members, students, patients, officers, or employees may be excluded from federal income tax.[5] The IRS has applied this exception very strictly, finding for example that the exception did not apply to a university's golf course that was made available to alumni.[6] Alternatively, the convenience rule was found to apply to laundry and dry cleaning services a university provided for its students.

Should a Separate Legal Entity Operate the Thrift Store?

A nonprofit organization may choose not to sell thrift items itself, but rather to create and operate a separate tax-exempt organization. This new organization may be a wholly owned subsidiary of the original nonprofit organization. The goal of creating this new entity may be for example, to protect the parent nonprofit against liabilities (like customer slip-and-fall lawsuits) it might otherwise incur if it engaged in those activities directly. The income generated by the newly created organization will not be tax-exempt simply because it is paid to the 'parent' tax-exempt organization. The subsidiary organization's activities must be tax-exempt on their own, otherwise it will have to pay income tax on goods sold.[7]

Will the IRS tax the sold merchandise?

To the extent that "substantially all" of the goods sold at a thrift shop are donated, any income derived from the sale of those goods will be exempt from federal tax.[8] The goods, however, will be subject to a sales tax (other than as noted below), since a charitable organization's retail sales of tangible personal property are subject to sales tax just like any other store, even if those sales are part of a temporary shop or store operated by the nonprofit organization. The only exceptions to sales tax are if (1) the item itself is tax-exempt (for example, most food items, drugs and medicine used for humans, and newspapers and periodicals are exempt from sales tax), or (2) some other exemption applies (for example, the purchaser of the goods is itself a tax-exempt organization).

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[3] https://www.irs.gov/charities-non-profits/charitable-organizations/unrelated-business-income-tax-exceptions-and-exclusions; see also: https://www.law.cornell.edu/cfr/text/26/1.513-1
[4] https://www.mhmcpa.com/insights/article/recent-developments-in-ubti-for-not-for-profits
[5] https://myrenosi.com/resources/documents/renosi%20operating%20a%20nonprofit%20(tax-exempt)%20thrift%20store.pdf
[6] https://www.irs.gov/charities-non-profits/charitable-organizations/unrelated-business-income-tax-exceptions-and-exclusions
[7] For an IRS ruling on this issue, see here: https://www.irs.gov/pub/irs-tege/rr71-581.pdf
[8] https://www.irs.gov/pub/irs-tege/eotopicf83.pdf

A full guide to sales tax in New York for nonprofits can be found here. Any nonprofit organization considering a substantial retail operation should consult counsel regarding sales tax before beginning to sell goods to the public.

Conclusion

Thrift stores can be a 'win-win' enterprise, as the clothes and items sold can help raise revenue for a nonprofit organization as well as provide goods to low income communities. Organizations who want to open a thrift store should consider if engaging in the sale of donated items is aligned with their mission. If not, these organizations should be cautious to follow the IRS guidance explained above to avoid the unrelated business income tax and the federal tax from the sale of goods.

This alert is meant to provide general information only, not legal advice. If you have any questions about this alert please contact Rafi Stern at rstern@lawyersalliance.org or visit our website at www.lawyersalliance.org for further information. To become a client, visit www.lawyersalliance.org/becoming-a-client.

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