

An organization that is otherwise qualified for exemption from income tax will not fail to qualify merely because its education and vocational training of unemployed and under-employed individuals is carried out through the manufacturing and selling of toy products.

Advice has been requested whether the activities of the nonprofit organization described below qualify for exemption from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954 where the organization otherwise qualifies for such exemption.

The organization was formed to provide educational and vocational training and guidance or nonskilled persons who are unable to find employment or cannot advance from poorly paid employment due to inadequate education. The organization operates a number of community programs including classes in remedial reading and language skills, general counseling services, and job training programs.

The organization's job training program centers around the manufacture and sale of a line of toy products. The organization recruits unskilled individuals who are, for the most part, residents of a particular economically depressed community and who are unemployed or under-employed, and it provides them with new skills through on-the-job training while they are earning a living. While some individuals hired for the management staff do possess managerial and technical competence, the organization hires these people only to insure the successful operation of the vocational training program. In addition, a substantial number of the management and administrative staff are unskilled trainees.

People hired by the organization as trainees are not hired as permanent employees and the organization tries to place them in permanent positions in the community as soon as they are adequately trained. Most of the merchandise produced by the organization is sold through regular commercial channels, although some merchandise is donated to other community organizations. The capital necessary to finance this program came from noninterest-bearing loans made by commercial business enterprises in the community. These enterprises also furnish technical assistance.

Any income resulting from the organization's manufacturing operation is used to finance the organization's other community service activities. Any operating deficits are met by public contributions.

Section 501(c)(3) of the Code provides for the exemption from Federal income tax of organizations organized and operated exclusively for charitable or educational purposes.

Section 1.501(c)(3)-1(d)(2) of the Income Tax Regulations defines the term 'charitable' as used in section 501(c)(3) of the Code as including the relief of the poor and distressed or of the underprivileged and the advancement of education.

Section 1.501(c)(3)-1(d)(3) of the regulations defines the term 'educational' as including the instruction or training of the individual for the purpose of improving or developing his capabilities.

Section 1.513-1(d)(4)(ii) of the regulations provides that, ordinarily, gross income from the sale of products which result from the performance of exempt functions does not constitute gross income from the conduct of unrelated trade or business if the product is sold in substantially the same state as it is in on the completion of the exempt function.

Although charitable organizations may, with certain exceptions and limitations not applicable here, engage in commercial endeavors for the production of income to be used for carrying on charitable programs and activities (Rev. Rul. 64-182, 1964-1 (Part 1) C.B. 186), the manufacture and sale of commercial items as an end in itself does not constitute a charitable purpose. Providing vocational training and guidance to the unskilled and under-employed, however, may qualify as a charitable purpose so long as the manner of its achievement is otherwise charitable. See Rev. Rul. 67-72, 1967-1 C.B. 125; Rev. Rul. 68-504, 1968-2 C.B. 211.

The question in this case is whether the organization is conducting its manufacturing and merchandising operation as an end in itself or as the means by which it accomplishes a charitable purpose other than through the production of income. Here, the facts clearly support the conclusion that the manufacturing and merchandising operation is the means of accomplishing the organization's declared charitable objectives. Thus, there is a clear and distinct causal relationship between the manufacturing activity and the training of individuals for the purpose of improving their individual capabilities. There is likewise no evidence that the scale of the endeavor is such as to suggest that it is being conducted on a larger scale than is reasonably necessary to accomplish the organization's charitable purpose.

Accordingly, it is held that the organization's activities are charitable and educational and, since it otherwise qualifies for exemption, it is held that the organization is exempt from Federal income tax under section 501(c)(3) of the Code.

Since the manufacturing activities are an integral part of the training process and, therefore, an integral part of the charitable program and since the articles are sold in substantially the same form they are in at completion of the training process, it follows, also, that the income from the sale of the articles does not constitute gross income from the conduct

of unrelated trade or business under section 1.513-1(d)(4)(ii) of the regulations mentioned above.

Compare Revenue Ruling 73-127, page 221, this Bulletin, which holds that an organization which had as its purpose both the operation of a grocery store and the operation of a training program is not entitled to exemption under section 501(c)(3) of the Code.

Even though an organization considers itself within the scope of this Revenue Ruling, it must file an application on Form 1023, Exemption Application, in order to be recognized by the Service as exempt under section 501(c)(3) of the Code. The application should be filed with the District Director of Internal Revenue for the district in which is located the principal place of business or principal office of the organization. See section 1.501(a)-1 of the regulations.