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INTERNAL REVENUE SERVICE

NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

Acting Area Manager, Exempt Organizations
Area Office

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification Number:

Years Involved:

Date of Conference:

OP:E:EO:T 2
U/L: 101.00-00
501.00-00
511.00-00
512.00-00
513.00-00

Legend:

M =
x =

Issues:

(1) Whether the operation of a tea room and a gift shop represents a substantial nonexempt purpose that would cause a revocation of M's exempt status under section 501(c)(3) of the Internal Revenue Code.

(2) If not, whether income earned by M from the operation of the tea room and gift shop is unrelated business income under sections 511 through 513 of the Code.

Facts:

M was recognized as exempt from federal income tax as a charitable organization under section 101(6) of the Revenue Act of 1936, which corresponds to section 501(c)(3) of the Internal Revenue Code of 1986. Subsequently, M was redetermined to be exempt under section 501(c)(3) of the Code and not a private foundation within the meaning of section 509(a)(1). M's stated purpose, as expressed in its original Articles of Incorporation, was to "establish and maintain...a place for the reception, exhibition and sale of articles, the product and manufacture of industrious and meritorious women" and to assist said women to earn an honest living and facilitate the sale of such articles as these women may desire to sell and "generally to assist needy and deserving women in their efforts to earn an honest livelihood by their own industry."

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M states that it was organized to aid deserving women to earn their own living by means of their own handiwork, by providing a place where they could sell articles and foodstuffs prepared by them. M operates three contiguous shops (a consignment shop, a gift shop, and a tea room), all approximately the same size. The consignment shop, operated by volunteers and paid employees, displays and sells the goods made by the needy women. The gift shop, operated by volunteers and paid employees, purchases decorative items from regular for-profit vendors for resale to the public. The tea room, operated by volunteers and paid employees, is a luncheon facility selling to the general public and consists of a dining room and a kitchen.

With regard to the consignment shop, M selects women (consignors) from whom it accepts handcrafted toys and clothing for children for consignment, or purchase by the general public. A prospective consignor learns about M's program through word of mouth and M's publicity campaigns, and submits samples of her work. Volunteers from M's membership assess the work of the proposed consignor to determine her suitability for M's program. Once M accepts a person as a consignor, it trains her. M states that the object of the training, virtually all of which is performed by volunteers, is to educate the person on how to make items that people will not only buy, but for which they will pay high prices. Training consists of educating the consignors on the types of items to make, explaining matters of fashion, fit, style, fabric, color, sewing technique, and type and number of products. After a consignor is trained, M supervises her work; volunteers select the fabrics that M sells at cost to the consignors. Items selected by M are displayed at the consignment shop and are sold to the general public.

With regard to the gift shop, adjacent to the consignment shop, volunteers from M's membership purchase decorative items from regular for-profit vendors for resale; the items are displayed and sold to the general public. M states that the consignment activity, by itself, would not bring many prospective customers into the shop since the operation would be perceived as a "craft fair," would not draw "top dollar" for the handmade items, and would not generate confidence in the quality of the items for sale. M states that it has learned that to attract and serve quality clientele who will support the consignors, it must (1) have a reason for people to come to the premises (which exposes them to the consigned items), (2) a showroom with ambiance that repeatedly attracts high end clientele, and (3) a showcase merchandising that implies quality. M states that the items in the gift shop are sophisticated, tasteful, and fashionable, and because they are in the same showroom with the consignment items, they enhance the consignment items.

M states that in order to optimize the prices of consignment items, and maximize returns to the consignors, M has developed a pricing strategy: gift shop items cover a broader price range than consignment items, with greater number of items in the low end and the high end; the low end items give the consumer a sense of bargain and comfort, while the high end items steer the consumer to mid-range prices, which is where the consignment items are concentrated. Prices for consignment items range from $4.50 to $250.00; prices for gift shop items range from $1.50 to $1,500.00 (one item). After eliminating a few high priced items, M states that representative sales for consignment items range from $4.50 to $95.00, while the range for the gift shop items range from $1.50 to $150.00.

Adjacent to both the consignment shop and the gift shop is the tea room (consisting of a dining room and a kitchen), which is a luncheon facility selling food to the general public. All of the items sold in the tea room are made from items purchased from regular for-profit vendors. The tea room is accessible only through the gift shop, and serves a light lunch. M states that the light lunch is ideal for shoppers, and the menu selections, the decor, the room arrangement, and the tableware are all designed to be sophisticated and tasteful. M states that beyond the tea room's intrinsic appeal, it attracts people by enhancing their schedules; a person can socialize and shop simultaneously, and when friends meet for lunch, shopping becomes a social activity. M states that three volunteers and three paid employees staff the dining area.

M states that its only purpose for its gift shop and tea room activity is to further its stated primary purpose of helping people who face adversity to help themselves, and that the reason it carries on the gift shop and tea room activities is to support its handicraft activity through attracting customers and by providing funds to support this exempt function. M states that its operations have not changed appreciably since it was originally recognized as exempt.

M is a membership organization comprising women of the community who pay dues and are required to volunteer a minimum amount of time to M's activities each year. On the average, the volunteers contribute approximately 5,000 documented hours to M per year. The volunteers work in a variety of activities, including the training of consignors, entering data in M's computer, doing bookkeeping for consignors, overseeing the arrangement and appearance of M's premises, publicizing M's mission, buying items for the gift shop, fund-raising, assisting with sales of consignment goods and items in the gift shop, working in the tea room, and performing office functions such as

the preparation of bills and sending statements. M states that the volunteers also perform a lot of services for it without documenting their time, such as attending meetings, computer data entry at home, and shopping for patterns and fabrics. M also states that most of its paid staff is allocated to the tea room and the consignment shop, and that their participation in the gift shop is limited to support: the paid staff will do overflow data entry that volunteers cannot handle when they mark in goods, and run the cash register that serves both the tea room and the gift shop. M states that the paid staff do most of the post-sale paperwork, such as reviewing daily sales records and preparing sales tax returns. M also employs a full-time paid Executive Director and a full-time paid bookkeeper.

For the year under examination, M's total revenue consisted of $x. M's greatest single source of revenue was from the tea room, comprising almost 34% of $x; the next greatest source of revenue was from the consignment shop, comprising slightly more than 33% of $x; the third greatest source of revenue was from the gift shop, comprising approximately 28% of $x; approximately 3% of $x came from donations and less than 1% came from membership dues. According to an estimate by M's Executive Director, the consignment shop utilized approximately 40% of M's financial and physical resources; the tea room and the gift shop each utilized approximately 30% of M's financial and physical resources. For the year under examination, M reported its revenues from the tea room and from the gift shop as unrelated business taxable income on its Form 990-T, Exempt Organization Business Income Tax Return and listed its largest single expense after the cost of goods sold as salaries and wages. An analysis of prior tax years shows that the percentages of M's revenues from the tea room, the consignment shop, and the gift shop, were fairly consistent with the percentages from the year under examination.

Law:

Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations organized and operated exclusively for religious, charitable, or educational purposes so long as no part of the organization's net earnings inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(a)(1) of the Income Tax Regulations provides that in order to be exempt as an organization described in section 501(c)(3) of the Code, an organization must be both organized and operated exclusively for one or more of the purposes specified in such section.

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Section 1.501(c)(3)-1(c)(1) of the regulations 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 specified in section 501(c)(3) of the Code. An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of any exempt purpose.

Section 1.501(c)(3)-1(e)(1) of the regulations provides that an organization may meet the requirements of section 501(c)(3) of the Code 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 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 of the Code. In determining the existence or nonexistence of such primary purpose, all the circumstances must be considered, including the size and extent of the trade or business and the size and extent of the activities which are in furtherance of one or more exempt purposes. An organization which is organized and operated for the primary purpose of carrying on an unrelated trade or business is not exempt under section 501(c)(3) even though it has certain religious purposes, its property is held in common, and its profits do not inure to the benefit of individual members of the organization.

Section 511(a) of the Code imposes a tax on the unrelated business taxable income of organizations described in section 501(c), which includes section 501(c)(3).

Section 512(a)(1) of the Code provides that as a general rule, except as otherwise noted, the term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business (as defined in section 512) regularly carried on by it, less certain allowable deductions and modifications.

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 such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of the charitable, educational, or other purpose or function constituting the basis for its exemption under section 501.

Section 513(a)(1) of the Code provides that the term unrelated trade or business does not include any trade or business in which substantially all the work in carrying on such

trade or business is performed for the organization without compensation.

Section 1.513-1(a) of the regulations provides that gross income of an exempt organization subject to tax imposed by section 511 of the Code is includible in the computation of unrelated business taxable income if: (1) it is income from a trade or business; (2) such trade or business is regularly carried on by the organization; and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions.

Section 1.513-1(b) of the regulations provides that, in general, any activity of an exempt organization which is carried on for the production of income and which otherwise possesses the characteristics required to constitute "trade or business" within the meaning of section 162 of the Code is a trade or business for purposes of sections 511-513. The regulation further provides that the term "trade or business" generally includes any activity carried on for the production of income from the sale of goods or performance of services.

Section 1.513-1(d)(1) of the regulations provides that, in general, gross income derives from "unrelated trade or business," within the meaning of section 513(a) of the Code, if the conduct of the trade or business which produces the income is not substantially related (other than through the production of funds) to the purposes for which exemption is granted. The presence of this requirement necessitates an examination of the relationship between the business activities which generate the particular income in question--the activities, that is, of producing or distributing the goods or performing the services involved--and the accomplishment of the organization's exempt purposes.

Section 1.513-1(d)(2) of the regulations provides that trade or business is "related" to exempt purposes, in the relevant sense, only where the conduct of the business activities has causal relationship to the achievement of exempt purposes, and is "substantially related," for purposes of section 513 of the Code, 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 the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes. Where the production or distribution of the goods or the performance of the

services does not contribute importantly to the accomplishment of the exempt purposes of an organization, the income from the sale of the goods or the performance of the services does not derive from the conduct of related trade or business. Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends in each case upon the facts and circumstances involved.

Section 1.513-1(e)(1) of the regulations refers to section 513(a) of the Code which specifically states that the term "unrelated trade or business" does not include any trade or business in which substantially all the work in carrying on such trade or business is performed for the organization without compensation. An example would be an exempt orphanage operating a retail store and selling to the general public, where substantially all the work in carrying on such business is performed for the organization by volunteers without compensation.

Rev. Rul. 68-167, 1968-1 C.B. 255, holds that a nonprofit organization created to market the cooking and needlework of needy women may be exempt from federal income tax under section 501(c)(3) of the Code. The revenue ruling states that the organization was formed to assist needy women in earning income by operating a market where it sells the cooking and needlework of these women who are not otherwise able to support themselves and their families. Although the organization charges a small sales commission for its services, it is not self-supporting and must depend upon public contributions. The revenue ruling concludes that the organization provides a necessary service for needy women by giving them a market for their products and a source of income and that by assisting needy persons in this manner, the organization serves a charitable purpose; accordingly, the organization is exempt under section 501(c)(3).

Rev. Rul. 73-105, 1973-1 C.B. 264, holds that the sale by a museum of folk art, exempt under section 501(c)(3) of the Code, of scientific books and various souvenir items relating to the city in which the museum is located constitutes unrelated trade or business. The revenue ruling concludes that such items have no causal relationship to art or to artistic endeavor and, therefore, the sale of these items does not contribute importantly to the accomplishments of the museum's exempt educational purpose which, as an art museum, is to enhance the public's understanding and appreciation of art.

Rev. Rul. 74-399, 1974-2 C.B. 172, holds that a museum's operation of a dining room, cafeteria, and snack bar for use by

the museum staff, employees, and members of the public visiting the museum does not constitute an unrelated trade or business activity. The facilities are of a size commensurate with accommodation of these special groups of patrons and are accessible from the museum's galleries and other public areas but not directly accessible from the street. The patronage of the eating facilities by the general public is not directly or indirectly solicited nor are the facilities contemplated or designed to serve as a public restaurant but merely to serve the exempt purposes of the museum. The revenue ruling reasons that, in this case, the operation of the eating facilities within the museum premises helps to attract visitors to the museum exhibits; because there are places of refreshment in the museum, visitors are able to devote a greater portion of their time and attention to the museum's collection, exhibits, and other educational facilities than would be the case if they had to interrupt or terminate their tours of the museum to seek outside eating facilities at mealtime; also, the eating facilities enhance the efficient operation of the entire museum by enabling the museum staff and employees to remain on its premises throughout the workday. The revenue ruling concludes that the museum's operation of the eating facilities in this manner is a service that contributes importantly to the accomplishment of its exempt purposes and consequently is not unrelated trade or business within the meaning of section 513 of the Code.

In Waco Lodge No. 166, Benevolent and Protective Order of Elks v. Commissioner, 696 F.2d 512 (5th Cir. 1983), an organization conducted bingo games where 23.1% of the work was performed for cash compensation and the balance of the work was performed by volunteers who received free drinks for their services. The court held that although free drinks did not constitute compensation, the 23.1% of the work performed for cash compensation was substantial enough to prevent the bingo game operation from meeting the exception for volunteer labor under section 513(a)(1) of the Code.

In Living Faith, Inc. v. Commissioner, 950 F.2d 365 (7th Cir. 1991), the Court of Appeals upheld a Tax Court decision, CCH T.C. Memo. 1990-484, that an organization operating restaurants and health food stores in a manner consistent with the doctrines of the Seventh Day Adventist Church does not qualify for exemption under section 501(c)(3) of the Code because the organization was not operated for exempt purposes. The court found substantial evidence to support a conclusion that the organization's activities furthered a substantial business purpose, including (a) the organization's operations were presumptively commercial, (b) the organization competed directly with other restaurants and food stores, (c) the organization used

profit-making pricing formulas common in the retail food business, (d) the organization engaged in a substantial amount of advertising, (e) the organization's hours of operation were competitive with other commercial enterprises, and (f) the organization lacked plans to solicit donations.

Rationale:

I. Section 501(c)(3) status.

As discussed in Rev. Rul. 68-167, supra, an organization engaged in the retail sale of handicraft items produced by needy and deserving women is exempt as a charitable organization within the meaning of section 501(c)(3) of the Code. Although the retail sale of goods is normally a business activity, the ultimate test is purpose. Under the circumstances in the revenue ruling, as in this case with M, it is clear that the stated primary purpose of the organization is the charitable purpose of enabling the needy women to support themselves. M states that the purpose of its activities in the gift shop and the tea room is to provide funds for the consignment shop and to help provide an optimum market by providing another line for customers as a "draw" for the consignment shop. Similarly, M states that while it reports the income from the tea room as unrelated trade or business, the purpose of the tea room is to attract customers and to provide funds for the consignment shop.

As provided in section 1.501(c)(3)-1(e) of the regulations, an organization may meet the requirements of section 501(c)(3) of the Code although it operates a trade or business as a substantial part of its activities if the trade or business is in furtherance of the organization's tax exempt purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business. It is important to note that section 1.501(c)(3)-1(e) does not require that the trade or business in question must be related to exempt purposes within the meaning of sections 511 through 513 of the Code, only that it be in furtherance of the exempt purposes. One way in which a trade or business may be in furtherance of exempt purposes is to raise money for the exempt purposes of the organization, notwithstanding that the actual trade or business activity may be taxable under sections 511 through 513. Thus, in determining whether an organization qualifies for section 501(c)(3) exemption, the proper focus is upon the purpose of its activities and not upon the taxability of its activities. If the purpose of a trade or business activity is not to further the exempt function of an organization, and the activity is substantial, then the organization may have a substantial

nonexempt purpose that would disqualify it from section 501(c)(3) exemption.

M states that the purposes of the gift shop and tea room activities are to raise funds for the consignment shop function and to attract clientele to the consignment shop. There is no suggestion or argument in the file that indicates any other purpose of the activities.

As we discuss below, we do not believe that the gift shop and tea room contribute importantly to the exempt purposes of M other than to raise funds to support its charitable program and to provide a means of attracting clientele. To the extent that an unrelated trade or business intended to raise funds is consistently operated at a loss, one might question whether there might be some actual nonexempt purpose that motivates continuation of the trade or business in the face of such nonproductivity. While we believe this may have been a reasonable question with respect to certain taxable years prior to the one under examination, the experience in the year under examination suggests that the tea room and gift shop do in fact raise funds for M.

Consequently, we have no reason to believe that the purposes of the gift shop and tea room in the year under examination are other than those advanced by M. These purposes are to raise funds for M's charitable program and to attract purchasers for the products produced through M's charitable program. These purposes help to further M's charitable function. Thus, there is no evidence that has been presented that M has a substantial nonexempt purpose in undertaking these activities, and we do not believe that M's exemption under section 501(c)(3) of the Code should be disturbed.

II. Unrelated trade or business

The regulations do not provide for a quantitative limitation on the "amount" of unrelated business an organization may engage in under section 501(c)(3) of the Code, other than that implicit in the fundamental requirement of charity law that charity properties must be administered exclusively in the beneficial interest of the charitable purpose to which the property is dedicated. M states that its primary purpose is not to conduct the gift shop and the tea room, but rather to aid deserving women to earn their own living by means of their own handiwork, by providing a place where they could sell articles and foodstuffs prepared by them.

The Exempt Organizations Area Office argues that M's activities in the gift shop and in the tea room are unrelated to M's exempt purposes except as a means to generate funds for the operation of the consignment shop. M's activities with the gift shop and the tea room constitute, both financially and physically, approximately 66% of M's resources. Section 1.513-1(d)(1) of the regulations indicates that the mere production of funds is not sufficient to establish that the activity giving rise to the funds is substantially related to exempt purposes. Section 1.513-1(d)(2) provides that where the production or distribution of the goods or the performance of the services does not contribute importantly to the accomplishment of the exempt purposes of an organization, the income from the sale of the goods or the performance of the services does not derive from the conduct of related trade or business. Thus the fact that M's activities in the gift shop and the tea room raise funds for the consignment shop does not necessarily make the activities related to exempt purposes.

Pursuant to section 1.513-1(a) of the regulations, before income from an activity may be taxed as unrelated business income, the following three conditions must be satisfied: (1) the activity must constitute a trade or business; (2) the trade or business must not be substantially related to the organization's exempt purpose; and (3) the trade or business must be regularly carried on.

It is obvious from the facts in this case, that the operation of the gift shop and the tea room constitute trade or business and that such trade or business is regularly carried on. M now argues, however, that the activity of the gift shop and the tea room is related to its stated exempt purpose because the items in the gift shop enhance the consignment items, attracts customers, and provides funds to support the consignment activity; the activity of the tea room is related to its stated exempt purpose because it also attracts the type of persons to the facility who will be willing to buy the consignment items.

To determine whether a business activity is or is not substantially related to an organization's performance of its exempt activities requires an examination of the relationship between the business activities which generate the particular income in question and the accomplishment of the organization's exempt purpose. To be related, in the statutory sense, the relationship must be a causal and substantial relationship. Thus, the activities which generate the income must contribute importantly to the accomplishment of the organization's exempt purposes.

As discussed in Rev. Rul. 73-105, supra, the sale of items which have no causal relationship to an organization's exempt purpose do not contribute importantly to the accomplishment of that organization's exempt purpose and thus constitute unrelated trade or business. While the items for the gift shop may have been purchased from for-profit vendors with the intent of imbuing the consignment items with an aura of sophistication and tastefulness, the gift shop items have no substantial causal relationship to the sale of handicraft items produced by needy and deserving women in a contiguous shop. Thus, in the same manner as the sale of scientific books and souvenirs in Rev. Rul. 73-105, the sale of the gift shop items constitutes unrelated trade or business.

As discussed in Rev. Rul. 74-399, supra, the operation of an eating facility that helps to attract visitors to a museum and enhances the efficient operation of the entire museum by enabling the staff and employees to remain on its premises throughout the workday may contribute importantly to the accomplishment of the museum's exempt purposes and would not constitute unrelated trade or business. As discussed in Living Faith, Inc. v. Commissioner, supra, however, where the operation of an eating facility is presumptively commercial, competes directly with other restaurants, uses profit-making pricing formulas, engages in advertising, has hours of operation competitive with commercial enterprises, and the underlying organization does not have plans to solicit donations, the organization does not qualify under section 501(c)(3) of the Code. M's operation of the tea room is more like the organization in Living Faith, Inc. v. Commissioner and is distinguishable from Rev. Rul. 74-399.

In a similar manner as the organization discussed in Living Faith, Inc. v. Commissioner, supra, there is substantial evidence to support a conclusion that M's activities regarding the tea room further a substantial nonexempt purpose, including the facts that (a) its operations are presumptively commercial, (b) it competes directly with other restaurants, (c) it uses profit-making pricing formulas common in the retail businesses, (d) its hours of operation are competitive with other commercial enterprises, and (e) M lacks plans to solicit donations from the general public, which is indicated by the less than substantial amount of income.

M's operation of the gift shop and the tea room is not substantially related to M's stated exempt purpose of aiding needy women, as discussed above, and constitutes unrelated trade or business that is regularly carried on. Unrelated trade or business is not in furtherance of an organization's exempt purpose or purposes, and therefore the exception for the

operation of trade or business described in section 1.501(c)(3)-1(e)(1) of the regulations is not applicable.

Although M states that volunteers contribute more than 5,000 documented hours a year to M, as well as other contributed time, M also has a number of persons, compensated in cash for work performed, who work directly in the consignment shop, the gift shop, and the tea room, as well as in various support roles for these functions, including the overall bookkeeping and supervision. In the same manner as the organization discussed in Waco Lodge No. 166, Benevolent and Protective Order of Elks v. Commissioner, supra, even though the information presented does not contain sufficient detail to enable a precise determination to be made of the percentage of paid personnel, the persons working for M for cash compensation in both the gift shop and the tea room clearly represent a substantial presence to keep the entire operation from meeting the exception for volunteer labor under section 513(a)(1) of the Code.

Conclusions:

(1) M's activities with respect to the operation of the gift shop and the tea room do not represent a substantial nonexempt purpose that would cause revocation of M's exempt status under section 501(c)(3) of the Code.

(2) Income earned by M from the operation of the gift shop and the tea room constitutes unrelated business taxable income under sections 511 through 513.

A copy of this technical advice memorandum is to be given to M. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

- END -