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INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

Chief, Appeals Office
Los Angeles, CA

T:EO:B 3

Through: Director, Appeals Division
National Office CC:AP

Taxpayer's Name:

Taxpayer's Address:

Years Involved:

Date of Conference:

Legend:

X =
Y =

ISSUES:

1) Whether X is exempt under section 501(c)(3) of the Internal Revenue Code as a charitable and educational organization.

2) If X is not exempt under section 501(c)(3) of the Code, would X be entitled to retroactive relief under section 7805(b).

3) Whether the revenue generated by providing Internet access is considered to be unrelated business income.

FACTS:

X received a determination letter dated June 2, 1993, recognizing it as exempt under section 501(c)(3) of the Code effective December 28, 1992. X was determined to be a publicly-supported organization described in sections 509(a)(1) and 170(b)(1)(A)(vi) during an advance ruling period. On May 5, 1997, the Service issued a definitive ruling changing X's public charity classification to an organization described in section 509(a)(2).

The Service based its determination for exemption on X's submissions which stated that it intended to provide and operate an educational and charitable community

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telecommunication network. X's Articles of Incorporation state that its purpose is "to establish and operate an online, community-based, public access information and communication service".

X states that it has now accomplished that goal, and has been operating an educational and charitable community telecommunications network for several years. It further states that its operations and activities have been substantially the same as described in its original application for exemption.

X is an Internet service provider (ISP). X owns and maintains an Internet website for "all members of the public regardless of their income or other factors." X's service fees vary from $7-15 per month depending on the type of membership. Low-income individuals, disadvantaged businesses, schools, libraries, etc. are charged a lower fee than the general public.

X is staffed primarily by community volunteers and controlled by an all volunteer large "Governing Council" that represents a broad cross-section of the general public. The Governing Council elects an unpaid, volunteer Board of Directors, which in turn manages the financial and corporate affairs of X and the work of the Executive Director. The Executive Director oversees the daily operations and activities of X and the performance of its large number of volunteers and the smaller number of paid staff.

X's financial information, as submitted to the Service on October 19, 1998, provides the following:

	1995	1996	1997
Income:			
*User Fees:	$117,939	$202,209	$197,015
Grants:	30,000	27,500	7,750
Donations:	4,865	13,227	15,403

*User fees do not reflect user fee income from low-income individuals.

Based on the above, X receives over 75% of its support from user fees for Internet services.

ADDITIONAL FACTS CONCERNING FUTURE OPERATIONS:

On December 17, 1998, X's conference of right was held with the National Office. At the conference, X agreed that its primary activity of providing internet services for a fee was a trade or business and did not further an exempt purpose. Thereafter, on January 14, 1999, X incorporated a new taxable subsidiary called "Y"

and soon transferred to Y all the activities that the Service found to be neither charitable nor educational under section 501(c)(3) of the Code. Because of this transfer, X requests that the Service allow it to retain its exemption under section 501(c)(3) of the Code.

X's restructuring of its operations and reorganization of its activities will be as follows. X will establish and control Y. Five of X's board members will also serve on the nine-member board of Y. Y will lease equipment to X. Y will charge X for ISP services. Y will donate its profits to X as grants. These arrangements are detailed in contracts executed by X and Y.

X has amended its Articles of Incorporation, Article V, to state the following: "This corporation is organized exclusively for charitable and educational purposes within the meaning of section 501(c)(3) of the Internal Revenue Code...specifically to provide internet access, email communication and related services at substantially below cost to charitable, educational, scientific and religious organizations, exempt under section 501(c)(3) of the Code; and for low-income individuals and families".

X will provide services only to low-income members and other section 501(c)(3) organizations. X has represented that it will provide these services at a charge substantially below X's cost. Grants and donations to X will make up the difference in the cost of providing these services.

LAW:

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(a) of the Income Tax Regulations states that to be tax exempt, an organization must be both organized and operated exclusively for one or more exempt purposes specified in section 501(c)(3) of the Code.

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

Section 1.501(c)(3)-1(d)(3) of the regulations defines educational in general. The term 'educational', as used in section 501(c)(3), relates to--(a) The instruction or training of the individual for the purpose of improving or developing his capabilities; or (b) the instruction of the public on subjects useful to the individual and beneficial to the community.

Section 1.501(c)(3)-1(e) of the regulations states 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 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.

Section 513 of the Code provides that the term "unrelated trade or business" means any trade or business the conduct of which is not substantially related to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501.

In Better Business Bureau v. U.S., 326 U.S. 279 (1945), the Supreme Court stated that the presence of even a single, non-exempt purpose, if more than insubstantial in nature, will defeat exemption under section 501(c)(3) of the Code, regardless of the number or importance of the truly exempt purposes.

In B.S.W. Group, Incorporated v. Commissioner, 70 T.C. 352 (1978), the Tax Court considered the qualification for exemption under section 501(c)(3) of the Code of an organization formed to provide consulting services for a fee to other organizations. In concluding that the organization did not qualify for exemption, the court noted that

> the fact that petitioner's activity may constitute a trade or business does not, of itself, disqualify it from classification under section 501(c)(3), provided the activity furthers or accomplishes an exempt purpose....Rather, the critical inquiry is whether petitioner's primary purpose for engaging in its sole activity is an exempt purpose, or whether its primary purpose is the nonexempt one of operating a commercial business producing net profits for petitioner.... Factors such as the particular manner in which an organization's activities are conducted, the commercial hue of those activities, and the existence and amount of annual or accumulated profits are relevant evidence of a forbidden predominant purpose.

In The Nationalist Movement v. Commissioner, 37 F.3d 216, the Court of Appeals for the 5th Circuit affirmed a decision by the Tax Court, denying exemption under section 501(c)(3) of the Code to an organization whose non-exempt activities constituted approximately 45% of its total activities. The court, citing section 1.501(c)(3)-1(c)(1) of the regulations and Better Business Bureau v. U.S., stated:

> Having found that neither Appellant's social services nor legal services were primarily for the benefit of the public, the Tax Court properly found

as a matter of law that Appellant's non-exempt activities were more than insubstantial. Appellant is therefore not entitled to an I.R.C. 501(c)(3) exemption.

See also Associated Master Barbers & Beauticians of America, Inc. v. Commissioner, 69 T.C 53 (revocation of tax exemption where approximately 30% of revenue derived from non-exempt activity), Orange County Agricultural Society, Inc. v. Commissioner, 893 F.2d 529 (2nd Cir.) (revocation of tax exemption where approximately 30% of revenues were from an unrelated business activity), and Bethel Conservative Mennonite Church v. Commissioner, 80 T.C. 352 (revocation of tax exemption where expenditures for a non-exempt purpose averaged 22% annually). The latter case explicitly states "While we do not believe that the medical aid plan was petitioner's primary activity...we cannot say that it constituted only an insubstantial activity of petitioner."

Rev. Rul. 80-287, 1980-2 C.B. 185, described a non-profit lawyer referral service. The organization arranged an initial half-hour appointment for a nominal charge with a lawyer whose name was on an approved list maintained by the organization. The organization's support included a nominal service charge of one dollar to individuals who use the services, and a fee paid by the attorneys' panel. The Service concluded that the organization was not exempt under section 501(c)(3) of the Code.

Rev. Rul. 69-528, 1969-2 C.B. 127, held an organization regularly carrying on an investment service business that would be an unrelated trade or business if carried on by any of the exempt organizations on whose behalf it operates was not exempt under section 501(c)(3) of the Code.

Rev. Rul. 71-529, 1971-2 C.B. 234, held an organization that provided assistance in the management of participating colleges' and universities' endowment or investment funds for a charge substantially below cost qualified for exemption under section 501(c)(3) of the Code.

Rev. Rul. 72-369, 1972-2 C.B. 245, described an organization formed to provide managerial and consulting services for nonprofit organizations to improve the administration of their programs. Its primary activities were to enter into agreements with unrelated exempt organizations to provide managerial and consulting services on a cost basis. The ruling held that an organization was not exempt merely because its operations were not producing profit. In this case, the organization was not exempt because its primary activity of providing managerial and consulting services for a fee was a trade or business ordinarily carried on for profit. The fact that services were provided at cost solely to exempt organizations was not sufficient to characterize the activity as charitable within the meaning of section 501(c)(3) of the Code.

Rev. Rul. 74-614, 1974-2 C.B. 164, describes an organization which operated a regional computer network to collect and disseminate scientific and educational information among member educational institutions. The organization did not itself own any computers. Rather, it acted as an information clearing house to inform members of resources available at member institutions. The ruling concluded that by providing a coordinated program which enabled the member institutions to benefit from the research and scientific projects developed by other members, the organization was advancing education.

Rev. Rul. 81-29, 1981-1 C.B. 329, describes an organization that developed a computer network to provide bibliographic information to member libraries. The ruling concluded that by making useful bibliographic information available to researchers, the organization advanced education and qualified for exemption under section 501(c)(3) of the Code.

ANALYSIS WITH RESPECT TO YEARS EXAMINED:

Is X exempt under section 501(c)(3) of the Code?

With respect to the first issue, it is a clearly established principle of the law of charity that a purpose is not charitable unless it is directed to the public benefit. Not every purpose which is beneficial to the community, however, is deemed charitable. As a general rule, providing services of an ordinary commercial nature in a community, even though the undertaking is conducted on a nonprofit basis, is not regarded as conferring a charitable benefit on the community unless the service directly accomplishes one of the established categories of charitable purposes.

Based on the information submitted, X's Internet services do not directly accomplish any of the established categories of charitable purposes. X's statement that it provides its services to disadvantaged businesses, individuals and communities does not establish that X is operated exclusively for the relief of the poor, distressed, or underprivileged. X's activities are directed toward assisting individuals in obtaining its Internet services. Thus, similar to the lawyer referral service described in Rev. Rul. 80-287, cited above, X's primary purpose is the promotion of its Internet services which is not an exempt activity under section 501(c)(3) of the Code.

Furthermore, X receives support primarily from fees for providing non-exempt Internet services. Generally, courts have denied exemption to organizations that conducted non-exempt activities which generated income in excess of approximately 25% of the organization's total annual income. See The Nationalist Movement v. Commissioner, as well as Associated Master Barbers & Beauticians of America, Inc.v. Commissioner, 69 T.C. 53 (revocation of tax exemption where approximately 30% of

revenue derived from non-exempt activity), Orange County Agricultural Society, Inc. v. Commissioner, 893 F.2d 529 (2nd Cir.) (revocation of tax exemption where approximately 30% of revenues were from an unrelated business activity), and Bethel Conservative Mennonite Church v. Commissioner, 80 T.C. 352 (revocation of tax exemption where expenditures for a non-exempt purpose averaged 22% annually). X receives 75% of its income through providing non-exempt Internet services. It therefore does not satisfy the requirements of section 1.501(c)(3)-1(c)(1) of the regulations. X is primarily supported through a non-exempt activity. Its exemption should therefore be revoked.

Section 7805(b) relief and prospective exemption.

X has restructured its activities to qualify for exemption as an organization described in section 501(c)(3) of the Code. The Commissioner, Tax Exempt and Government Entities Division has approved relief under section 7805(b) of the Code for the earlier period during which time X conducted disqualifying activities. Therefore, the prior exemption under section 501(c)(3) remains undisturbed.

With respect to prospective exemption, the issue remains as to whether X is providing its internet services at substantially below cost.

X's future operations are distinguishable from those outlined in Rev. Rul. 72-369, above. X will operate in a way that insures that its services will be provided at substantially below cost. X has transferred all nonexempt activities to its new taxable subsidiary, Y. Grants from Y will defray the high cost of operating the internet services. Thus, X's operations are similar to those outlined in Rev. Rul. 71-529. Like the organization described in that revenue ruling, X is providing services to a charitable class for a charge that is substantially below cost. In this respect, X is performing a charitable activity within the meaning of section 501(c)(3) of the Code.

Accordingly, since X has transferred all nonexempt activities to a taxable subsidiary, and X has shown that its internet services will be provided to a charitable class at substantially below cost, X is entitled to retain its exempt status under section 501(c)(3) of the Code.

CONCLUSION:

1) X, as now operated, is providing internet-related services substantially below cost to a charitable class of individuals. Accordingly, X is exempt under section 501(c)(3) of the Code, effective January 1, 1999 forward as long as it continues to operate in this manner. A new exemption letter has been prepared recognizing exemption for the restructured organization effective January 1, 1999.

2) The Commissioner, Tax Exempt and Government Entities Division has granted section 7805(b) relief to X for the period January 1, 1992 through December 31, 1998.

3) We are not ruling on whether the revenue generated by providing Internet access is considered as unrelated business income because we are granting section 7805(b) relief to X. We believe that because the organization's activities were approved and an exemption letter was approved based on its operation as an ISP, any income generated from the organization during those subsequent years cannot be considered unrelated business income.