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Index:

170.07-03
170.07-05
170.07-06

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Contact Person:

Identification Number:

Contact Number:

FAX Number:

E Mail Address:

Dear _____ :

This letter is in response to your recent request for an information letter concerning the treatment of government grants for specific projects to medical research organizations under sections 170(b)(1)(A)(vi) and 170(b)(1)(A)(iii) of the Internal Revenue Code.

Section 170(b)(1)(A)(vi)

One of the requirements for an organization to be described in section 170(b)(1)(A)(vi) of the Internal Revenue Code is that it must be publicly supported. One test for determining whether an organization is publicly supported is that the organization normally receives at least 33-1/3 percent of its total support from governmental units and/or from contributions made by the general public. See section 1.170A-9(e)(2) of the Income Tax Regulations.

Support from a governmental unit includes amounts received in connection with a contract entered into with a governmental unit for the performance of services or in connection with a Government research grant, but not if the amounts are received from the exercise or performance by the organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501(a) of the Code ("Exempt Function Income"). Regs. 1.170A-9(e)(8)(i). In general, Exempt Function Income include amounts received from any activity which is substantially related to the furtherance of the organization's exempt purpose or function. Regs. 1.170A-9(e)(7)(i)(a). An amount paid by a governmental unit is not treated as Exempt Function Income if the purpose of the payment is primarily to enable the organization to provide a service to, or maintain a facility for, the direct benefit of the public rather than to service the direct and immediate needs of the governmental payor. Regs. 1.170A-9(e)(8)(ii).

For example, the primary purpose of each of the following payments is to enable the recipient organization to provide a service or maintain a facility for the direct benefit of the public, rather than to serve the direct and immediate needs of the governmental payor:

- (a) Amounts paid for the maintenance of library facilities which are open to the public.
- (b) Amounts paid under Government programs to nursing homes or homes for the aged in order to provide health care or domiciliary services to residents of such facilities.
- (c) Amounts paid to child placement or child guidance organizations under Government programs for services rendered to children in the community.

In addition, any amount received from a governmental unit under circumstances such that the amount would be treated as a grant will generally constitute support from a governmental unit. Regs. 1.170A-9(e)(8)(ii).

A grant is normally made to encourage the grantee organization to carry on certain programs or activities in furtherance of its exempt purposes. It may contain certain terms and conditions imposed by the grantor to insure that the grantee's programs or activities are conducted in a manner compatible with the grantor's own programs and policies and beneficial to the public. The grantee may also perform a service or produce a work product which incidentally benefits the grantor. Thus, grants for carrying on exempt activities are sometimes difficult to distinguish from amounts received as gross receipts from the carrying on of exempt activities. Regs. 1.509(a)-3(g)(1).

Gross receipts means amounts received from an activity which is not an unrelated trade or business, if a specific service, facility, or product is provided to serve the direct and immediate needs of the governmental payor, rather than primarily to confer a direct benefit upon the general public. In general, payments made primarily to enable the governmental payor to realize or receive some economic or physical benefit as a result of the service, facility, or product obtained will be treated as gross receipts of the payee. Research leading to the development of tangible products for the use or benefit of the governmental payor will generally be treated as a service provided to serve the direct and immediate needs of the payor, while basic research or studies carried on in the physical or social sciences will generally be treated as primarily to confer a direct benefit upon the general public. Regs. 1.509(a)-3(g)(2).

For example, a nonprofit research organization described in section 501(c)(3) of the Code engages in some contract research. It receives funds from the government to develop a specific electronic device needed to perfect articles of space equipment. The initiative for the project came solely from the government. Since the organization provided a specific product at the government's request and thus was serving the direct and immediate needs of the governmental payor, the funds received from the government for this project are gross receipts and do not constitute grants. Regs. 1.509(a)-3(g)(3), Example (1).

In another example, a public service corporation described in section 501(c)(3) of the Code carries on medical research. Its efforts have primarily been directed toward cancer research. It sought funds from the government for a particular project being contemplated in connection with its work, and received \$25,000 from the government. Since the research project sponsored by government funds is primarily to provide direct benefit to the general

public, rather than to serve the direct and immediate needs of the governmental payor, the funds are considered as a grant. Regs. 1.509(a)-3(g)(3), Example (5).

Therefore, whether National Institute of Health restricted grants for specific projects or grants for basic medical research goals are treated as support from a governmental unit, and thus as public support, cannot be determined generally. Instead, each grant must be considered separately. For example, a grant to a section 501(c)(3) organization to provide a service or maintain a facility for the direct benefit of the public would be treated as public support. On the other hand, a grant to a 501(c)(3) organization that results in the government agency realizing or receiving some economic or physical benefit as a result of a service, facility, or product would not be treated as public support.

Section 170(b)(1)(A)(iii)

A medical research organization is described in section 170(b)(1)(A)(iii) of the Code if its principal purpose or functions are medical research and it is primarily engaged directly in the continuous active conduct of medical research in conjunction with a hospital. Regs. 1.170A-9(c)(2)(i); 1.170A-9(c)(2)(ii)(b).

In order for an organization to be primarily engaged directly in the continuous active conduct of medical research, it must either devote a substantial part of its assets to, or expend a significant percentage of its endowment for, such purposes, or both. Whether an organization has done so depends upon the facts and circumstances existing in each specific case. However, an organization will be so treated if it meets at least one of two tests. Regs. 1.170A-9(c)(2)(v)(a).

Under one test, an organization which devotes more than one-half of its assets to the continuous active conduct of medical research will be considered to be devoting a substantial part of its assets to the continuous active conduct of medical research. Under the other test, an organization which expends funds equaling at least 3.5 percent of the fair market value of its endowment for the continuous active conduct of medical research will be considered to have expended a significant percentage of its endowment for such purposes. Regs. 1.170A-9(c)(2)(v)(b). However, engaging directly in the continuous active conduct of medical research does not include the disbursing of funds to other organizations for the conduct of research by them or the extending of grants or scholarships to others. Regs. 1.170A-9(c)(2)(v)(c).

Therefore, whether the expenditure of grants received by a medical research organization described in section 170(b)(1)(A)(iii) of the Code is included in satisfying the 3.5 percent test depends on whether the organization uses the funds from these grants to conduct medical research itself, rather than merely disbursing these funds to other organizations so that they may conduct medical research.

In accordance with Section 3.06 of Rev. Proc. 2001-4, 2001-1 I.R.B. 121, 127, this information letter is advisory only and has no binding effect on the Internal Revenue Service.

Sincerely,
Marvin Friedlander
Manager, Exempt Organizations
Technical Group 1