The following information will address some of the legal issues that often arise when considering the business activities of not-for-profit and tax-exempt organizations that provide veterinary medical care for a fee.

The information provided in this document should not be construed as legal advice or legal opinion on specific facts. This document is not intended as a definitive statement on the subject but rather to serve as a resource providing practical information for the reader.

I. Federal Tax Law

Section 501(c)(3) of the Internal Revenue Code ("IRC") provides an exemption from federal income tax for organizations that are organized and operated “exclusively” for charitable purposes, including the prevention of cruelty to animals. Most animal shelters and not-for-profit clinics enjoy exempt status under section 501(c)(3) of the IRC.

Exempt organizations have traditionally enjoyed special privileges granted by the government that lower their cost of operation, thus giving them an advantage over their for-profit counterparts. In exchange, exempt organizations must stay true to the purpose for which they were granted exempt status by the Internal Revenue Service ("IRS").

IRS regulations provide that an organization will meet the requirements for exemption under section 501(c)(3) even if it operates a “trade or business” as a substantial part of its activities. To avoid taxation on the income derived from trade or business activities, the operation of these activities must be in furtherance of the organization’s tax-exempt purposes, and the organization must not be organized or operated for the primary purpose of engaging in an “unrelated” trade or business. Thus, tax law places some restrictions on the amount of services exempt organizations provide or goods they sell that are not “substantially related” to their tax-exempt purpose or function.

These restrictions are often misunderstood as prohibiting such organizations from generating any revenue by engaging in business activities that are not directly related to their tax-exempt purposes. However, exempt organizations are permitted to engage in some business activities that are not related to their exempt purpose. These business activities are termed “unrelated business” by the IRC and are taxable essentially in the same manner as income earned by for-profit entities.

A primary objective of taxing the income generated by the “unrelated business” of exempt organizations is to eliminate a source of unfair competition with for-profit entities by placing the unrelated business activities of exempt organizations on the same tax basis as the for-profit business endeavors with which they compete. The idea is to prevent exempt organizations from commercially exploiting their exempt status for the purpose of unfairly competing with taxpaying organizations.

In general, the unrelated business activities of an exempt organization must be limited to something less than a substantial portion of the organization’s overall activities. In other words, engaging in unrelated business activities must not be the primary purpose of the organization. If a substantial portion of the exempt organization’s income comes from unrelated business activities, or these activities become the organization’s primary purpose, the organization may not qualify for tax exemption or may have its tax-exempt status revoked.
II. Illustrative Tax Cases

The IRS has issued several administrative opinions addressing the tax consequences of various business activities engaged in by animal shelters and other tax-exempt veterinary organizations. These opinions are informative and illustrate how the IRS views the business endeavors of these organizations.

In one case, the IRS considered whether the provision of low-cost or full cost veterinary services was in furtherance of an animal shelter’s exempt purpose of preventing cruelty to animals, or whether the provision of services for a fee constituted unrelated business activity. The organization at issue was involved in investigating animal cruelty case, sheltering lost and unwanted animals, caring for disabled wildlife, educating children about preventing animal cruelty, and disposing of unwanted animals humanely. The organization also operated a full service animal clinic open to the public that provided a “full range of veterinary care.” The clinic provided free or reduced cost services to indigents and low cost veterinary services to the general public. The clinic constituted a “very substantial” part of the organization’s overall activities. The IRS determined that the veterinary services provided by the clinic were of the kind normally carried on for profit as an ordinary commercial service. Under these circumstances, providing veterinary services for a fee to the owners of pets “has no causal relationship to the prevention of cruelty to animals” because the animals “are neither unwanted nor the victims of any form of cruel or inhumane treatment.” The IRS rejected the organization’s argument that the income from the clinic subsidized the animal shelter activities because the IRC provides that the organization’s need for funds or the use it makes of the profits derived from a trade or business is not to be considered in determining whether a trade or business is substantially related to its exempt purpose. The IRS ultimately concluded that the clinic’s provision of veterinary services for a fee constituted unrelated trade or business.9

In a separate case, the IRS found that a tax-exempt humane society offering a number of veterinary services to the general public at full cost, low cost, or on deferred payment plans does not constitute unrelated trade or business. Providing these services was seen as related to the organization’s exempt purpose because the clinic only provided those services which the organization determined to be directly related to the prevention of cruelty to animals and the promotion of the animal’s health and well-being. It did not provide services that are considered essentially services for the owner and do not benefit the animal involved, such as cosmetic surgery, offering boarding facilities, or assisting in breeding programs. It was found that the fees charged tended to encourage pet owners who are able to afford care from the private sector to seek such care and there was no evidence that the organization had promoted the fee producing segment of its services.10

In another case, an exempt animal shelter took steps to avoid negative tax consequences by forming a separate wholly-owned for-profit subsidiary to provide commercial boarding services for the public at normal rates. The IRS determined that the shelter’s ownership of, and the receipt of donations from, the for-profit subsidiary did not adversely impact the shelter’s exempt status because the shelter did not run the “day to day” operations of the for-profit subsidiary, and the for-profit subsidiary was a separate organization with a “real and substantial” purpose of its own.11

III. Illustrative Court Cases

In addition to IRS opinions, several courts have issued opinions in cases involving exempt organizations that provide veterinary medical care.

In one case, a local SPCA in Virginia was forced to stop operating a full-service animal health care clinic that was open and available to the public. Although the SPCA employed a licensed veterinarian, the court found that employment of a veterinarian by an entity not licensed to practice veterinary medicine constituted the unlawful practice of veterinary medicine under Virginia law. The employment relationship was illegal because the veterinarian was not an owner, partner or officer of the SPCA.12

In another case, a local group of veterinarians in California sued the Humane Society of Pomona Valley over a municipal ordinance that required veterinarians to transmit copies of canine rabies vaccination certificates to the Society, which was acting as the city pound master. The veterinarians claimed that the Society unlawfully used the vaccine information to solicit customers for its veterinary hospital and lost cost vaccination clinics.
The court agreed, finding that the Society engaged in “egregious unfair competition” by using the vaccine information, collected in its capacity as pound master, to “solicit and advertise its wares.”

IV. Conclusion

Federal tax law appears to allow tax-exempt animal shelters and similar organizations to provide veterinary medical care for a fee. The issue is whether an exempt organization’s business activities are substantially related to its exempt purpose, in which case the income is likely not taxable as unrelated business income. If the activities are unrelated to the exempt purpose, then the income may be subject to taxation. In some instances, the extent of the organization’s unrelated business activities may be so substantial that its exempt status may be in jeopardy. In all cases, the tax consequences of engaging in unrelated business activities must be determined through a fact-specific analysis.

10. IRS PLR 8450006.
11. IRS PLR 9131058.