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### Community Arts Q&A Series

#### **Income-Generating Activities, Part Two: Sales of Food and Merchandise**

*As part of its Community Arts program area, Lawyers Alliance is providing a series of Q&As to help community arts organizations better understand how the law applies to them.*

*In challenging times, managers and directors of arts nonprofits may be thinking of ways to increase revenue and preserve programming. Alternatively, they may want to confirm that revenue generating activities are conducted in compliance with law. We are providing this Legal Alert on income-generating activities (part one of two Alerts) so that if you are looking to generate funds through sales of goods or services (or if you are already generating income through sales), you understand how to comply with law and protect your organization.*

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Arts nonprofits often stage performances, art exhibits, or other events at which they sell refreshments or merchandise. This memo explores some of the legal issues that arise from such sales, focusing primarily on (1) tax deductibility to purchasers, (2) the Unrelated Business Income Tax (UBIT), (3) New York State sales tax and (4) online sales.

Legal counsel should carefully review the specific facts and circumstances of any income-generating activity an arts nonprofit conducts to assess potential tax liability. In addition, the tax deductibility of certain nonprofit contributions depends on each individual's tax status. Nevertheless, we hope that this Legal Alert, which is not intended as legal advice, will provide some helpful general information.

This Legal Alert 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 tax deductible to the purchaser?
- Are purchases of food, beverages, or merchandise at prices above their fair market value tax deductible to the purchaser?
- Does the arts nonprofit need to provide any documentation to the purchaser so he or she can take a tax deduction on goods or services purchased at above their fair market values?

- Does the amount the arts nonprofit spends on providing the goods or services determine their fair market value?
- Is the entire charitable donation deductible when the arts nonprofit gives the donor a low-cost gift or benefit in exchange for the donation?
- When is an arts nonprofit subject to UBIT?
- Is revenue generated by volunteer work taxable?
- Is income from the sale of goods that an arts nonprofit produces taxable when those goods are created in connection with the nonprofit organization's tax-exempt purpose?
- Is income derived from fundraising activities taxable?
- If a nonprofit organization is subject to federal UBIT, do additional New York State taxes apply, too?
- How does the New York State sales tax apply to income generated from food, beverage, or merchandise sales?
- What federal and New York tax rules apply to revenue generated from online merchandise sales?

### **Issue #1: Tax Deductibility of Food, Beverage, or Merchandise Purchases**

***Question: Are purchases of food, beverages, or merchandise from an arts nonprofit at their fair market value tax deductible to the purchaser?***

**Answer:** As a general rule, individuals who purchase food and beverages or other merchandise, such as T-shirts, posters, etc., at an arts nonprofit event may not deduct the sales price of any such goods as a charitable contribution. In other words, if the nonprofit organization 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 record of the orchestra's top recordings. The record's fair market value is \$20, which is what the patron pays. The patron cannot deduct the record's cost as a charitable contribution.

***Question: Are purchases of food, beverages, or merchandise from an arts nonprofit at prices above their fair market values tax deductible to the purchaser?***

**Answer:** If an individual pays more than fair market value for food, beverages, or other merchandise, a portion of the price paid may be tax deductible as a "quid pro quo" contribution. The IRS clearly states that if a donor receives a benefit as a result of contributing 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 an individual pays more than fair market value to an exempt organization for goods or

services (including food, beverages, or merchandise), the excess may be considered 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 tax-deductible contribution is \$32 (\$40 payment – \$8 regular price).

**Question: Does the arts 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:** If an individual pays more than \$75 for food, beverages, or other merchandise and that payment is partly a donation and partly in exchange for those goods or services (as discussed immediately above), the nonprofit organization must provide the individual with a written statement (1) confirming the purchaser can only deduct the amount of the payment that exceeds the fair market value of the goods or services received and (2) providing a good-faith estimate of the fair market value of those goods or services. The nonprofit organization should ideally 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 organization should not attempt to advise donors as to the deductibility of their contributions.

**Example:** An individual pays \$80 for popcorn and soda at a screening for the benefit of a nonprofit film academy. The academy provides the purchaser with a receipt (1) 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 purchaser can potentially deduct \$72; \$80 payment – \$8 fair market value of goods received.)

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

**Answer:** The cost to the arts nonprofit to provide the goods or services to its patrons is not relevant when determining fair market value of the goods or services for tax deductibility purposes. Instead, it is the commercial value of the goods or services (i.e., the typical cost of the goods or services in the marketplace) that governs. When there is no clear fair market value for the goods or services provided, the nonprofit organization should make a good faith effort to estimate value using the market value of comparable goods or services.

**Example:** A poster for an art exhibition has a fair market value of \$15, based on comparable prices of posters sold by arts nonprofits across the City. That value is what is relevant for tax deductibility purposes, even if the actual cost to the nonprofit organization to produce each poster was substantially lower at \$3/poster.

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

**Answer:** 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, nominal 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 (as of 2023):

- The fair market value of all the benefits received is not more than 2% of the contribution or \$117, whichever is less; or
- The contribution is \$58.50 or more *and* the only benefits received by the donor are token items bearing the charity's logo (such as bookmarks, calendars, key chains, mugs, posters, T-shirts, etc.), which cost the nonprofit, in the aggregate, \$11.70 or less.

**Example 1:** An individual makes a \$100 donation to a nonprofit community choir. In return for the donation, 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 likely tax deductible to the donor.

**Example 2:** An individual makes a \$75 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 the school \$6, and the hat costs \$2.50. Therefore, the donor's entire \$50 contribution is likely tax deductible because the aggregate cost of the benefits he or she received is less than \$11.70 (\$8.50) and the contribution was more than \$58.50.

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

**Question:** *When is an arts nonprofit subject to UBIT?*

**Answer:** Even though an arts nonprofit is recognized by the IRS as exempt from federal tax, it may still need to pay UBIT on certain income. An organization's UBIT liability depends on the circumstances of each revenue-generating activity. For most organizations, an activity is considered an "unrelated business" and therefore subject to UBIT if the activity (1) is a trade or business,<sup>1</sup> (2) regularly carried on,<sup>2</sup> and (3) not substantially related to furthering the exempt purpose of the organization.<sup>3</sup>

A key element in analyzing whether revenue generated from food, beverage, or merchandise sales is subject to UBIT is whether the activity is "substantially related" to the nonprofit organization'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 (or charitable mission). In the context of food, beverage, and

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

<sup>2</sup> 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.

<sup>3</sup> 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 charitable mission. To be substantially related, the activities that generate the income must contribute importantly to accomplishing the organization's exempt purposes.

merchandise sales, the IRS would look to scope of the sales and how the sale activities actually serve the nonprofit organization's exempt function.

It is important to note that the law is unsettled in the area of logo merchandise and UBIT. Courts have differed on whether or not the dissemination of a nonprofit organization's logo (for example, on t-shirts sold to the public) truly raises awareness of a nonprofit organization's mission, thus furthering the organization's exempt purpose. Counsel should be consulted in regards to logo merchandise sales and UBIT liability, and more information can found in this Lawyers Alliance [legal alert](#).

**Example 1:** A nonprofit 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. The sales activity conducted by the eating facilities would likely not be deemed an unrelated trade or business of the museum, and the cafeteria revenue would likely not be subject to UBIT.<sup>4</sup>

**Example 2:** A nonprofit art museum operates a gift shop. The museum should 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 would not be considered an unrelated trade or business, as the reproductions contribute to the museum's arts education mission. However, revenue generating from selling souvenirs of the city where the museum is located, which have no causal relationship to art or artistic endeavor, will likely be subject to UBIT.<sup>5</sup>

**Example 3:** A nonprofit art 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 revenue generated from these sales are likely not subject to UBIT because they enhance public awareness of art, which contributes importantly to the achievement of the museum's mission.

**Question: Is revenue generated by volunteer work for an arts nonprofit subject to UBIT?**

**Answer:** The Internal Revenue 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:** Revenue generated from a volunteer-operated bake sale held to benefit a nonprofit ceramics studio will likely not be taxable under the UBIT rules.

**Question: Is income derived from the sale of goods that an arts nonprofit produces itself, in the normal course of fulfilling its charitable purpose, subject to UBIT?**

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<sup>4</sup> See IRS Rev. Rul. 74-399 (<https://www.irs.gov/pub/irs-tege/rr74-399.pdf>).

<sup>5</sup> See IRS Exempt Organizations Publication 79 and referenced Revenue Rulings (<https://www.irs.gov/pub/irs-tege/eotopicu79.pdf>).

**Answer:** The IRS has stated that income earned from selling products created via a nonprofit organization's exempt functions isn't subject to UBIT, so long as the products are sold in substantially the same state as they were when the exempt functions were completed.<sup>6</sup>

**Example:** An arts nonprofit's exempt function is to educate school-age children on the art of printmaking. As part of the teaching process, the children make numerous prints. The nonprofit organization then sells the prints to the public as is, not framed or altered by the teachers in any way. The revenue derived from the print sales is likely not subject to UBIT because the prints are produced when the organization performs its tax-exempt function.

**Question: *Is income derived from fundraising events subject to UBIT?***

**Answer:** Although regular fundraising activities (for example, holding an annual gala or sending out mass mailing donation requests) may satisfy all three prongs of the UBIT test (trade or business, regularly conducted, unrelated to the organization's mission-related activities), the IRS generally does not subject nonprofit income generated from fundraising activities to UBIT. The argument may be made that soliciting donations is not a "trade or business" in the normal sense because often times 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 arts nonprofit operates a fundraising department, charged with raising funds for the organization via a variety of means, including sending regular donation solicitations over email and in the mail. Even though the department's activities may meet all the elements of the UBIT test, the IRS has historically declined to tax the funds the department raises.

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

**Answer:** In New York, organizations that are subject to federal UBIT are taxable under New York State Tax Law Article 13. Specifically, if an organization regularly conducts a 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 nonprofit contemporary art 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 educating the public on contemporary art, revenue generated from the souvenir sales are subject to federal UBIT. This revenue is subject to New York State tax as well. Accordingly, the museum must file Form CT-13.

### **Issue #3: Sales Tax in New York State**

**Question: *How does the New York State sales tax apply to income generated from food, beverage, or merchandise sales?***

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<sup>6</sup> See IRS Publication 598 (<https://www.irs.gov/publications/p598>).

**Answer:** An arts nonprofit that has secured exemption from New York State sales and use taxes will be exempt from paying New York State sales tax on items the nonprofit purchases,<sup>7</sup> but not from collecting sales taxes on items the organization sells, to the extent such items are generally subject to New York State sales tax. New York State sales tax is imposed on the purchaser of a taxable good or service, but is collected by the seller and then remitted to New York State.

**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 his or herself is exempt from New York State sales tax).

#### Issue #4: Online Sales

**Question:** *What federal and New York tax rules apply to revenue generated from online merchandise sales?*

**Answer:** The same principles that apply to the sale of merchandise in a New York arts nonprofit’s physical location govern the taxability of any merchandise the nonprofit sells online. Like revenue generated from in-person sales, online revenue’s taxability is based on the unique facts and circumstances of online sale activity. Essentially, the federal and New York taxability of merchandise sales is determined regardless of where the purchaser is located. Separate counsel should be sought in regards to a nonprofit organization’s tax liability in other states due to online sales.

**Example:** A nonprofit community ballet school sells ballet shoes to further its mission and fund its activities. If the income from ballet shoe sales is not subject to UBIT when the sales are made in-person, then income derived from any online shoe sales also not be subject to UBIT. Similarly, if New York sales tax is generally collectible on in-person shoe sales, the nonprofit must collect New York sales tax on shoes sold on its website (unless the online purchaser is exempt from New York State sales tax).

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<sup>7</sup> Once the exemption is secured, to make a tax-exempt purchase the organization must present the NY Form ST-119.1, *Exempt Purchase Certificate*, to the vendor at the time of purchase. For more information, see <https://www.tax.ny.gov/bus/st/exempt.htm>.

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