DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

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Dear

This letter responds to a letter dated April 24, 2000, and supporting documents, requesting a ruling whether fees generated by a community foundation for providing certain services to local private foundations will be subject to the unrelated business income tax under section 511 of the Internal Revenue Code of 1986, as amended (hereafter "Code").

FACTS:

You are an organization described in section 501(c)(3) of the Code and classified as a publicly supported organization under sections 509(a)(1) and 170(b)(1)(A)(vi). You are a community trust under section 1.170A-9(e)(10) of the Income Tax Regulations. Your primary purpose is to support the charitable activities that benefit the citizens of X through grant-making activities within X. To carry out your grant-making purpose, you engage in various internal grant management and administrative functions. These internal grant management and administrative functions include undertaking research of potential grantees, designing and operating strategic grant-making programs, exercising proper oversight over the grants made, and numerous routine administrative, accounting and clerical tasks necessary for the daily operation of your organization. You report that the sources of your grants include both component funds and certain non-component funds affiliated with you (such as section 509(a)(3) supporting organizations, pooled income funds, and split-interest trusts).

Presently, you propose to sell your internal grant management and administrative services to other grant-making charities (primarily private foundations) that operate

independently in X and who lack the staff, expertise or resources to conduct their own internal grant-making functions. Your goal in providing these services, which are listed in detail below, is to educate and assist these entities to provide more efficient support to the citizens of X and ultimately for them to establish cooperative relationships with you that will maximize the pool of charitable resources available for the strategic funding of X-based programs. You assert that education will be a core component of all the services you intend to sell and that every entity will receive, on a continuing basis, instruction and educational materials from you on tactics for strategic and effective grant-making in X. You state that these services are not available from any other for-profit or nonprofit organization that services X. Furthermore, you state that "[i]f comparable services were available to organizations in the region, it might not be necessary for [us] to offer them, but this is not the case."

You intend to charge these entities a reasonable fee based upon your staff's hourly rate in providing these services and you request that the fees earned will not constitute unrelated business taxable income. Each entity will be required to execute a sales contract with you, whereby they become your "enrollee organization." This sales contract will consist of a menu of core organizational functions that you agree to perform, for an hourly fee, on behalf of the enrollee organization. Although you will generally contract only with entities located and operated in X, you conceded that exceptions may be made where an organization is located elsewhere but retains you to administer any funds to be distributed within X.

You propose to sell for a reasonable fee the following services to enrollee organizations.

1. Assisting with the establishment of a grant-making program (i.e., developing guidelines, processes/procedures for reviewing requests, etc.).

2. Reviewing/evaluating grant requests and preparing written reports on findings. May include reviewing written proposals and/or conducting site visits, interviews or other pre-grant inquiries to obtain necessary information to evaluate proposals.

3. Preparing research in specific grant making areas of interest and/or identifying nonprofits conducting programs in specific areas of interest.

4. Designing and/or maintaining a system of monitoring funded programs.

5. Identifying opportunities for collaborating with other funders.

6. Handling day-to-day inquiries (via mail or telephone) from potential grant applicants.

7. Printing checks (for review/signature by authorized representative of the Enrollee) for approved grants/expenses and balancing the checking account.

8. Organizing/staffing board and grant committee meetings.

9. Tracking all grant applications and grants awarded and generating related reports.

RULING REQUESTED:

You request a ruling that the income you receive from charging reasonable fees for providing various services related to grant management and administration (listed 1-9 above) to separate grant-making organizations that serve X will not constitute unrelated business taxable

income under section 512 of the Code, and therefore will not be subject to unrelated business income tax under section 511 of the Code.

LAW:

Section 501(c)(3) of the Code, in part, provides for the exemption from federal income tax of organizations organized and operated exclusively for charitable, educational, scientific, and certain other purposes.

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

Section 512(a)(1) of the Code defines the term "unrelated business taxable income" as the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less the allowable deductions which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in section 512(b).

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 the organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its exempt purpose or function.

Section 513(c) of the Code provides that "trade or business" includes any activity which is carried on for the production of income from the sale of goods or the performance of services. An activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization.

Section 1.513-1(a) of the regulations provides that gross income of an exempt organization subject to the 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 the primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete. In general, any activity of a section 511 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--and which, in addition, is not substantially related to the performance of exempt functions--presents sufficient likelihood of unfair competition to be within the policy of the tax. Accordingly, for purposes of section 513 the term "trade or business" has the same meaning it has in section 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of services. Thus, the term "trade or business" in section 513 is not limited to integrated aggregates of assets, activities and good will which comprise businesses for the purposes of certain other provisions of the Internal Revenue Code. Activities of producing or distributing goods or performing services from which a particular amount of gross income is derived do not lose identity as trade or business merely because they are carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization. Thus,

for example, the regular sale of pharmaceutical supplies to the general public by a hospital pharmacy does not lose identity as trade or business merely because the pharmacy also furnishes supplies to the hospital and patients of the hospital in accordance with its exempt purposes or in compliance with the terms of section 513(a)(2). Similarly, activities of soliciting, selling, and publishing commercial advertising do not lose identity as a trade or business even though the advertising is published in an exempt organization periodical which contains editorial matter related to the exempt purposes of the organization.

Section 1.513-1(c)(1) of the regulations provides that in determining whether trade or business from which a particular amount of gross income derives is "regularly carried on" within the meaning of section 512 of the Code, regard must be had to the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued.

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 and 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 a causal relationship to the achievement of exempt purposes (other than through the production of income), 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 a 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.

Section 1.513-1(d)(3) of the regulations provides that in determining whether activities contribute importantly to the accomplishment of an exempt purpose, the size and extent of the activities involved must be considered in relation to the nature and extent of the exempt function which they purport to serve. Thus, where income is realized by an exempt organization from activities which are in part related to the performance of its exempt functions, but which are conducted on a larger scale than is reasonably necessary for performance of such functions, the gross income attributable to that portion of the activities in excess of the needs of exempt functions constitutes gross income from the conduct of unrelated trade or business. Such income is not derived from the production or distribution of goods or the performance of services which contribute importantly to the accomplishment of any exempt purpose of the organization.

Section 1.513-1(d)(4)(iii) of the regulations provides that in certain cases, an asset or facility necessary to the conduct of exempt functions may also be employed in a commercial endeavor. In such cases, the mere fact of the use of the asset or facility in exempt functions

does not, by itself, make the income from the commercial endeavor gross income from related trade or business. The test, instead, is whether the activities productive of the income in question contribute importantly to the accomplishment of exempt purposes. Assume, for example, that a museum exempt under section 501(c)(3) of the Code has a theater auditorium which is specially designed and equipped for showing of educational films in connection with its program of public education in the arts and sciences. The theater is a principal feature of the museum and is in continuous operation during the hours the museum is open to the public. If the organization were to operate the theater as an ordinary motion picture theater for public entertainment during the evening hours when the museum was closed, gross income from such operation would be gross income from conduct of unrelated trade or business.

Section 1.170A-9(e)(10) of the regulations provides that community trusts have often been established to attract large contributions of a capital or endowment nature for the benefit of a particular community or area, and often such contributions have come initially from a small number of donors. While the community trust generally has a governing body comprised of representatives of the particular community or area, its contributions are often received and maintained in the form of separate trusts or funds, which are subject to varying degrees of control by the governing body. To qualify as a "publicly supported" organization, a community trust must meet the 33 1/3 percent-of-support test of section 1.170A-9(e)(2), or, if it cannot meet that test, be organized and operated so as to attract new and additional public or governmental support on a continuous basis sufficient to meet the facts and circumstances test of section 1.170A-9(e)(3). Such facts and circumstances test includes a requirement of attraction of public support which, as applied to community trusts will generally be satisfied, if they seek gifts and bequests from a wide range of potential donors in the community or area served, through banks or trust companies, through attorneys or other professional persons, or in other appropriate ways which call attention to the community trust as a potential recipient of gifts and bequests made for the benefit of the community or area served. A community trust is not required to engage in periodic, community-wide, fund-raising campaigns directed toward attracting a large number of small contributions in a manner similar to campaigns conducted by a community chest or united fund. Section 1.170A-9(e)(11) provides rules for determining the extent to which separate trusts or funds may be treated as component parts of a community trust, fund or foundation (herein collectively referred to as a "community trust" and sometimes referred to as an "organization") for purposes of meeting the requirements of this paragraph for classification as a "publicly supported" organization. Section 1.170A-9(e)(14) contains rules for trusts or funds which are prevented from qualifying as component parts of a community trust by section 1.170A-9(e)(11).

Section 1.170A-9(e)(11)(i) of the regulations provides that for purposes of sections 170, 501, 507, 508, 509, and Chapter 42 of the Code, any organization that meets the requirements contained in section 1.170A-9(e)(11)(iii) through (iv) will be treated as a single entity, rather than as an aggregation of separate funds, and except as otherwise provided, all funds associated with such organization (whether a trust, not-for-profit corporation, unincorporated association, or a combination thereof) which meet the requirements of section 1.170A-9(e)(11)(ii) will be treated as component parts of such organization.

Section 1.170A-9(e)(14)(i) of the regulations provides that for purposes of sections 170, 501, 507, 508, 509 and Chapter 42 of the Code, any trust or not-for-profit corporation or association which is alleged to be a component part of a community trust, but which fails to meet the requirements of section 1.170A-9(e)(11)(ii), shall not be treated as a component part of a community trust and, if a trust, shall be treated as a separate trust and be subject to the provisions of section 501 or section 4947(a)(1) or (2), as the case may be. If such organization is a not-for-profit corporation or association, it will be treated as a separate entity, and, if it is described in section 501(c)(3), it will be treated as a private foundation unless it is described in

section 509(a)(1), (2), (3), or (4). Any transfer made in connection with the creation of such separate trust or not-for-profit organization, or to such entity, will not be treated as being made "to" the community trust or one of its components for purposes of sections 170(b)(1)(A) and 507(b)(1)(A) even though a deduction with respect to such transfer is allowable under sections 1.170-1(e), 20.2055-2(b), or 25.2522(a)-2(b), unless such treatment is permitted under sections 1.170A-9(e)(4)(v)(b) or 1.508-1(b)(4).

Rev. Rul. 69-572,1969-2 C.B. 119, held exempt under section 501(c)(3) of the Code an organization created to construct and maintain a building for the exclusive purpose of housing and serving 501(c)(3) member agencies of a community chest, thereby facilitating coordination among the agencies and making more efficient use of the available voluntary labor force. Membership in the organization was limited to the board of directors of the community chest. The building's construction expenses were financed by contributions from the general public and by the issuance of non-interest bearing obligations to other charitable organizations. The organization's building was erected on city land that was the subject of a long-term lease under which the organization paid only a nominal rental and was committed to use the premises for the exclusive purpose of housing and otherwise serving the community chest agencies. Office space in the building was leased to member agencies at a rate that made the organization's rental income approximately equal to its total annual operating costs without any allowance for depreciation, resulting in a rental rate substantially less than commercial rates for comparable facilities. The building also contained a large central meeting room separately maintained for the free use of the lessees and other interested community chest agencies under the general supervision and control of the organization's executive director. The Service reasoned that the organization's operations materially aided its various tenants and other users of its facilities in the performance of their respective charitable functions, by charging below-market rates, and through a common location facilitating coordination of volunteer labor and interrelated operations and services. The Service distinguished the situation from Rev. Rul. 58-547, C.B. 1958-2, 275, which held that a business lease between 501(c)(3) organizations was not related business solely because the lessee was likewise an exempt organization, as not involving a lease of space in a non-commercial manner at substantially below the market rate to tenants with purposes and functions closely related to the lessor.

Rev. Rul. 71-529,1971-2 C.B. 234, held exempt under section 501(c)(3) of the Code an organization that provided assistance in the management of participating colleges' and universities' endowment or investment funds for a charge substantially below cost. Membership in the organization was restricted to 501(c)(3) colleges and universities. Its board of directors was composed of representatives of the member organizations. Each member had the right to an accounting of its pro rata share of the investment funds and could withdraw from participation upon thirty days notice. The organization did not make its services available to anyone other than the exempt organizations controlling it. Most of the operating expenses of the organization, including the costs of the services of the investment counselors and the custodian banks, were paid for by grants from independent charitable organizations. The member organizations paid only a nominal fee for the services performed. These fees represented less than 15% of the total costs of operation. The Service reasoned that by providing the service described above to its members, the organization performed an essential function for charitable organizations. By performing this function for the organizations for a charge substantially below cost, the organization performed a charitable activity. Rev. Rul. 69-528 was distinguished as involving an organization that was primarily engaged in carrying on an investment management business for charitable organizations on a fee basis free from control of the participants.

Rev. Rul. 72-369, 1972-2 C.B. 245, held not exempt under section 501(c)(3) of the Code an organization formed to provide managerial and consulting services at cost to unrelated 501(c)(3) organizations. The services consisted of writing job descriptions and training

manuals, recruiting personnel, constructing organizational charts, and advising organizations on specific methods of operation. These activities were designed for the individual needs of each client organization. Receipts of the organization were from services rendered. Disbursements were for operating expenses. The Service reasoned that providing managerial and consulting services on a regular basis for a fee is trade or business ordinarily carried on for profit. The fact that the services were provided at cost and solely for exempt organizations was not sufficient to characterize the activity as charitable within the meaning of section 501(c)(3) of the Code. Furnishing the services at cost lacked the donative element necessary to establish the activity as charitable. The case was distinguished from Rev. Rul. 71-529, where an organization controlled by a group of exempt organizations provided investment management services for a charge substantially less than cost solely to that group.

In B.S.W. Group, Inc. v. Commissioner, 70 T.C. 352 (1978), the court upheld the Commissioner's denial of exemption under section 501(c)(3) of the Code. The organization's sole planned activity was to offer consulting services for a fee to nonprofit organizations having limited resources (some of which were exempt organizations) and engaged in various rural-related activities. The organization's goals were to help its clients deal with problems they face regarding the external environments within which they operate, change their priorities, implement realistic internal planning and management policies, and improve their understanding of governmental policy processes and methods for becoming more effective in their work through public and private funding. The organization obtained appropriate individuals to perform research projects for the clients. The organization did not advertise its services. The organization's officers planned for the first few years to serve without compensation. The fees charged by the organization were set at or close to cost and were to some extent based on the client's ability to pay, but as a whole were intended to cover its costs. The organization projected a net profit in its first year of operation. The court considered such factors as the particular manner in which the organization's activities were conducted, the commercial hue of those activities, and the existence and amount of annual or accumulated profits as relevant evidence of the organization's predominant purpose to conduct a business. The organization failed to show that it was not in competition with commercial enterprises, which the court considered strong evidence of the predominance of a nonexempt commercial purpose. The court contrasted the case to one where an organization, concededly conducting substantial educational, scientific, or charitable activities, also conducts a trade or business related to its exempt functions. The organization's activity of linking researchers with client organizations was not inherently charitable, and the organization failed to show that such research would further exclusively exempt purposes. The organization's sole source of support was fees for services. The organization's clientele was not limited to section 501(c)(3) organizations.

In Carle Foundation v. U.S., 611 F 2d 1192, 45 AFTR 2d 80-341 (1979), the Court of Appeals held that sales by a foundation's tax-exempt pharmacy to a nonexempt clinic and to clinic's private patients did not contribute importantly to the foundation's exempt purposes of operating a hospital for the treatment of sick and disabled persons. The foundation, which was composed of a hospital and a pharmacy, rented out office space within its complex to a private clinic run by doctors who engaged in a for-profit medical practice of treating the sick and disabled. In determining that foundation's sales were not substantially related to its exempt purpose, the court found persuasive that foundation was operating as a business and its activities were broader then necessary to achieve its exempt purpose. The Court held that "[p]rofits are, although not conclusive, at least some evidence that the business purpose is primary." Id at 1198. The Court found that the foundation made profits on its pharmacy sales to the clinic, and the realization of profits, although not conclusive, contribute importantly to a business rather than an exempt purpose. The Court concluded that "[w]here income is realized by an exempt organization from activities which are in part related to the performance of its exempt functions, but which are conducted on a larger scale than is reasonably necessary for

performance of such functions, the gross income attributable to that portion of the activities in excess of the needs of exempt functions constitutes gross income from the conduct of unrelated trade or business." Id. Although pharmaceutical sales to the clinic's patients "treated the sick and disabled" and should have meet the foundation's exempt purpose, the activity was operated as a business venture to earn a profit as it extended beyond the hospital's own patients and competed with commercial pharmacies as would a for profit venture.

In Hi-Plains Hospital v. US., 670 F. 2d 528 5th Cir. (1982), the Court of Appeals addressed the issue of whether the organization's business activities were conducted on a larger scale than necessary. Hi-Plains Hospital's exempt purpose was to provide medical services to a small rural community that lacked such services. The Court of Appeals found that to attract doctors to the community, Hi-Plains had to make its hospital pharmacy available (in addition to other services) to serve the private patients of any doctor who moved their practice to the hospital and provided medical services to the community. The Court held that the selling of pharmaceuticals to doctor's private patients was deemed narrowly tailored to achieve Hi-Plains' exempt purpose whereby the exempt purpose included inducing doctors to relocate their practice to the hospital and community. However, the Court also found that sales of pharmaceuticals to the general public was too broad an activity and went beyond the scope of Hi-Plains' exempt purpose. The Court noted that the community was already well served by for-profit pharmacies. As such, the Court of Appeals held that Hi-Plains' sales to the community was not narrowly tailored to achieve its exempt purpose, with the income being unrelated taxable business income.

In U.S. v. American College of Physicians, 475 U.S. 834, 106 S.Ct. 1591 (1986), the United States Supreme Court held that a substantial casual relationship did not exist between the exempt medical association's business activity of publishing an educational medical journal and the income it earned from selling journal space for medical advertising. The organization's exempt purpose was to maintain high standards in medical education and practice, encourage research, and foster measures for preventing disease and improving public health. The Supreme Court found that although the advertisements had some educational content, the advertisements did not contribute importantly to the medical journal's educational purpose. "While the advertisements contain certain information, the informational function of the advertising is incidental to the controlling aim of stimulating demand for the advertised products and differs in no essential respect from the informational function of any commercial advertising." Id at 842. The Supreme Court held that the lower court erroneously determined that the advertisements contributed importantly to the organization's exempt function because the advertisements had some educational content, in that the advertisements focused on pharmaceuticals and medical supplies and equipment useful in the practice of medicine.

ANALYSIS:

Under sections 511 and 512 of the Code, an organization described in section 501(c)(3) that provides services for a fee will have unrelated trade or business taxable income if three conditions are satisfied. First, the trade or business must generate income. Second, the trade or business is regularly carried on. Third, the trade or business is unrelated to the organization's exempt purpose or function. The term trade or business has the same meaning for purposes of section 513 as it does for section162, "and generally includes any activity carried on for the production of income from the sale of goods or performance of services." See Section 1.513-1(b) of the regulations.

The services you intended to provide for a reasonable fee satisfy the first and second conditions listed above. By providing services at a reasonable fee to other exempt organizations, you are engaging in a trade or business that generates income within the

meaning of section 513(c) of the Code and section 1.513-1(b) of the regulations. Furthermore, these services will be provided to enrollee organizations on a daily basis, and as such, are considered regularly carried on as defined under sections 512(a)(1) and 1.513-1(c). Therefore, the remaining question is whether your activities meet the third condition listed above for a conclusion that the income you earn from these services is taxed as unrelated business income.

The third condition is met if your income-producing trade or business activity is unrelated to your exempt purpose or function. See sections 513(a) of the Code and 1.513-1(d) of the regulations. Under section 513, the term unrelated trade or business is defined as any trade or business the conduct of which is not substantially related (aside from the need of the organization for income) to the exercise or performance of such organization's exempt functions. Section 1.513-1 lists several factors to consider in evaluating whether an organization's trade or business income is not substantially related to the purpose for which the organization's exempt status was granted.

We begin our analysis by noting that under section 1.513-1(b) of the regulations, the primary objective of adopting the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated trade or business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete. Review of the foundation management industry as a whole reveals that there are dozens of for-profit companies that provide services similar to those you intend to sell. Several of these companies include A, B, C, and D. These companies, along with the for-profit foundation management industry as a whole, provide a diverse array of services. These services include policy development; grant making (including grant screening and evaluation, communicating with potential grantees, screening requests to assure they fall within the trustees guidelines, distributing grant applications, site visits to prospective grantees, evaluating proposals, following up on grants made, to measure success, verifying challenge grants, tracking multiyear grants); foundation accounting (including a monthly or quarterly balance sheet and an income and expense/statement, consolidate statements from multiple asset managers, check writing and reconciliation with adequate checks and balances, quarterly comparison of investment returns with established benchmarks, and providing monthly minimum distribution calculations); asset management (including selection and oversight of a professional asset manager(s), advise in developing policy and setting asset allocation, assist in screening and selecting manager(s), monitor the performance of each manager compared to pre-selected benchmarks, and coordinate reporting meetings between managers and trustees); regulatory matters (including keeping the foundations apprised of the legal environment and notifying Trustees of changes in law that effect the management of the foundation, preparation and filing of the Form 990PF return, publishing required public notices, assisting in keeping the foundations minutes, Trustees' policies and corporate documents current, and advising on new and applicable government regulations); and other services: (including assisting foundations in a number of additional ways upon request, providing resource materials, circulate meeting announcements, intra-generational training for trusteeship, plan and facilitate trustee retreats, work with trustees on special projects, provide continuing education, and prepare board documents and agenda materials). Therefore, we find that the above services are nearly identical to those you propose to sell and that you are in direct competition with the for-profit foundation management industry.

Nevertheless, the fact that commercial entities may also provide similar services, in and of itself, is not determinative as to whether a particular service is or is not substantially related to exempt functions. If the provision of a service contributes importantly to benefiting the charitable class served by an organization's activities, the commercial nature of the service should not be controlling. On the other hand, where commercial alternatives are available, the argument that a service is substantially related to an organization's exempt function because

the organization is uniquely qualified to provide a particular service to help charitable organizations address unmet charitable needs in the community served by the organization would be difficult to sustain.

In evaluating whether your trade or business income is substantially related to your exempt function, we consider the relationship between the activity that generated the particular income and the accomplishment of your tax-exempt purpose. See Section 1.513-1(d)(1) of the regulations. Under section 1.513-1(d)(2), a substantial casual relationship must exist between the conduct of the organization's trade or business activities that generated the income and the achievement of the organization's exempt purpose. A substantial casual relationship exists where the production or distribution of the goods or the performance of the services (from which the income is derived) contributes importantly to the accomplishment of the organization's exempt purpose. See Section 1.513-1(d)(2). Therefore, where the goods or services do not contribute importantly to the accomplishment of the organization's exempt purposes, the income earned is not derived from the conduct of related trade or business. See, section 1.513-1(d)(2); American College of Physicians; Carle Foundation.

Presently you plan to sell for a reasonable fee nine (9) separate business services listed above. These services can be organized into three (3) main groups: grant making, administrative, and clerical.

Your grant-making group of services consists of activities that rely upon the particular knowledge and skills you developed through years of awarding grants and coordinating grant-making for the benefit of the community of X. Of the nine (9) services you propose to sell for a reasonable fee to enrollee organizations, the following are grant-making in nature:

1. Assisting with the establishment of a grant-making program (i.e., developing guidelines, processes/procedures for reviewing requests, etc.).

4. Designing a system of monitoring funded programs.

These activities help enrollee organizations design an effective grant making program, which benefits the local community.

2. Reviewing/evaluating grant requests and preparing written reports on findings. May include reviewing written proposals and/or conducting site visits, interviews or other pre-grant inquiries to obtain necessary information to evaluate proposals.

These activities help direct charitable giving in the local community more efficiently. They also increase your knowledge regarding charitable causes and programs in the local community, which you can use to better coordinate your own grant-making program and the grant-making of others.

3. Preparing research in specific grant making areas of interest and/or identifying nonprofits conducting programs in specific areas of interest.

5. Identifying opportunities for collaborating with other funders.

These activities help to inform enrollee organizations of effective charitable causes and programs in the local community, resulting in efficient charitable giving in the local community.

Review of the grant-making group of services that you propose to sell at a reasonable fee shows that these services contribute importantly to accomplishing your exempt purpose. Your exempt purpose is to issue grants that support charitable activities that benefit citizens of X. Based upon the representations made, these grant-making services are specific services developed by you, honed through years of grant-making in X, and uniquely developed to benefit the charitable community in X. By providing grant-making services to a number of enrollee organizations, you are able to uniquely coordinate their grant-making activities for the benefit of the community, provide advice about unmet charitable needs in your community, and provide advice about how to effectively address those needs. Although similar services are available from the for-profit foundation management industry, your specific grant-making services are uniquely tailored to allow you to achieve your exempt purpose in X effectively and efficiently. By providing these services to enrollee organizations in X, these services will contribute importantly to accomplishing your exempt purpose in X.

Your administrative group of services consists of activities requiring the expertise of office staff skilled and educated in general business administration and business management, personnel management and office procedures. The skill set required to conduct these activities is not unique to the charitable sector or to you. Rather, these activities are conducted throughout the business community on a daily basis by individuals such as office administrators, personnel managers, and executive assistants. Of the nine (9) services you propose to sell for a reasonable fee to enrollee foundations, the following is administrative in nature:

4. Maintaining a system of monitoring funded programs.

Your clerical group of services consists of activities requiring office staff trained in general office procedures, including word processing, data entry and bookkeeping entries. The skill set required to conduct these activities is not unique to the charitable sector or to you. Rather, these activities are conducted on a daily basis in both small and large size businesses by secretaries, receptionists and bookkeepers. Of the nine (9) services you propose to sell for a reasonable fee to enrollee foundations, the following are clerical in nature:

6. Handling day-to-day inquiries (via mail or telephone) from potential grant applicants.

7. Printing checks (for review/signature by authorized representative of the Enrollee) for approved grants/expenses and balancing the checking account.

8. Organizing/staffing board and grant committee meetings.

9. Tracking all grant applications and grants awarded and generating related reports.

Review of the administrative and clerical services you propose to sell for a reasonable fee to enrollee organizations shows that these services do not contribute importantly to accomplishing your exempt purpose. These services are not uniquely grant-making services, but rather, are general business administration and clerical services. Some of these services can be characterized as "back office administration," which are conducted routinely by most organizations, and do not require any specific knowledge of the X charitable community. Providing these services does not contribute importantly to accomplishing your grant-making purpose in X. Although your sale of administrative and clerical services may incidentally serve your exempt purpose of assisting charities in X, they are generic and routine commercial services that do not contribute importantly to accomplishing your exempt purpose in X.

Another factor to consider in evaluating whether your trade or business income is or is

not substantially related to your exempt function is whether the scope of your activity is "conducted on a larger scale than is reasonably necessary" to achieve your tax-exempt purpose. See section 1.513-1(d)(3) of the regulations; Hi-Plains Hospital v. US. Therefore, an exempt organization's gross income will be subject to unrelated trade or business tax if the activities that give rise to this income are not narrowly tailored to accomplish the organization's exempt purpose.

Review of the grant-making services you propose to sell at a reasonable fee shows that these services are narrowly tailored to achieve your exempt purpose. Your exempt function is to issue grants that support charitable activities that benefit the citizens of X. Based upon the representations made, these grant-making services are narrowly tailored to achieve your exempt purpose in that these specific services have been developed to address the specific needs and concerns of the charitable community in X. Because the grant-making services you propose to sell to enrollee organizations in X are narrowly tailored to accomplish your exempt purpose, we find that these services are substantially related to your exempt purpose.

Review of the administrative and clerical services you propose to sell at a reasonable fee to enrollee organizations shows that these services are not narrowly tailored to achieve your exempt purpose. Rather, these services are "conducted on a larger scale than is reasonably necessary." See Section 513-1(d)(3) of the regulations; Hi-Plains Hospital v. US. In Hi-Plains Hospital, the Court of Appeals held that exempt hospital's pharmaceutical sales to doctors' private patients, in exchange for doctors relocating their practice to the rural community in which the hospital was located, was narrowly tailored to achieve hospital's exempt purpose of administering to the sick and disabled in the community. However, the Court also held that exempt hospital's sales of pharmaceuticals to the general public was too broad an activity and went beyond the scope of the hospital's exempt purpose. Although in Hi-Plains Hospital pharmaceutical sales to the general population would help achieve the hospital's exempt purpose of "administering to the sick and disabled," the scope of the activity was deemed too broad. Similarly, your sales of administrative and clerical services are activities that encompass a wide range of services and are too broadly conducted. Although an argument may be made that these services assist charities in X conduct their charitable functions, this argument taken to its logical extreme would include any and all services that you could possibly provide to a charitable organization in X. For example, providing janitorial services to maintain a charitable organization's physical place of operations would assist the charity accomplish its exempt purpose by removing the burdens associated with routine organizational administration, thereby, allowing the charity to focus solely on charitable activities. Naturally, providing janitorial services or a host of other services that a charitable organization routinely conducts as part of its internal management or administration functions cannot be claimed to be a narrowly tailored activity that is conducted to accomplish the exempt organization's purposes. Similarly, the administrative and clerical services you propose to sell are not narrowly tailored to be substantially related to your exempt purpose. Because sales of these services to enrollee organizations in X are conducted on a larger scale than is reasonably necessary to achieve your tax-exempt purpose, we find that these services are not substantially related to your exempt purpose.

Under the facts presented, you are not providing services at substantially below your cost to charitable organizations, such as by charging 15 percent of your costs and subsidizing 85 percent of your costs incurred to deliver these services to the charitable organizations. Therefore, none of the services are substantially related to your exempt function on this ground because they are not provided at substantially below cost. See Rev. Ruls. 71-529 and 72-369.

Of interest is that you also contend that the enrollee organizations, while not your component parts or funds, have a special relationship to you as "non-component" funds, and

that the services you provide to your component funds must also be related business when provided to your non-component funds. You look to section 1.170A-9(e)(10) of the regulations, which provides that contributions to a community trust are often received and maintained in the form of separate trusts or funds, which are subject to varying degrees of control by the governing body. We find it difficult to distinguish between your non-component fund and any other charitable organization with which you contract to provide services. While community trusts historically may have had dealings with some non-component funds, that does not settle the question whether all such activities contribute importantly to the accomplishment of their exempt purposes. We think that the services you provide above to your component funds are not necessarily a related business when provided to other entities.

Under sections 513(c) of the Code and 1.513-1(b) of the regulations, you must make a reasonable allocation of the fees from enrollee organizations between the related and unrelated business activities. Similarly, under section 1.512(a)-1(c) of the regulations, you must make a reasonable allocation of expenses between the related and unrelated business activities. However, we are not ruling on whether your allocation of the fees and expenses is reasonable.

CONCLUSION:

Accordingly, based on the information submitted, we rule that the income you receive from reasonable fees charged for providing grant-making services, as defined in this ruling, to separate tax-exempt organizations that serve the community of X will not constitute unrelated business taxable income under section 512 of the Code.

We also rule that the income you receive from reasonable fees charged for providing administrative and clerical services, as defined in this ruling, to separate tax-exempt organizations that serve the community of X will constitute unrelated business taxable income under section 512 of the Code, and therefore will be subject to unrelated business income tax under section 511.

Except as we have ruled above, we express no opinion as to the tax consequences of the transaction under the cited provisions of the Code or under any other provisions of the Code.

This ruling is directed only to you. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Because this letter could help resolve future tax questions, a copy of this ruling should be kept in your permanent records.

If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Robert C. Harper, Jr.
Manager, Exempt Organizations
Technical Group 3