Beware of Schemes to Split Real Estate Commissions or Earn Referral Fees

A business approaches your nonprofit with a simple plan – for every customer your nonprofit sends its way, it will donate either a percentage of its profits or give you a flat referral fee. It seems like a win-win situation. Your nonprofit gets funding to support its mission, and the business gets a new customer. The catch is that this approach might get your nonprofit in hot water with the IRS and can even jeopardize its tax-exempt status.

The basic principle in play is the prohibition against private benefit. Tax law requires that a §501(c)(3) nonprofit be organized and operated exclusively for religious, educational, charitable and other specific purposes. The law also provides that §501(c)(3) nonprofits don’t pay income tax on their net profits, and donors to such nonprofits may take a tax deduction for their donations. These are wonderful benefits, but with them come restrictions. One such restriction, “private benefit,” is that §501(c)(3) nonprofits cannot provide a "nonincidental benefit" to people or businesses thereby serving their private interests. In simple terms, a nonprofit’s exempt activities must be for a public good as defined by its tax-exempt mission, not for the benefit of private individuals or entities. Violating this restriction can lead to loss of tax-exempt status.

The key question is whether the benefit provided is part of the organization’s exempt activities. For example, a nonprofit that works to prevent homelessness provides free housing to individuals below the poverty level. The benefit (free housing) is permissible because it furthers the nonprofit’s tax-exempt mission. The nonprofit cannot provide those exact same services to individuals with ample resources and means to obtain their own housing because it does nothing to serve their mission, and would provide a significant benefit to private individuals. In addition, the same nonprofit can pay an electrician to fix wiring in the free housing units they provide because, while the electrician is getting a benefit, the nonprofit is getting the benefit of the fixed wiring needed for serving its mission. However, if the nonprofit paid the electrician more than a reasonable amount for the work (compared to what other electricians would charge), then the electrician would receive a private benefit.

Let’s apply the private benefit concept to the plan to split real estate commissions. ABC Real Estate Company (ABC) approaches the same nonprofit described above and offers to donate 1% of its standard 3% commission for any house sale that resulted from a referral from the nonprofit. The nonprofit includes an announcement in its newsletter and regularly posts on its social media encouraging individuals looking to buy or sell a home to use ABC. A supporter of the nonprofit reads the newsletter, contacts ABC and sells their house with ABC’s help. ABC then donates 1% of its commission to the nonprofit. The result: the nonprofit has provided an impermissible private benefit on ABC. The sale of the house has nothing to do with the nonprofits mission—providing housing to those who cannot afford it. And the benefit to ABC is quite substantial—a commission that it would not have otherwise received. In addition, while the nonprofit is earning income from the deal, the amount is small compared to benefit provided to ABC.
The same analysis would apply to other referral fee schemes, a telephone company, a bank or an electrician gives your nonprofit a fee each time a new customer is sent their way. Instead of furthering your nonprofit's mission, you are using your nonprofit’s resources to drum up business for a for-profit entity. The fact that your nonprofit also receives a benefit doesn’t change that result. Even assuming that the arrangement could be structured legally, your nonprofit might also be subject to unrelated business income tax or “UBIT” as advertising income. See our article UBIT: Four Letters Your Nonprofit Needs to Know and our webcast Unrelated Business Income for more information.

It is possible to partner with ABC Real Estate Company to support your nonprofit. ABC Real Estate Company can advertise that it will donate 1% of its commissions to your nonprofit as a way to attract customers. But what it can’t do is require you to refer clients to it as a condition of that donation. Such an arrangement is called a co-venture arrangement. It is allowed under the Georgia Charitable Solicitation Act, but there are some rules to follow. See our webcast Conducting Fundraising Activities with For-Profits.

Please reach out to your PBPA attorney with any questions.