F. IRC 502 - FEEDER ORGANIZATIONS

1. Introduction

An organization described in IRC 502 does not qualify for exemption under any paragraph of IRC 501(c). The purpose of this article is to discuss some of the basic issues presented by IRC 502, to explain how it should be interpreted and applied, and to consider the amount of unrelated business activity that an exempt charitable organization may engage in.

IRC 502 provides that an organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt under IRC 501 on the ground that all of its profits are payable to one or more organizations exempt under IRC 501.

2. Purpose of Feeder Provisions

A brief consideration of the reasons for the enactment of IRC 502 provides some insight as to how it should be interpreted. There was growing concern, particularly after World War II, about the increasing amount of business activities carried on by exempt organizations, particularly, charitable organizations.

In a series of cases involving taxable years prior to 1951, certain organizations popularly called "feeder organizations" were held exempt from federal income tax under the predecessor to IRC 501(c)(3), even though their sole activity was engaging in commercial business, and the only basis for exemption was the fact their profits were payable to specified exempt organizations. See Roche's Beach, Inc. v. Commissioner, 96 F. 2d 776 (1938); C. F. Mueller Company v. Commissioner, 190 F. 2d 120 (1951). The courts held that the exclusive purpose required by the statute was met when the only object of the organization was religious, scientific, charitable, or educational, without regard to the method of obtaining funds necessary to effectuate the objective. Under this rationale, C. F. Mueller Company, which, as its sole activity, operated a commercial macaroni factory and turned the profits over to its exempt parent, was held exempt from federal income tax as an exclusively charitable organization.

Although the above cases involved subsidiary organizations having no charitable programs of their own, our concern was not limited to this situation. Organizations with extensive charitable programs, such as colleges and

universities, were operating substantial business enterprises to finance their charitable programs. They were competing with for-profit businesses and not paying any income tax.

IRC 502 was designed to deny tax exemption to business subsidiaries (such as the macaroni factory) of charitable parents. However, enactment of the feeder provision (IRC 502) alone could have been emasculated if no action had been taken to tax the business activities carried on directly by exempt organizations because these organizations could have simply transferred the business activities from their subsidiaries to themselves.

Thus, to counter the unfair advantage that businesses operated by exempt organizations had over their for-profit competitors, the Revenue Act of 1950 used a two-pronged attack on these business activities. In addition to the IRC 502 feeder provision, Congress enacted what is now IRC 511 through 514. As a result of this two-pronged attack, the Act provided not only for denying exemption to and, therefore, taxing feeder organizations but also for taxing the income derived by exempt organizations from the unrelated business activities carried on directly by them.

3. Meaning of Terms

IRC 502 is unusual in that it describes organizations that do not qualify for exemption. If an organization is not disqualified by IRC 502 that, however, does not mean that it qualifies for exemption.

IRC 502 states as follows:

> (a) General Rule.--An organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt from taxation under section 501 on the ground that all of its profits are payable to one or more organizations exempt from taxation under section 501.
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> (b) Special Rule.--For purposes of this section, the term "trade or business" shall not include --
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> > (1) the deriving of rents which would be excluded under section 512(b)(3), if section 512 applied to the organization,

> (2) any trade or business in which substantially all the work in carrying on such trade or business is performed for the organization without compensation, or
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> (3) any trade or business which is the selling of merchandise, substantially all of which has been received by the organization as gifts or contributions.

In determining precisely what a feeder organization is, the terms of the statute must be analyzed and interpreted. The key terms are: trade or business for profit; primary purpose; and payable.

A. Trade or Business for Profit

The term "trade or business" is interpreted as having generally the same meaning that it has in Reg. 1.513-1(b) which provides that in general it means any activity carried on for the production of income from the sale of goods or performance of services and which otherwise possesses the characteristics required to constitute "trade or business" within the meaning of IRC 162. "Carrying on a trade or business for profit" refers to the kind of a trade or business ordinarily carried on for profit, regardless of whether a particular organization operates the trade or business in a manner designed to return only operational costs or a profit. The phrase "for profit" was intended to describe the commercial nature of an IRC 502 organization's activities.

Generally, the term "trade or business" under IRC 502 does not include passive investment income, but the difference between a trade or business activity and a passive investment is not always clear. In Southwest Endowment Corporation v. United States, 58-2 U.S.T.C. 9577 (CCH), 1 AFTR 2d 1860 (P-H) 1958, a nonprofit corporation was set up to finance its program of charitable giving with oil production payments. Its sponsors arranged for the organization to borrow a large sum of money at a low rate of interest and to purchase oil production payments at a price sufficiently low to permit the yield to substantially exceed the cost amortization and interest payments. The Service contended that the organization was being operated for the primary purpose of carrying on an oil business, maintaining that the operations could be characterized as buying large quantities of oil with borrowed funds and selling them at a profit. The court disagreed, apparently basing its decision upon either of two conclusions: that the

income-producing activity was not a trade or business; or that the organization was not primarily engaged in such income-producing activity.

B. Primary Purpose of Carrying on a Trade or Business

We are concerned here with how much business activity constitutes primarily engaged in a trade or business. What constitutes "primarily operating" a trade or business for profit has not been strictly defined under IRC 502, although it is clear that the test involves the evaluation of the facts and circumstances in each case. If an organization's principal income-producing activity is the conduct of a trade or business and it has no significant charitable activity other than the required payment of its profits to one or more organizations, the organization is operated for the "primary purpose of carrying on a trade or business for profit". Rev. Rul. 73-164, 1973-1 C.B. 223.[1] Rev. Rul. 73-164 suggests that if an organization is engaged in a business for profit but has some significant exempt activity, it will not be a feeder. However, if an organization with extensive business activities is not an IRC 502 feeder because it is not deemed to be operated for the primary purpose of conducting such business activities, it does not necessarily follow that the organization will qualify for exemption under IRC 501(c).

C. Payable

The term "payable" means that the organization is obligated to turn over its profits to one or more designated exempt organizations. If an organization is operated for the primary purpose of carrying on a trade or business for profit and it has the discretion as to which exempt organizations it will give its profits to, it is not an IRC 502 feeder. This does not mean that the organization qualifies for exemption, but denial or revocation of exemption cannot be on the basis that it is a feeder. This is probably the key point of IRC 502 and is discussed later in some detail.

D. Exceptions

IRC 502 also contains some specific exceptions which are: (1) the deriving of rent which would be excluded under IRC 512(b)(3), if IRC 512 applied to the

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[1] Rev. Rul. 73-164 and most other revenue rulings cited in the text are reproduced at the end of this article.

organization; (2) any trade or business in which substantially all the work in carrying on such trade or business is performed for the organization without compensation; or (3) any trade or business which is the selling of merchandise, substantially all of which has been received by the organization as gifts or contributions. Congress provided these exceptions because such business activities would not be subject to unrelated business income tax if carried on directly by the parent.

1. Bingo

IRC 513(f)(1) provides that the operation of certain bingo games conducted by exempt organizations is not unrelated trade or business. The law was enacted in recognition of the fact that many jurisdictions permit some nonprofit organizations to conduct bingo games but do not permit for-profit organizations to conduct them. Congress decided that the income derived from the operation of bingo games when conducted by exempt organizations should not be taxed where they are not in competition with commercial businesses. The bingo games not subject to tax are those that do not violate any state or local law and are not conducted in a jurisdiction in which bingo games are ordinarily carried on by commercial businesses for profit.

IRC 513(f) was added by section 301(a) of Public Law 95-502,but IRC 502 was not similarly amended and a question naturally arises as to whether an organization formed by an exempt organization to conduct bingo games is a feeder, assuming that it would otherwise be described in IRC 502.

The situation posed is similar to that which resulted in the amendment to IRC 502 by the Tax Reform Act of 1969, Public Law 91-172, which provides that the term "trade or business" as used in IRC 502 does not include any trade or business in which substantially all the work is performed without compensation or in which substantially all of the goods sold are donated. Prior to this amendment, a question arose as to whether a business carried on with donated goods or volunteer labor could be a "feeder" in light of IRC 513(a), which provided that the term "unrelated trade or business" does not include any trade or business in which substantially all the work is performed without compensation or in which substantially all of the goods sold are donated. When Congress amended IRC 502, it indicated that it did so because it felt that it was appropriate for a business operated by an exempt organization through a separate entity not to be taxed when the business would be exempt from tax if operated directly by the exempt organization. Senate Report No. 91-552, page 2099.

Prior to this amendment to IRC 502, Rev. Rul. 68-439, 1968-2 C.B. 239, held that the operation of a "thrift shop" constituted a "trade or business for profit" within the meaning of IRC 502. The "thrift shop" operated with substantially all work performed by volunteers, sold only donated goods, and turned over the profits to a specific charitable organization. Rev. Rul. 68-439 concluded that it was a feeder. Because the amendment to IRC 502 was effective only for years beginning after 1969, Rev. Rul. 68-439 was, at that point, applicable to prior years.

However, subsequent to the IRC 502 amendment, Rev. Rul. 71-581, 1971-1 C.B. 236, revoked Rev. Rul. 68-439 and held that the type of thrift shop described therein was not precluded from qualification for exemption under IRC 501(c)(3) by IRC 502 for years prior to the effective date of the amendment of the Tax Reform Act of 1969.

The rationale stated that if the activity had been carried on directly by any one of the exempt organizations, any profit therefrom would have been excluded from taxation under IRC 511 by the provisions of IRC 513(a)(3). The organization was organized as a separate corporation to operate the thrift shop in order to insulate the assets of the exempt organizations from any potential liability arising out of the operations of the thrift shop and to enable the organization to have a separate governing body and organizational structure composed of persons interested in aiding the exempt organizations principally through volunteer work in connection with the operation of the thrift shop.

The rationale stated further that the primary purpose for which the organization was operated was to serve the group of exempt organizations by performing an essential function for them; that is, to solicit contributions of goods on behalf of the exempt organizations and to convert the contributed goods to cash for charitable purposes with a minimum of expense by the use of volunteer labor.

Perhaps a similar rationale could be used with the operation of bingo games arguing that if income from bingo games operated by an exempt organization is not taxable under IRC 513(f)(1), a separate corporation established by the exempt organization to conduct the bingo games should not be taxable and would not be an IRC 502 feeder.

However, we believe that at this point the rather unusual rationale of Rev. Rul. 71-581 should be limited to thrift shops. Any cases where a separate

corporation is set up to engage in bingo and appears to be a feeder should be referred to the National Office.

2. Substantially All

There is no specific percentage provided by the regulations as to the meaning of the "substantially all" requirement with respect to the donated goods and uncompensated labor exception. No revenue rulings have specified the percentages under IRC 513(a) or IRC 502, but the term "substantially all" as found elsewhere in the Internal Revenue Code has been interpreted as 85 percent or more. For example, Rev. Rul. 73-248, 1973-1 C.B. 295, held that the meaning of the requirement of IRC 521(b)(2) that "substantially all" of the capital stock of a farmers' cooperative must be held by producers, means that at least 85 percent should be held by producers. The regulations pertaining to the "substantially all" requirement of IRC 4942(j)(3) state that "substantially all" means 85 percent or more. Reg. 53.4942(b)-1(c).

Although 85 percent is the unofficial guideline, a definite percentage cannot always be applied because of the difficulty in applying a percentage test to donated goods and uncompensated labor. For example, some persons who volunteer their services may perform clerical duties while compensated employees may be in managerial positions.[2]

In Smith-Dodd Businessman's Association v. Commissioner, 65 T.C. 620 (1975), the organization was operating a bingo game with individuals who were paid $ 8.00 a night for four hours of work. The organization argued that this amount represented reimbursement of expenses. However, the Tax Court held that the payments constituted compensation, and under the facts of the case the exception for volunteer labor was not applicable.

With respect to donated goods, neither the Code nor the regulations indicate whether "substantially all" refers to the value or the quantity of the goods, but presumably either would be acceptable. With regard to certain items, such as clothing, the percentage in terms of value would seem difficult to calculate. In any event, 85 percent is a good starting point and then all the facts and circumstances of a particular case have to be considered.

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[2] See EO CPE 1982 for discussion of "substantially all" on pages 124-127.

4. Feeder Organizations and Charities

A. Charitable Organizations

While IRC 502 refers to the denial of exemption under all subsections of IRC 501(c), as indicated previously, Congress was particularly concerned with businesses conducted by charitable organizations. In order to get a better understanding of charities and IRC 502 one should consider the basic requirements for exemption under IRC 501(c)(3). IRC 501(c)(3) provides for exemption of organizations organized and operated exclusively for religious, charitable, or educational purposes. Thus, the issue of exemption for a charitable organization turns on its purpose. Some charitable organizations conduct their own charitable programs and some carry out their charitable purpose by donating funds to other charitable organizations. Compare this to other paragraphs of IRC 501(c) where exemption turns upon the amount of exempt activities. Although a charity must be operated for exempt purposes, there is the question as to how much nonexempt activities, particularly business activities, may be conducted.

B. The Primary Purpose Test of IRC 501(c)(3)

Reg. 1.501(c)(3)-1(c)(1) provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes. Thus, if an organization engages more than insubstantially in activities which do not accomplish a charitable purpose, it does not qualify for exemption. Reg. 1.501(c)(3)-1(e)(1) provides that an organization may meet the requirements of IRC 501(c)(3), although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose and if the organization is not organized and operated for the primary purpose of carrying on an unrelated trade or business as defined in IRC 513. These two provisions appear to contradict one another. Reg. 1.501(c)(3)-1(e)(1) permits business activities while Reg. 1.501(c)(3)-1(c)(1) seems to prohibit any substantial noncharitable activity.

However, because Reg. 1.501(c)(3)-1(e)(1) specifically refers to business activities, it controls. Support is also found in the legislative history. The "(e)(1)" regulation was adopted in 1952, along with the unrelated business income tax regulations, to conform to the Revenue Act of 1950. Its purpose was to permit charities to carry on substantial unrelated businesses so long as such businesses are

in furtherance of exempt purposes. The latter purpose is accomplished by using the profits from the businesses for charitable purposes.

Thus, if an organization carries on a business and its only other activity is the turning over of the business profits to one or more charities, it may qualify for exemption under IRC 501(c)(3), provided it is not an IRC 502 feeder, because the turning over of such profits may be deemed to be in furtherance of a charitable purposes. Consider Rev. Rul. 64-182, 1964-1 (Part 1) C.B. 186, which indicates the extent to which a charitable organization may receive income where its only claim to exemption is that the income will be turned over to charitable organizations. The organization described in the revenue ruling derived its income principally from the rental of space in a large commercial office building that it owned and operated. Its charitable purposes were carried out by aiding other charitable organizations, selected in the discretion of its governing body, through contributions and grants to such organizations for charitable purposes. The issue was the amount of business that a charitable organization could conduct when it had no charitable programs of its own and still be considered to be operated exclusively for charitable purposes. The revenue ruling held that the organization was deemed to meet the primary purpose test of Reg. 1.501(c)(3)-1(e)(1) because it was shown to be carrying on through its contributions and grants a charitable program commensurate in scope with its financial resources. Thus, the relative extent to which a charitable organization carries on a particular kind of business activity in the physical sense is not a valid test or measure of whether the "primary purpose" is charitable. Although the revenue ruling involved rental income, the principle would apply to an organization operating any type of business.

The question that arises, however, is why IRC 502 does not apply to the organization. One reason is that at the time the revenue ruling was published IRC 502 was not applicable to the rental of real property.[3] However, if the profits had not been derived from the rental of real property, IRC 502 would still not have applied. For example, if the profits had been derived from the operation of a

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[3] The definition of "trade or business" was changed by the Tax Reform Act of 1969 and the rental of real property is no longer automatically excluded from the special IRC 502 concept of "trade or business" and this exclusion has been limited to activities involving the receipt of nothing more than so-called "passive" rentals. See Senate Report 91-552, 91st Congress, 68-9 (1969) and the new statutory language of IRC 512(b)(3).

department store, IRC 502 would not have applied to deny exemption because the charitable organizations to which the grants and contributions were made were selected in the discretion of the governing body. As previously mentioned, if an organization has discretion as to which charity or charities it will give the business profits to, it is not a feeder under IRC 502. In order for IRC 502 to apply there must be a legal or practical obligation to turn over the profits to one or more charitable organizations. If there is a question as to whether such obligation exists, technical advice should be requested.

For example, Rev. Rul. 73-164, 1973-1 C.B. 223, describes a church controlled commercial printing corporation whose business profits are payable to the church, but which has no other significant charitable activity. Rev. Rul. 73-164 recognizes that the organization is organized and operated for charitable purposes by virtue of the fact that the beneficial use of its assets is effectively dedicated to exclusively charitable objects and thereby qualifies under IRC 501(c)(3), in the absence of IRC 502. However, because its income is required to be turned over to the church, the revenue ruling concludes that IRC 502 precludes exemption.

Another question arises with respect to the type of organization described in Rev. Rul. 64-182 and exemption under IRC 501(c)(3). The revenue ruling states that the primary purpose test of Reg. 1.501(c)(3)-1(e)(1) has been met when the organization makes contributions to other charities commensurate in scope with its financial resources. What if an organization claims that that is its intention but throughout its history, say five years, there have been consistent losses with the result that no disbursements have been made to charity?

We assume that the organization in this instance is not a feeder and that it otherwise qualifies for charitable status under IRC 501(c)(3). The question is whether the organization meets the "commensurate test".

In such a situation an organization may well argue that despite the nonprofitable results of its business efforts, its "purpose" in the undertaking, nevertheless, is the production of income for its charitable purposes, and that the fact the business has not proved profitable does not defeat the charitable character of its operations.

This is admittedly a factual circumstance which will have to be taken into consideration in attempting to evaluate the presence or absence of the charitable purpose in an organization's operations. Nevertheless, we think that where an organization is shown, without reasonable cause, and after a reasonable period of

experience, to be devoting its time, energy and assets to a business activity which does not, in fact, provide any significant financial support for any charitable accomplishment, its purpose in such conduct should be carefully scrutinized to insure no noncharitable purpose is involved.

This is not to suggest that there should be any substitution of business judgment on the part of the Service in such cases. It is merely to point out that where there is an apparent indifference to the nonproductive character of the activity, and a consequent lack of any definite charitable accomplishment, it may be argued that there is ground for denial of exemption under the concept of the primary purpose test of the regulations.

C. Other IRC 501(c) Organizations

A question arises whether an organization set up to "feed" noncharitable exempt organizations could qualify for exemption. As previously mentioned, an organization can carry on a business as its primary activity and still not be disqualified from exemption by IRC 501(c)(3) if its primary purpose is charitable, provided it is not disqualified by IRC 502. With noncharitable organizations the test is different. If a noncharitable organization applies for recognition of exemption under another paragraph of IRC 501 and it carries on a business for profit as its primary activity and turns the profits over to noncharitable exempt organizations, it does not qualify for exemption under any paragraph of IRC 501(c) regardless of whether IRC 502 applies. That is because exemption under other paragraphs of IRC 501(c) is governed by an activities test. The principles of the primary purpose test of IRC 501(c)(3) regulations do not apply to other paragraphs of IRC 501(c) because they do not deal with charities or predicate exemption on qualification as a charity. Their qualification for exemption depends upon meeting the adjectival descriptions of the subsections of IRC 501(c) in terms of activity.

For example, if a nonprofit organization operates a department store and its articles of incorporation and bylaws state that its purpose is to engage in social welfare by contributing to social welfare organizations exempt under IRC 501(c)(4) selected by its officers, the organization would not qualify for exemption under IRC 501(c)(4) even if all proceeds derived from the business operation commensurate with its financial resources were expended annually in furtherance of its social welfare purpose. The reason for this conclusion is that there is no precedent for the allowance of an exemption under the social welfare provisions of IRC 501(c)(4) to any organization whose primary activities do not promote the

common good and general welfare of the people of the community in some direct way. In such case IRC 502 would not come into play.

5. Providing Business Services to One or More Exempt Organizations

A. Basic Concept

Reg. 1.502-1 provides:

> (b) If a subsidiary organization of a tax-exempt organization would itself be exempt on the ground that its activities are an integral part of the exempt activities of the parent organization, its exemption will not be lost because, as a matter of accounting between the two organizations, the subsidiary derives a profit from its dealings with its parent organization, for example, a subsidiary organization which is operated for the sole purpose of furnishing electric power used by its parent organization, a tax-exempt educational organization, in carrying on its educational activities. However, the subsidiary organization is not exempt from tax if it is operated for the primary purpose of carrying on a trade or business which would be an unrelated trade or business (that is, unrelated to exempt activities) if regularly carried on by the parent organization. For example, if a subsidiary organization is operated primarily for the purpose of furnishing electric power to consumers other than its parent organization (and the parent's tax-exempt subsidiary organizations), it is not exempt since such business would be an unrelated trade or business if regularly carried on by the parent organization. Similarly, if the organization is owned by several unrelated exempt organizations, and is operated for the purpose of furnishing electric power to each of them, it is not exempt since such business would be an unrelated trade or business if regularly carried on by any one of the tax-exempt organizations.

Some organizations are not engaged in a business to make money for designated charitable organizations but are organized and operated to provide services for specific charitable organizations. If an exempt organization creates another organization to furnish it with certain services, the organization so established may itself qualify for exemption under the same subsection of IRC 501(c) as the parent, even though, as a matter of accounting between the two, the subsidiary derives a profit from its dealings with the parent. However, it will not

qualify for exemption if the service provided by the subsidiary would constitute the conduct of an unrelated trade or business if conducted directly by the parent. Reg. 1.502-1(b). The example given in the regulations is that of an exempt subsidiary organization that is operated for the sole purpose of furnishing electric power used by its parent, a tax exempt educational organization, in carrying on its educational activities.

However, if a subsidiary is operated primarily to furnish electric power to consumers on behalf of its parent organization, it would not qualify for exemption because the sale of such power by the parent would be an unrelated trade or business of the parent if regularly carried on by the parent organization. Reg. 1.502-1(b).

According to the regulations, if a subsidiary organization is owned by several unrelated exempt organizations and is operated to furnish electric power to them, it is not exempt because such business would be unrelated trade or business if regularly carried on by any one of the exempt organizations.

However, IRC 501(e) provides that a cooperative hospital service organization providing specifically enumerated services to two or more hospitals may under certain circumstances qualify for exemption under IRC 501(c)(3). But the enumerated services do not include laundry services, and Rev. Rul. 69-160, 1969-1 C.B. 147, held that a hospital service organization providing laundry service for its member hospitals does not meet the requirements of IRC 501(e).

Also, IRC 501(f) provides for organizations to be treated as organized and operated exclusively for charitable purposes if they are organized and operated solely to provide collectively certain investment services in stock and securities with money contributed by their members, which in general are exempt schools.

Cooperative hospital laundry organizations were the subject of several court decisions resulting from the Service position that they did not qualify for exemption because they were feeder organizations and were not covered by IRC 501(e). Some of the decisions agreed with the Service's position and others did not, but these conflicts were resolved by the Supreme Court decision in HCSC Laundry v. United States, 450 U. S. 1 (1981), that held that such organizations were not covered by IRC 501(e).

Not all organizations formed to provide services to two or more exempt organizations are described in IRC 502. Three factors have to be considered before concluding that an organization is a feeder:

(1) Are the organizations providing and receiving the services related?

(2) Do the services furnished constitute the conduct of an exempt function?

(3) Are the services furnished substantially below cost?

If the answer to any of these questions is yes, the organization is not a feeder.

B. Related Organizations

According to Reg. 1.502-1(b), organizations are related if they consist of --

(1) A single parent organization and one or more of its subsidiary organizations; or

(2) Subsidiary organizations having a common parent organization.

An exempt organization is not related to another exempt organization merely because they engage in the same type of exempt activities.

Reg. 1.502-1(b) contemplates that a subsidiary organization may provide essential services to a single distinct parent organization and its subsidiaries, or to a group of related subsidiary organizations that have a single parent organization in common with the organization that provides the services. A subsidiary organization is one that is controlled and closely supervised by the parent organization.

Generally, an organization is a subsidiary because the parent organization owns the majority of the voting stock with the concomitant control over the subsidiary. The nonstock nature of most exempt organizations makes it difficult to apply these tests to determine parent-subsidiary relationships. Rev. Rul. 68-26, 1968-1 C.B. 272, applied a control test in a nonstock situation. It concerned an organization established by a church to print and sell educational material to its parochial school system. Notwithstanding the absence of a technical parent-

subsidiary relationship, the revenue ruling stated that a parent-subsidiary relationship can be present if "a substantially similar relationship does in fact exist through the control and close supervision of its affairs."

C. Services Furnished Constitute Exempt Function

In some cases the nature of the activities conducted constitutes the performance of an exempt function rather than the conduct of a trade or business for profit. In these cases it does not matter if the organizations are not related and the charge for the service is not substantially below cost.

Rev. Rul. 74-614, 1974-2 C.B. 164, concerns an organization that was created and controlled by IRC 501(c)(3) colleges and universities in a particular geographical region. The purposes and activities of the organization were to devise, operate and provide the organizational structure for a regional computer network to enable member educational institutions, including faculties and students, to benefit from research and scientific information developed by other member institutions and the Federal Government. The organization conducted an information clearing house responsive to the curriculum and research needs of its members and kept them informed of the educational data and computer time available on the equipment. The organization did not own any computers and the members utilized computers of member suppliers. The computer network was not used for administrative matters. The educational institutions were not related within the meaning of Reg. 1.502-1(b).

The revenue ruling held that the organization qualified for exemption under IRC 501(c)(3) because it advanced education by providing a coordinated program that enabled the member institutions to benefit from its research and scientific projects developed by the various institutions and organizations. While the revenue ruling did not discuss IRC 502, it is apparent that it did not apply because the basic nature of the organization's activities was educational and such activities did not constitute carrying on a trade or business for profit within the meaning of IRC 502. See also Rev. Rul. 81-39, 1981-1 C.B. 329.

D. Services Furnished at Substantially Below Cost

Rev. Rul. 71-529, 1971-2 C.B. 234, concerned an organization that provided investment management services to unrelated colleges and universities exempt under IRC 501(c)(3). The organization received capital from the member participating exempt organizations and placed it in one or more common funds in

the custody of various banks. The funds were controlled and managed by the organization and were invested upon the advice of independent counsel retained by the organization. Most of the operating expenses were paid for by grants from independent charitable organizations. The member organizations paid only a nominal fee for the services which represented less than fifteen percent of the total costs of operation. The revenue ruling concluded that because the organization was performing an essential function for its member charitable organizations at substantially below cost the organization was performing a charitable activity within the meaning of IRC 501(c)(3) and qualified for exemption. It was similar to a grant-making charity assisting the recipient organizations to carry out their charitable programs. While the revenue ruling did not mention IRC 502, that section would not apply because the providing of such services substantially below cost is not carrying on a trade or business for profit within the meaning of IRC 502. Compare this to Rev. Rul. 69-528, 1969-2 C.B. 127, which describes an organization formed to provide investment services on a fee basis exclusively to IRC 501(c)(3) organizations. The organization received funds from the exempt organizations, invested in common stock, reinvested income and realized appreciation, and upon request liquidated a participant's interest and distributed the proceeds to the participant. The organization was free from the control of the participants and had absolute discretion in investment of property, sale of investments, distributions of income and principal, etc., and dealt with the property and funds as if it were the absolute owner thereof.

Citing IRC 502 and regulations, the revenue ruling concluded that providing investment services on a regular basis for a fee is a trade or business ordinarily carried on for profit. The revenue ruling held that the organization was not described in IRC 501(c)(3) or 501(c)(2) inasmuch as it was regularly carrying on activities that would be an unrelated trade or business if carried on by any of the participant exempt organizations.

It should be noted that while the facts of Rev. Rul. 71-529 show that the payments for the investment management services were less than fifteen percent of the total costs of operation, this percentage is not a standard for determining what is "substantially below cost." No definite percentage can be established but something significantly in excess of fifteen percent would be acceptable.

Rev. Rul. 64-182, 1964-1 (Part 1) C.B. 186

A corporation organized exclusively for charitable purposes derives its income principally from the rental of space in a large commercial office building which it owns, maintains and operates. The charitable purposes of the corporation are carried out by aiding other charitable organizations, selected in the discretion of its governing body, through contributions and grants to such organizations for charitable purposes. Held, the corporation is deemed to meet the primary purpose test of section 1.501(c)(3)-1(e)(1) of the Income Tax Regulations, and to be entitled to exemption from Federal income tax as a corporation organized and operated exclusively for charitable purposes within the meaning of section 501(c)(3) of the Internal Revenue Code of 1954, where it is shown to be carrying on through such contributions and grants a charitable program commensurate in scope with its financial resources.

An organization may not consider itself exempt from tax merely because it falls within the scope of this Revenue Ruling. In order to establish its status, an organization claiming exemption under section 501(c)(3) of the Code should file its application on Form 1023, Exemption Application, with the District Director of Internal Revenue for the internal revenue district in which is located the principal office of the organization. See section 1.501(a)-1 of the Income Tax Regulations.

Rev. Rul. 68-26, 1968-1 C.B. 272

26 CFR 1.502-1:Feeder organizations. Rev. Rul.68-26
(Also Section 501;1.501(c)(3)-1.)

A nonprofit organization controlled by a church to print and sell educational and religious material to the church's parochial school system is not a feeder organization defined in section 502 of the Internal Revenue Code of 1954 when it sells the material at a profit which is returned annually to the parochial school system. Thus, it may be exempt from Federal income tax under section 501(c)(3) of the Code.

The Internal Revenue Service has been asked whether the nonprofit organization described below is a feeder organization within the meaning of section 502 of the Internal Revenue Code of 1954.

The organization was incorporated without stock by a church to provide a standardized source of educational and religious material for the church's parochial school system. Its affairs are managed by a board of directors composed of clergymen appointed by the church and responsible to the church for the organization's finances and operations. The organization prints material which is prepared and edited by the school system. The organization sells the material exclusively to the parochial school system. All profits are returned annually to the school system.

Section 502 of the Code provides that an organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt under section 501 on the ground that all of its profits are payable to one or more organizations exempt under section 501 of the Code from taxation.

Section 1.502-1(a) of the Income Tax Regulations provides that in determining the primary purpose of an organization, all the circumstances must be considered, including the size and extent of its exempt activities.

Section 1.502-1(b) of the regulations provides that if a subsidiary organization of a tax-exempt organization would itself be exempt on the ground that its activities are an integral part of the exempt activities of the parent organization, the former's exemption will not be lost because, as a matter of accounting between the two organizations, the subsidiary derives a profit from its dealings with its parent organization. This is illustrated by the example of an organization operated for the sole purpose of furnishing electric power to an exempt parent or to a group of related

exempt organizations, having a common parent, and such power is used in carrying on exempt functions.

Although a technical parent-subsidiary relationship between the church and the organization is lacking because of the nonstock character of the organization, a substantially similar relationship does in fact exist through the control and close supervision of its affairs by the church. In printing material which has been prepared by the parochial school system, the organization is carrying out an integral part of the activities of the church, the parent organization. Accordingly, it qualifies for exemption from Federal income tax under section 501(c)(3) of the Code because it is operated as an integral part of the exempt activities of the parent. Furthermore, since the sole source of its profits is the sales made to a component of its parent organization, the profits are essentially a matter of accounting among the organizations involved and thus, it is not a feeder described in section 502 of the Code.

An organization which considers itself within the scope of this Revenue Ruling must, in order to establish exemption under section 501(c)(3) of the Code, file an application on Form 1023, Exemption Application, with the District Director of Internal Revenue for the internal revenue 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.

Rev. Rul. 69-528, 1969-2 C.B. 127

An organization regularly carrying on an investment service business that would be unrelated trade or business if carried on by any of the exempt organizations on whose behalf it operates, is not exempt under section 501(a) of the Code.

Rev. Rul. 69-528

Advice has been requested whether the organization described below qualifies for exemption from Federal income tax under section 501(a) of the Internal Revenue Code of 1954 as an organization described in either section 501(c)(2) or section 501(c)(3) of the Code.

The organization was formed to provide investment services on a fee basis exclusively to organizations exempt from Federal income tax under section 501(c)(3) of the Code. It receives funds from the participating exempt organizations, invests in common stocks, reinvests income and realized appreciation, and upon request liquidates a participant's interest and distributes the proceeds to the participant.

The organization is free from the control of the participants and has the absolute and uncontrolled discretion in (1) investment of the property, (2) sale of investments and reinvestment of the proceeds, (3) payment of taxes and liens, (4) distributions of income and principal or the addition of accumulated income to principal, and (5) dealing with the property and managing the funds as if it were absolute owner thereof. In addition, a participant's ownership interest in the property does not entitle such participant to the whole or any part of the property or the right to call for a partition, division, or accounting of the property.

Section 502 of the Code provides that an organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt under section 501 on the ground that all of its profits are payable to one or more organizations exempt from Federal income tax under section 501.

Section 1.502-1(b) of the Income Tax Regulations provides that a subsidiary organization of an exempt organization is not exempt from tax if it is operated for the primary purpose of carrying on a trade or business which would be an unrelated trade or business (that is, unrelated to exempt activities) if regularly carried on by the parent organization. For example, if a subsidiary organization is operated primarily for the purpose of furnishing electric power to consumers other than its parent organization (and the parent's tax-exempt subsidiary organizations), it is

not exempt since such business would be an unrelated trade or business if regularly carried on by the parent organization. Similarly, if the organization is owned by several unrelated exempt organizations, and is operated for the purpose of furnishing electric power to each of them, it is not exempt since such business would be an unrelated trade or business if regularly carried on by any one of the tax-exempt organizations.

Providing investment services on a regular basis for a fee is trade or business ordinarily carried on for profit. If the services were regularly provided by one tax-exempt organization for other tax-exempt organizations, such activity would constitute unrelated trade or business. Based upon the above-cited statute and regulations, it is held that this organization is not exempt under section 501(a) of the Code as an organization described in either section 501(c)(2) or section 501(c)(3) since it is regularly carrying on the business of providing investment services that would be unrelated trade or business if carried on by any of the tax-exempt organizations on whose behalf it operates.

Compare Revenue Ruling 56-267, C.B. 1956-1, 206, which holds that where, under certain specified conditions, exempt employees' trusts pool their funds in a group trust to provide diversification of investment, the group trust may qualify as an exempt employees' trust and the exempt status of the separate trusts will not be adversely affected. That Revenue Ruling specifies that in order to meet the qualification requirements under section 401(a) of the Code, the group trust must itself be adopted as a part of each employer's pension or profit-sharing plan, and that the group trust instrument must prohibit that part of its corpus or income which equitably belongs to any participating exempt employees' trust from being used for or diverted to any purpose other than for the exclusive benefit of the employees or their beneficiaries who are entitled to benefits under such participating trust. Under such conditions, one or more trusts may form part of a qualified plan, referred to in section 401(a), and maintain exemption under section 501(a).

Rev. Rul. 71-581, 1971-2 C.B. 236

Operation of a separately incorporated thrift shop to raise funds for a group of specified exempt organizations may qualify for exemption under section 501(c)(3) of the Code; Revenue Ruling 68-439 revoked.

Rev. Rul. 71-581

Internal Revenue Service has given further consideration to Revenue Ruling 68-439, C.B. 1968-2, 239. The question concerns the application of section 502 of the Internal Revenue Code of 1954, prior to its amendment by the Tax Reform Act of 1969, Public Law 91-172, C.B. 1969-3, 10, to an organization that operated a thrift shop where substantially all of the goods had been donated and more than half of the work was performed without compensation, under the circumstances described below.

X, a nonprofit organization, operated a thrift shop. X was organized by a group of nonprofit organizations described in section 501(c)(3) of the Code and all of X's profits were payable to these organizations. Substantially all of the merchandise sold by X had been contributed and more than half of the work in operating the thrift shop was performed without compensation. Paid employees were reasonably compensated for their services.

Section 502 of the Code provides that an organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt under section 501 on the ground that all of its profits are payable to one or more organizations exempt under section 501.

Had the activity described above been carried on directly by any one of the exempt organizations, any profit therefrom would have been excluded from taxation under section 511 of the Code by the provisions of section 513(a)(3) of the Code. X was organized as a separate corporation to operate the thrift shop in order to insulate the assets of the exempt organizations from any potential liability arising out of the operations of the thrift shop and to enable X to have a separate governing body and organizational structure composed of persons interested in aiding the exempt organizations principally through volunteer work in connection with the operation of the thrift shop.

The primary purpose for which X was operated was to serve the group of exempt organizations by performing an essential function for them; that is, to solicit contributions of goods on behalf of the exempt

organizations and to convert the contributed goods to cash for charitable uses with a minimum of expense by the use of volunteer labor. X was organized as a separate corporation only to secure the organizational advantages described above.

Accordingly, it is held that X is not precluded from qualification for exemption under section 501 of the Code by section 502 of the Code prior to its amendment by the Tax Reform Act of 1969. X may qualify as an organization described in section 501(c)(3) of the Code, if it otherwise meets the requirements of that section.

For taxable years beginning after December 31, 1969, section 502(b)(2) of the Code, added by section 121(b)(7) of the Tax Reform Act of 1969, permits the exemption of certain thrift shops.

Revenue Ruling 68-439, which held that the operation of a separately incorporated thrift shop to raise funds for a specific charitable organization constitutes a trade or business within the meaning of section 502 of the Code, and accordingly precludes exemption of such a thrift shop under section 501(c)(3), is hereby revoked.

Rev. Rul. 73-146, 1973-1 C.B. 223

A church-controlled commercial printing corporation whose business earnings are paid periodically to the church, but which has no other significant charitable activity, is a feeder organization as described in section 502 of the Code and does not qualify for exemption under section 501(c)(3).

Rev. Rul. 73-164

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

The organization is a charitable corporation formed by a church to promote and provide financial support for the charitable programs of the church through the performance of certain printing functions for the church and the production of income for church use. It seeks to accomplish these charitable objectives by printing religious materials for the church at cost and in addition derives substantial profit from the operation of a commercial printing business. The publication functions performed for the church account for approximately 10 percent of the overall publishing activities of the organization. All of its profits are derived from the commercial printing business. In accordance with an express requirement in the articles of incorporation, all the net income of the organization is paid over to the church at the end of each calendar quarter of operation.

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

Section 502 of the Code provides that an organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt from taxation under section 501 on the ground that all of its profits are payable to one or more organizations exempt from taxation under section 501.

Section 1.502-1(a) of the Income Tax Regulations provides in effect that for the purposes of section 502 as applied to organizations described in section 501(c)(3) in determining the primary purpose for which an organization is operated, consideration is to be given to the relative size and extent of the trade or business activities of the organization and to whether it has any significant charitable activities other than the required payment of all of its profits over to one or more other charitable

organizations that are exempt under section 501(c)(3). If its principal income-producing activity is the conduct of trade or business and it has no significant charitable activity other than the required payment of all of its profits to one or more charitable organizations exempt under section 501(c)(3), it is deemed to be operated for the "primary purpose" of carrying on a trade or business for profit within the meaning of section 502.

Although the organization may be said to be organized and operated exclusively for charitable purposes by virtue of the fact that the beneficial use of all of its assets is effectively dedicated to exclusively charitable objects, its only basis for qualifying in that respect, apart from the relatively insignificant amount of printing performed at cost for the church, is that all of its profits are required to be paid to the church. Since the organization has no other significant charitable activity and its principal income-producing activity is the conduct of a trade or business, it is held that it is precluded from exemption under section 501(c)(3) by reason of section 502.

Compare Revenue Ruling 68-26, 1968-1 C.B. 272, which holds that an organization controlled by a church to print and sell educational and religious material exclusively to the church's parochial school system is not precluded from exemption under section 501(c)(3) of the Code by section 502.

Rev. Rul. 74-614, 1974-2 C.B. 164

Educational; regional computer network. An otherwise exempt organization of exempt colleges and universities that devises, operates, and provides the organizational structure for a regional network of member owned or leased computers to collect and disseminate scientific and educational information to exempt members' faculties and students is operated exclusively for charitable purposes and exempt under section 501(c)(3) of the Code.

Rev. Rul. 74-614

The Internal Revenue Service has been asked whether the nonprofit organization described below, which otherwise qualifies for exemption from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954, is operated exclusively for charitable purposes.

The organization was created and is controlled by the colleges and universities in a particular geographical region, each of which has been recognized as exempt from Federal income tax under section 501(c)(3) of the Code.

The purposes and activities of the organization are to devise, operate, and provide the organizational structure for a regional computer network to enable member educational institutions, including faculties and students, to benefit from research and scientific information developed by other member institutions and the Federal government. Any member-user can utilize any of several computers owned (or leased) by member-suppliers, for the collection and dissemination of scientific and educational information in connection with the educational and research programs of the member-user's faculty and students.

The organization does not own, nor does it plan to own, any computers. It conducts an information clearing house responsive to the curriculum and research needs of member-users. It informs each member institution of the educational data and computer time available on the equipment of member suppliers. The organization's employees also visit the campuses of member suppliers to determine available resources, and also the campuses of member users keeping them advised of new educational data and to keep aware of their curriculum needs.

The computer network is not used for administrative matters such as class scheduling, billing, or processing applications. The equipment, through which the network functions, is not designed to accommodate the

high speed batch programs characteristic of administrative data processing.

The organization also maintains a staff to conduct research into the technical and managerial problems which arise from the operation of a regional computer network and to devise solutions to those problems and to disseminate the results of its research. The results of this research are made available not only to members but also to the general public.

The organization is supported by governmental grants, contributions, and membership dues. In addition the organization acts as a conduit with respect to amounts paid by member-users of the equipment to member suppliers, retaining only a small part to defray its expenses in connection with this activity.

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

Section 1.501(c)(3)-1(d)(2) of the Income Tax Regulations provides that the term "charitable" is used in section 501(c)(3) of the Code in its generally accepted legal sense, which includes advancement of education.

By providing a coordinated program which enables the member institutions, including faculty and students, to benefit from the research and scientific projects developed by the various institutions and the organizations, the organization is advancing education.

Accordingly, the organization is operated exclusively for charitable purposes and, since it otherwise qualifies, is exempt from Federal income tax 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, Application for Recognition of Exemption, 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 of the organization. See section 1.501(a)-1 of the regulations.