



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

FILE

Date: OCT 30 2001

[REDACTED]

Contact Person:

Identification Number:

Contact Number:

Employer Identification Number: [REDACTED]

Dear Applicant:

We have considered your application for recognition of exemption from federal income tax under section 501(a) of the Internal Revenue Code as an organization described in section 501(c)(3). Based on the information submitted, we have concluded that you do not qualify for exemption under that section. The basis for our conclusion is set forth below.

You were organized on [REDACTED] as a [REDACTED] nonprofit corporation. You request recognition of exemption under section 501(c)(3) of the Code and an advance ruling as an organization described in section 509(a)(2).

Your directors are [REDACTED] and [REDACTED] is your only compensated employee.

You provide Internet access, web design, and on-site assistance to nonprofit and for-profit organizations and individuals. You operate the [REDACTED] through your web-site [REDACTED]. You state "Every business has different Internet needs, and [REDACTED] had a solution for your business no matter what size." You offer [REDACTED] dial-up accounts for a monthly access fee of \$ [REDACTED] and Basic Web Hosting for \$ [REDACTED] a month. All nonprofit organizations are eligible for discounts of twenty percent (which approximates your cost). Nonprofits are eligible for additional discounts of twenty, forty, or sixty percent if they can demonstrate need. You will provide the subsidies by your profits from your individual and for-profit organization accounts. A copy of materials posted on your web-site [REDACTED], copy enclosed) discusses these matters in greater detail.

A [REDACTED] search of ISP's in your area revealed [REDACTED] organizations offering services similar to yours. For example, [REDACTED] offers budget ISP service at [REDACTED] dollars a month, small business at [REDACTED] offers basic at [REDACTED] premium unlimited at [REDACTED] non-profit web hosting at \$ [REDACTED] and [REDACTED] information at \$ [REDACTED] for small business. Your prices for Internet Service and web hosting are competitive with for-profit operations in your area. Web-site materials on these businesses are enclosed.

[REDACTED]

You also provide work experience to college interns seeking business and technical degrees with the supervision of qualified volunteer staff, and hope to develop a formal relationship with a local university. In the future, you hope to receive donations of old computers and recycle and sell them.

Currently, you are soliciting [REDACTED] service revenues from the consumer market at large using conventional media in advertising and word of mouth. You have listed your source of revenues as [REDACTED] Service Revenues, Equipment donations, and cash donations.

LAW

Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations that are organized and operated exclusively for charitable and educational purposes, no part of the net earnings of which inures to the benefit of any individual.

Sections 1.501(c)(3)-1(a) of the Income Tax Regulations provides that in order to be exempt as an organization described in section 501(c)(3), the organization must be one that is both organized and operated exclusively for one or more of the purposes specified in that section. An organization that fails to meet either the organizational or operational test is not exempt.

Section 1.501(c)(3)-1(c) of the regulations provides that an organization will not be regarded as "operated exclusively" for one or more exempt purposes if more than an insubstantial part of its activities is not in furtherance of a purpose described in section 501(c)(3) of the Code.

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations states that an organization is not operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. Thus, to meet these requirements, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

Section 1.501(c)(3)-1(d)(2) of the regulations states that the term "charitable" is used in section 501(c)(3) of the Code in its generally accepted legal sense. Such terms include: relief of the poor or distressed or the underprivileged; advancement of religion; advancement of education or science; relieving the burdens of government; and promotion of social welfare by organizations designed to accomplish any of the above purposes, or (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and to combat community deterioration and juvenile delinquency; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency.

Section 1.501(c)(3)-1(e)(1) of the regulations provides that an organization may meet the requirements of section 501(c)(3) although it operates a trade or business as a substantial part

[REDACTED]

of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business, as defined in section 513. In determining the existence or nonexistence of such primary purpose, all the circumstances must be considered, including the size of the trade or business and the size of the activities that are in furtherance or one or more exempt purposes.

Section 513(a) of the Code defines the term "unrelated trade or business" as any trade or business the conduct of which is not substantially related (aside from the need of the organization for income or funds of the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function forming the basis for its exemption under section 501.

Under Treas. Reg. §1.513-1(a), gross income of a tax exempt organization is includable in the computation of unrelated business taxable income if (1) it is income from a trade or business; (2) the trade or business is regularly carried on by the organization; and (3) the conduct of the trade or business is not substantially related to the organization's performance of its tax exempt functions.

Treas. Reg. §1.513-1(d)(1) requires an examination of the relationship between the business activities that generate the particular income in question and the accomplishment of the organization's tax-exempt purposes. Further, Treas. Reg. §1.513-1(d)(2), provides an activity is substantially related to an organization's exempt purpose if it contributes importantly to the accomplishment of the organization's tax-exempt purposes. In U.S. v. American College of Physicians, 475 U.S. 834, 106 S Ct. 1592(1986), the United States Supreme Court determined that the focus of the substantial relation tests is on the process of providing the activity and not the benefit conferred by the activity.

Under Section 1.513-1(d)(2), a trade or business is 'related' to exempt purposes only where the conduct of the business activities has a causal relationship to the achievement of the exempt purposes; and it is 'substantially related,' for purposes of section 513, only if the causal relationship is a substantial one. Thus, for the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of goods or the performance of the services from which gross income is derived must contribute importantly to the accomplishment of those purposes.

Under Treas. Reg. §1.513-1(d)(3), if part of a business activity relates to the performance of an organization's exempt function, but the activity is conducted on a scale larger than reasonably necessary for the performance of the exempt function, the conduct of the part of the business activity exceeding this needs of the exempt function does not contribute importantly to the achievement of the organization's exempt purposes. See also Hi-Plains Hospital v. U.S., 600 F.2d 528, 531-32(5th Cir. 1982); California Thoroughbred Breeders Association v. Commissioner, 57 T.C.M. 962, 974 (1989).

[REDACTED]

In Better Business Bureau v. United States, 316 U.S. 279 (1945), the Supreme Court held that an organization is not organized and operated exclusively for charitable purposes if it has a substantial non-exempt purpose.

In Living Faith v. Commissioner, 950 F.2d 365 (7th Cir. 1991), affg T.C.M. 1990-484, in which an organization that operated vegetarian restaurants and health food stores in a manner consistent with the religious beliefs of the Seventh-Day Adventist religion did not qualify for exemption under IRC 501(c)(3). The court concluded its operations evidenced a substantial nonexempt commercial purpose.

In B.S.W. Group, Incorporated v. Commissioner, 70 T.C. 352, the court held that an organization which operated at a profit whose only role is that of a conduit linking individual researchers with interested client organizations, both exempt and nonexempt, did not qualify for exemption under section 501(c)(3) of the Code. It was conducting a consulting business of the sort, which is ordinarily carried on by commercial ventures organized for profit. The court upheld the Commissioner's denial of exemption under section 501(c)(3) of the Code.

In Federation Pharmacy Services, Inc. v. Commissioner, 72 T.C. 687 (1979), the court upheld the Commissioner's denial of exemption under section 501(c)(3) of the Code. The organization was organized to operate a pharmacy to sell drugs at discount prices to elderly and handicapped persons. It had no commitment to use excess receipts to provide drugs for free or below cost to the elderly or handicapped persons. The organization served elderly and handicapped people almost exclusively, and did not sell toiletry articles, magazines, cards, or other items normally sold for profit by pharmacies. The organization's board consisted of community leaders, none of whom obtained any personal financial benefit from the participation. The organization used the services of volunteers (for mailing prescriptions, completing patient profiles, maintenance, etc.) instead of paid employees. All gifts were used for the benefit of financially distressed senior citizens who, because of a catastrophic illness or accident, incurred large prescription drug bills. The court reasoned that the organization operated its business primarily for commercial purposes, in competition with profit-making drug stores. The mere fact that products sold by the organization were helpful to health did not necessarily entitle it to exemption under section 501(c)(3).

Rev. Rul. 69-528, 1969-2 C.B. 127, held not exempt under section 501(a) of the Code an organization formed to provide investment services for a fee exclusively to 501(c)(3) organizations. The organization was free from the control of the participants and had absolute and uncontrolled discretion in investing decisions, distributions of income or principal. The Service reasoned that providing investment services on a regular basis for a fee is a business ordinarily carried on for profit and would constitute unrelated business if conducted by one tax-exempt organization for other tax-exempt organizations (citing 502).

Rev. Rul. 71-529, 1971-2 C.B. 234 held that an organization providing assistance in the management of participating colleges' and universities' endowment or investment funds for a charge substantially below costs held to qualify for exemption under 501(c)(3) of the Code. Membership in the organization is restricted to colleges and universities exempt under section 501(c)(3) of the Code. Its board of directors is composed of representatives of the member

organizations. The organization will not make its services available to anyone other than the exempt organizations controlling it. The member organizations only pay a nominal fee for the services performed. These fees represent less than fifteen percent of the total costs of operation.

Rev. Rul. 72-369, 1972-2 C. B. 245, held that an organization which carries on a trade or a business of the kind that would ordinarily be taxable clearly does not satisfy the test for exemption under 501(c)(3) merely because it conducts its business solely for a group of organizations exempt under that section. The Rev. Rul. further determined that providing managerial and consulting services on a regular basis for a fee is trade or business ordinarily carried on for profit. The fact that the services in this case are provided at cost and solely for exempt organizations is not sufficient to characterize this activity as charitable within the meaning of section 501(c)(3) of the Code. "Furnishing the services at cost lacks the donative element necessary to establish this activity as charitable." In the Rev. Rul., the organization enters into agreements with unrelated nonprofit organizations to furnish managerial and consulting services on a cost basis. The services consist of writing job descriptions and training manuals, recruiting personnel, constructing organizational charts, and advising organizations on specific methods of operation. These activities are designed for the individual needs of each client organization.

An organization which provides goods and services to section 501(c)(3) organizations at substantially below its own cost is, in effect, similar to a grant-making charity assisting the recipient organizations in carrying out their charitable programs. The price charged must be sufficiently below cost that the activities of the organization are clearly distinguishable from those of its commercial counterparts be manifestation of its donative intent. It is emphasized that the cost relevant to the analysis is the cost to the organization seeking exemption in providing its similar goods and services on the open market. See, Federation Pharmacy Services v. Commissioner, 72 T.C. 687 (1979), aff'd, 625 F.2d 804 (8th Cir. 1980); B.S.W. Group, Inc. v. Commissioner, 70 T.C. 352(1978).

While the Authorities have not determined what percentage of costs is an acceptable discount, they do offer some guidelines. In Rev. Rul. 71-529, 1971-2 C.B. 234 an organization which charged its members less than 15 percent of operational costs was operating in a charitable manner. In Paratransit Insurance Corp. v. Commissioner, 102 T.C. 745(1994) annual percentages of 60%, 80% and 84% were too high (502 case). Nonprofits' Insurance Alliance of California v. Commissioner, 32 Fed. Cl. 277 (1994) held percentages 47% (in a two month year), 65%, and 78% as percentages to be unacceptably high. These organizations were found not to be operating in a charitable manner.

ANALYSIS

Your proposed operations look like those of for-profit Internet Service Providers, Web design and consulting businesses. You would not be described in section 501(c)(3) of the Code unless 501(c)(3) beneficiaries controlled you and your services were provided substantially below cost to exclusively 501(c)(3) beneficiaries, under the reasoning of Rev. Ruls. 69-528, 71-529, and 72-369. However, you are not controlled by exempt organizations, and you have

[REDACTED]

failed to establish that your services will be provided substantially below cost. For-profit organizations appear to charge similar fees for similar services, and it appears that you will compete for with them for business. Under the circumstances, we find that you are operated primarily for the purpose of conducting a business, and that the charitable aspects of this business are incidental. Thus, you are not operated exclusively for exempt purposes, but also for a substantial non-exempt purpose to conduct business for its own sake. In this respect, you are similar to organizations denied exemption in Rev. Rul. 69-528 and 72-369 and cases such as American Institute for Economic Research, B.S.W. Group, Inc., Senior Stores, Inc., Christian Manner International, Inc., Federation Pharmacy Services, Inc., and Living Faith, Inc.

Accordingly, you do not qualify for exemption as an organization described in section 501(c)(3) of the Code and you must file federal income tax returns.

Contributions to you are not deductible under section 170 of the Code.

You have the right to protest this ruling if you believe it is incorrect. To protest, you should submit a statement of your views to this office, with a full explanation of your reasoning. This statement, signed by one of your officers, must be submitted within 30 days from the date of this letter. You also have a right to a conference in this office after your statement is submitted. You must request the conference, if you want one, when you file your protest statement. If you are to be represented by someone who is not one of your officers, that person will need to file a proper power of attorney and otherwise qualify under our Conference and Practices Requirements.

If you do not protest this ruling in a timely manner, it will be considered by the Internal Revenue Service as a failure to exhaust available administrative remedies. Section 7428(b)(2) of the Code provides, in part, that a declaratory judgment or decree under this section shall not be issued in any proceeding unless the Tax Court, the United States Court of Federal Claims, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted administrative remedies available to it within the Internal Revenue Service.

If we do not hear from you within 30 days, this ruling will become final and a copy will be forwarded to the Ohio Tax Exempt and Government Entities (TE/GE) office. Thereafter, any questions about your federal income tax status should be directed to that office, either by calling 877-829-5500 (a toll free number) or sending correspondence to: Internal Revenue Service, TE/GE Customer Service, P.O. Box 2508, Cincinnati, OH 45201. The appropriate State Officials will be notified of this action in accordance with Code section 6104(c).

When sending additional letters to us with respect to this case, you will expedite their receipt by using the following address:

Internal Revenue Service
[REDACTED] T:EO:RA:T:2
1111 Constitution Ave. N.W.
Washington, D.C. 20224

[REDACTED]

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Terrell M. Berkovsky
Manager, Exempt Organizations
Technical Group 2

Enclosure:

[REDACTED]

[REDACTED]

[REDACTED]