

## **REVENUE RULING 2004-51**

### **Part I**

Section 501 - Exemption from Tax on Corporations, Certain Trusts, Etc.; Section 513 - Unrelated Trade or Business

26 CFR 1.501(c)(3)-1: Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals. (Also Sections 511-513.)

Rev. Rul. 2004-51, 2004-22 I.R.B (June 1, 2004)

### **ISSUES**

1. Whether, under the facts described below, an organization continues to qualify for exemption from federal income tax as an organization described in § 501(c)(3) of the Internal Revenue Code when it contributes a portion of its assets to and conducts a portion of its activities through a limited liability company (LLC) formed with a for-profit corporation.
  
2. Whether, under the same facts, the organization is subject to unrelated business income tax under § 511 on its distributive share of the LLC's income.

### **FACTS**

M is a university that has been recognized as exempt from federal income tax under § 501(a) as an organization described in § 501(c)(3). As a part of its educational programs, M offers summer seminars to enhance the skill level of elementary and secondary school teachers. To expand the reach of its teacher training seminars, M forms a domestic LLC, L, with O, a company that specializes in conducting interactive video training programs. L's Articles of Organization and Operating Agreement ("governing documents") provide that the sole purpose of L is to offer teacher training seminars at off-campus locations using interactive video technology. M and O each hold a 50 percent ownership interest in L, which is proportionate to the value of their respective capital contributions to L. The governing documents provide that all returns of capital, allocations and distributions shall be made in proportion to the members' respective ownership interests. The governing documents provide that L will be managed by a governing board comprised of three directors chosen by M and three directors chosen by O. Under the governing documents, L will arrange and conduct all aspects of the video teacher training seminars, including advertising, enrolling participants, arranging for the necessary facilities, distributing the course materials and broadcasting the seminars to various locations. L's teacher training seminars will cover the same content covered in the seminars M conducts on M's campus. However, school teachers will participate through an interactive video link at various locations rather than in person. The governing documents grant M the exclusive right to approve the curriculum, training materials, and instructors, and to determine the standards for successful completion of the seminars. The governing documents grant O the exclusive right to select the locations where participants can receive a video link to the seminars and to approve other personnel (such as camera operators) necessary to

conduct the video teacher training seminars. All other actions require the mutual consent of M and O. The governing documents require that the terms of all contracts and transactions entered into by L with M, O and any other parties be at arm's length and that all contract and transaction prices be at fair market value determined by reference to the prices for comparable goods or services. The governing documents limit L's activities to conducting the teacher training seminars and also require that L not engage in any activities that would jeopardize M's exemption under § 501(c)(3). L does in fact operate in accordance with the governing documents in all respects. M's participation in L will be an insubstantial part of M's activities within the meaning of § 501(c)(3) and § 1.501(c)(3)-1(c)(1) of the Income Tax Regulations. Because L does not elect under § 301.7701-3(c) of the Procedure and Administration Regulations to be classified as an association, L is classified as a partnership for federal tax purposes pursuant to § 301.7701-3(b).

## **LAW**

### **Exemption under § 501(c)(3)**

Section 501(c)(3) provides, in part, for the exemption from federal income tax of corporations organized and operated exclusively for charitable, scientific, or educational purposes, provided no part of the organization's net earnings inures to the benefit of any private shareholder or individual.

Section 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 that accomplish one or more of the exempt purposes specified in § 501(c)(3). Activities that do not further exempt purposes must be an insubstantial part of the organization's activities. In *Better Business Bureau of Washington, D.C. v. United States*, 326 U.S. 279, 283 (1945), the Supreme Court held that "the presence of a single . . . [non-exempt] purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly . . . [exempt] purposes."

Section 1.501(c)(3)-1(d)(1)(ii) provides that an organization is not organized or operated exclusively for exempt purposes unless it serves a public rather than a private interest. To meet this requirement, an organization must "establish that it is not organized or operated for the benefit of private interests. . . ."

Section 1.501(c)(3)-1(d)(2) defines the term "charitable" as used in § 501(c)(3) as including the advancement of education.

Section 1.501(c)(3)-1(d)(3)(i) provides, in part, that the term "educational" as used in § 501(c)(3) relates to the instruction or training of the individual for the purpose of improving or developing his capabilities.

Section 1.501(c)(3)-1(d)(3)(ii) provides examples of educational organizations including a college that has a regularly scheduled curriculum, a regular faculty, and a regularly enrolled body of students in attendance at a place where the educational activities are

regularly carried on and an organization that presents a course of instruction by means of correspondence or through the utilization of television or radio.

### Joint Ventures

Rev. Rul. 98-15, 1998-1 C.B. 718, provides that for purposes of determining exemption under § 501(c)(3), the activities of a partnership, including an LLC treated as a partnership for federal tax purposes, are considered to be the activities of the partners. A § 501(c)(3) organization may form and participate in a partnership and meet the operational test if 1) participation in the partnership furthers a charitable purpose, and 2) the partnership arrangement permits the exempt organization to act exclusively in furtherance of its exempt purpose and only incidentally for the benefit of the for-profit partners. *Redlands Surgical Services*, 113 T.C. 47, 92-93 (1999), *aff'd* 242 F.3d 904 (9th Cir. 2001), provides that a nonprofit organization may form partnerships, or enter into contracts, with private parties to further its charitable purposes on mutually beneficial terms, “so long as the nonprofit organization does not thereby impermissibly serve private interests.” The Tax Court held that the operational standard is not satisfied merely by establishing “whatever charitable benefits [the partnership] may produce,” finding that the nonprofit partner lacked “formal or informal control sufficient to ensure furtherance of charitable purposes.” Affirming the Tax Court, the Ninth Circuit held that ceding “effective control” of partnership activities impermissibly serves private interests. 242 F.3d at 904. *St. David’s Health Care System v. United States*, 349 F.3d 232, 236-237 (5th Cir. 2003), held that the determination of whether a nonprofit organization that enters into a partnership operates exclusively for exempt purposes is not limited to “whether the partnership provides some (or even an extensive amount of) charitable services.” The nonprofit partner also must have the “capacity to ensure that the partnership’s operations further charitable purposes.” *Id.* at 243. “[T]he non-profit should lose its tax exempt status if it cedes control to the for-profit entity.” *Id.* at 239.

### Tax on Unrelated Business Income

Section 511(a), in part, provides for the imposition of tax on the unrelated business taxable income (as defined in § 512) of organizations described in § 501(c)(3).

Section 512(a)(1) defines “unrelated business taxable income” as the gross income derived by any organization from any unrelated trade or business (as defined in § 513) regularly carried on by it less the deductions allowed, both computed with the modifications provided in § 512(b).

Section 512(c) provides that, if a trade or business regularly carried on by a partnership of which an organization is a member is an unrelated trade or business with respect to the organization, in computing its unrelated business taxable income, the organization shall, subject to the exceptions, additions, and limitations contained in § 512(b), include its share (whether or not distributed) of the gross income of the partnership from the unrelated trade or business and its share of the partnership deductions directly connected with the gross income.

Section 513(a) 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 the organization for income or funds or the use it makes of the profits derived) to the exercise or performance by the organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under § 501.

Section 1.513-1(d)(2) provides that a trade or business is “related” to an organization’s exempt purposes only if the conduct of the business activities has a causal relationship to the achievement of exempt purposes (other than through the production of income). A trade or business is “substantially related” for purposes of § 513, only if the causal relationship is a substantial one. Thus, to be substantially related, the activity “must contribute importantly to the accomplishment of [exempt] purposes.” Section 1.513-1(d)(2). Section 513, therefore, focuses on “the manner in which the exempt organization operates its business” to determine whether it contributes importantly to the organization’s charitable or educational function. *United States v. American College of Physicians*, 475 U.S. 834, 849 (1986).

### **ANALYSIS**

L is a partnership for federal tax purposes. Therefore, L’s activities are attributed to M for purposes of determining both whether M operates exclusively for educational purposes and therefore continues to qualify for exemption under § 501(c)(3) and whether M has engaged in an unrelated trade or business and therefore may be subject to the unrelated business income tax on its distributive share of L’s income.

The activities M is treated as conducting through L are not a substantial part of M’s activities within the meaning of § 501(c)(3) and § 1.501(c)(3)-1(c)(1). Therefore, based on all the facts and circumstances, M’s participation in L, taken alone, will not affect M’s continued qualification for exemption as an organization described in § 501(c)(3).

Although M continues to qualify as an exempt organization described in § 501(c)(3), M may be subject to unrelated business income tax under § 511 if L conducts a trade or business that is not substantially related to the exercise or performance of M’s exempt purposes or functions.

The facts establish that M’s activities conducted through L constitute a trade or business that is substantially related to the exercise and performance of M’s exempt purposes and functions. Even though L arranges and conducts all aspects of the teacher training seminars, M alone approves the curriculum, training materials and instructors, and determines the standards for successfully completing the seminars. All contracts and transactions entered into by L are at arm’s length and for fair market value, M’s and O’s ownership interests in L are proportional to their respective capital contributions, and all returns of capital, allocations and distributions by L are proportional to M’s and O’s ownership interests. The fact that O selects the locations and approves the other personnel necessary to conduct the seminars does not affect whether the seminars are substantially related to M’s educational purposes. Moreover, the teacher training seminars L conducts using interactive video technology cover the same content as the seminars M conducts on

M's campus. Finally, L's activities have expanded the reach of M's teacher training seminars, for example, to individuals who otherwise could not be accommodated at, or conveniently travel to, M's campus. Therefore, the manner in which L conducts the teacher training seminars contributes importantly to the accomplishment of M's educational purposes, and the activities of L are substantially related to M's educational purposes. Section 1.513-1(d)(2). Accordingly, based on all the facts and circumstances, M is not subject to unrelated business income tax under § 511 on its distributive share of L's income.

**HOLDINGS**

1. M continues to qualify for exemption under § 501(c)(3) when it contributes a portion of its assets to and conducts a portion of its activities through L.
2. M is not subject to unrelated business income tax under § 511 on its distributive share of L's income.

**DRAFTING INFORMATION**

The principal author of this revenue ruling is Virginia G. Richardson of Exempt Organizations, Tax Exempt and Government Entities Division. For further information regarding this revenue ruling, contact Virginia G. Richardson on (202) 283-8938 (not a toll-free call).