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HOW THE COMMERCIALITY DOCTRINE CAN AFFECT YOUR NON-PROFIT

When considering the type of income-producing activities your non-profit may want to engage in, a key consideration is whether each of these activities will support your exempt purpose and whether they fall under the Commerciality Doctrine guidelines.

What is the Commerciality Doctrine?

The Commerciality Doctrine is an operational test developed to support the statutory requirement that charitable organizations must operate in furtherance of their exempt purposes. Its underlying goal is to prevent non-profits from competing at an unfair tax advantage with for-profit businesses.

The operational test is applied to a non-profit's activities through a comparison of its activities to similar activities by for-profit businesses. The thought behind this is that a non-profit operating in a commercial manner has commercial activity as its primary purpose, meaning the commercial activities are substantial and unrelated to its exempt purpose.

When Should Non-profits be Concerned About the Commerciality Doctrine?

Engagement by a non-profit in commercial business activities will not by itself fail the Commerciality Doctrine operational test. The operational test requires that no more than an insubstantial part of an organization's activities further a non-exempt purpose. This means that a non-profit may operate a business as a substantial part of its activities as long as the business is in furtherance of the non-profit's exempt purpose. For example, a university may charge students tuition because those fees directly support the university's exempt purpose of providing education.

Any non-profit that carries out substantial commercial activities that are unrelated to its exempt purpose will fail the operational test. Factors that may point to a non-profit operating commercial activity for a non-exempt purpose are pricing to maximize profits, use of commercial and promotional methods, generating and accumulating unreasonable reserves, using paid staff instead of volunteers, selling to the general public instead of a charitable class, and not receiving donations as a substantial portion of your organization's total support.

What Are the Consequences of Violating the Commerciality Doctrine?

If the operational test shows your non-profit is operating like a for-profit business, there are a few consequences that can occur. At the very least, the income your organization generates from

unrelated activity may be subject to Unrelated Business Income Taxes (“UBIT”). Worst case, your organization can lose its tax-exempt status.

How Can Non-profits Manage Commerciality Doctrine Requirements?

The best way to avoid a violation of the Commerciality Doctrine is to ensure that all of your non-profit’s income-producing activities are in furtherance of its exempt purpose. In doing so, it is important to note that just applying the income towards charitable activities is insufficient; the income-producing activity must further the exempt purpose.

Another way to avoid a violation is to not charge for the services or charge below cost. While charging at cost would appear to make an activity not commercial, the IRS may view it as being competitive by charging lower than the competition to increase business. So, when charging for services that are typical in the for-profit sector and unrelated to their exempt purpose, organizations should consider charging about 15% below or 85% of the cost to avoid a loss of their exempt status. The remaining cost should be subsidized with charitable contributions. This reliance on donations from the general public makes the activity look more charitable and less commercial. However, these percentages are subjective thresholds and not one size fits all. That is why it is vital to discuss intended operations with your attorney if you have concerns that you may run afoul of the commerciality doctrine.

JAH Can Help

The rules surrounding the Commerciality Doctrine for non-profit organizations are complex, and a violation can result in the non-profit losing its exempt status. The attorneys at JAH can navigate these complex matters so you don’t have to. Contact a member of our **Non-profit Entities and Tax-Exempt Organizations Practice Group** or complete our **General Contact Form** if you need assistance.

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