

## Small Change: A Column about Finance and Accounting in Libraries

# Why You Might Not Want a Starbucks in Your Basement

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Herb Snyder

## Nonprofits and the Tax Implications of Renting Out Space

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Questions? Comments? Simply want to tell Herb where he was wrong? Feel free to write or e-mail.

**A** short time ago I was guest speaker in a library school class that dealt with fundraising in libraries and other nonprofit organizations. In truth, I don't know much about getting donors to give money for worthy purposes and I don't really have any talent in that area. My purpose for being in the class was to try and explain how to balance the challenge of being creative in fundraising with the equally compelling (but less well understood) difficulties that nonprofits face in dealing with the IRS. It is in fact possible to be so creative and successful in generating money that an organization can end up paying taxes or even losing its nonprofit status.

A case in point was that of a class member who ran a drama program in a high school. Her funding had been cut

incrementally year by year until she was forced to rent out the high school stage for various functions in order to have enough funds to keep the program running. As it turns out, renting out the stage is fine insofar as keeping your nonprofit status, but renting out the stage complete with equipment or the services of stagehand isn't. Let me try and make the distinction as plain as I can, but don't look for a strong logical argument, this is the IRS after all. However, in order to begin, we need to understand a little of the history surrounding nonprofits and earned income.

### A Brief History of Nonprofits and Unrelated Business Income

Prior to 1950, nonprofits could own or engage in any income-generating activi-

ty without penalty as long as the proceeds were used to support the organization's nonprofit purpose. The system gave rise to a number of instances in which nonprofits competed unfairly with profit-making businesses, including the infamous case of a pasta company owned by New York University. The IRS attempted to impose taxes on what was clearly a commercial enterprise, but the courts ruled that no tax could be assessed under the existing tax codes. As result, Congress amended the tax law in 1950 and established for the first time the principle of unrelated business income (UBI).

The key issue in establishing UBI is whether the income was earned in a way that advances the purposes for which the nonprofit organization was established. The distinction between commercial and nonprofit activities has blurred as nonprofits have been forced to become more creative in generating income to pay for their activities. What, for example, distinguishes a university bookstore from a Barnes & Noble beyond the fact of ownership by the university? In the case of university bookstores, the issues become muddier still as universities expand their services to include sales of computers, clothing, and sporting goods.

A complete exploration of UBI is beyond the scope of this or any other single article and readers who are interested are directed to the readings at the end of this essay. For the moment, however, let us limit ourselves to a discussion of what the IRS refers to as "passive income."

## Passive Income

The IRS specifically excludes passive income from taxation. Passive, in this context, refers to the proceeds from interest, dividends, annuities, royalties, rents from some sources, research, and capital gains from the sale of real property. Since it is a major income source for many nonprofits, rent requires some additional clarification. Rental income is passive only if it is received in exchange for the use of space and basic maintenance services such as utilities, trash removal, etc. The income becomes active when the lessor provides additional

services for the convenience of the occupants such as janitorial services, office assistance, snow removal, etc.

Consider the following two situations:

1. Apex library makes the decision to lease space for a coffee bar in its basement. The lease payments include payment for the utilities, cleaning the common restroom areas, and trash removal.
2. Apex Library makes the same decision to lease space, but offers to assist the shop owner by making purchases of supplies through the library. The purchases are identified as the coffee bar's and sales tax is paid on them. The library is reimbursed weekly.

Income in the first case is passive and tax exempt. Income in the second becomes active as the result of providing additional services for the convenience of the lessee. Similar results might be found in the earlier example of the theater rental versus the rental of the theater along with ushers and a projectionist. In the latter case, our theater director faces the prospect of paying tax.

Rental income is excluded only for the use of real property. Rentals of personal property such as equipment are taxable unless it is incidental (i.e., less than ten percent of the cost) to the rental of the real property. For example, an archive rents office space to independent researchers who carry out searches in the archive for a fee. In addition to the space, researchers have the option of renting a telephone and fax machine. The additional equipment adds \$100 to a monthly rent of \$400. Income in the first case is passive and nontaxable. In the second instance, the rental income is not considered passive.

## Facilities for the Convenience of Employees and Users

As with all IRS regulations, however, there are exceptions, notably in cases where the facilities are operated primarily for the convenience of the employees or users of the organization. Income from facilities that are operated for the convenience of employees and qualified members of the public is exempt from UBI tax.

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The sale of pens, pencils, paper, computer disks, and similar supplies in an archive allows patrons to work longer and more easily with the archival materials, thereby furthering the exempt purposes of the archive. Similarly, cafeterias and pay-parking lots open to employees and qualified patrons allow them to remain longer in the facility and thus further the organization's exempt purpose. Facilities that are open to members of the public who are not users of the facility, as in the case of a separate, street-level entrance to a shop or cafeteria, render the operation subject to UBI tax.

### Where Does This Leave Us?

As you might imagine, all of the discussion left the class members bewildered and in some cases nervous. I won't tell

you that tax law isn't convoluted or that you shouldn't consult with a tax professional on matters of innovative fundraising, but most of these matters are clearer if we keep a few principles firmly in mind:

1. Any instance when you do rent space must be either in support of your nonprofit purpose or incidental to it. Selling paper and copier services that help researchers use the library are fine, but building a carwash in the parking lot is probably not appropriate.
2. The IRS doesn't like it when nonprofits compete directly with profit-making programs. Copier services are fine, but if you expand your capacity to the point where you're drawing customers away from Kinkos you shouldn't expect to keep your nonprofit status.

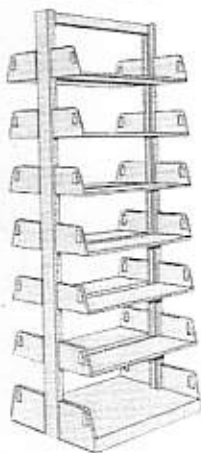
### Further Reading

Jody Blazek, *Tax Planning and Compliance for Tax-Exempt Organizations*, 2d ed. (Somerset, N.J.: John Wiley & Sons, 1993), 444.

Mark Bookman, *Protecting Your Organization's Tax-Exempt Status* (San Francisco: Jossey-Bass, 1992).

Department of the Treasury, Internal Revenue Service, *Publication 598, Tax on Unrelated Business Income of Exempt Organizations* (Washington, D.C.: GPO, 1995). Note that IRS publications are available on the Web and may be downloaded at no cost using Adobe Acrobat. The IRS Web address for forms and publications is [www.irs.ustreas.gov/prod/forms\\_pubs/forms.html](http://www.irs.ustreas.gov/prod/forms_pubs/forms.html).

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