SECTION 502 AND THE PRIMARY PURPOSE TEST: WHO'S ON FIRST?

Presentation by Rochelle Korman
to The Nonprofit Forum

June 16, 1994

INTRODUCTION

My original thought for this nugget was to sort through the seeming inconsistencies between the interpretation and application of the integral part test of Section 502 and the supporting organization requirements of Section 509(a)(3). It seemed to me that all too often an organization that was denied exempt status because it was determined (indirectly) to be a feeder organization, (or, more accurately, not that it was a feeder organization, but rather failed to meet the integral part test of 502), could by a bit of re-packaging be recognized as a supporting organization. Unfortunately, I not so quickly figured out that a key source of what I perceived to be inconsistencies lay in the conflicting and confused interpretation of the Section 502 feeder corporation rules themselves, which I believe stems from the failure of the IRS and the courts to ask and to properly analyze a threshold question: what is the organization's primary purpose? To be sure, asking that question does not guarantee internally coherent responses, but at least it helps to provide an analytically sound basis for further analysis, debate, and policy refinement.

In a sense, this nugget offers a preliminary exploration of a derivative and therefore related question from some of the Forum's previous discussions. Peter Swords and Rob Atkinson put forth theories of a global concept of charity; Miriam Galston addressed the trust vs. statutory definitions of charity; and,

using the UCC case, Laura Brown Chisolm analyzed the confusing web drawn by the courts and the IRS around the private benefit and private inurement provisions of the Code.

This will be my attempt to look at Section 502 and corresponding Regulations with a particular emphasis on the primary purpose test. Clarity is particularly needed in this area because the integral part test has become a key driving concept in the determination of exemption, particularly in the health care delivery area. Just as GCM 39862 is now the latest word on the Service's view of private inurement and private benefit, so too are the Geisinger Health Plan GCM and court rulings the latest word on Section 502.

THE RELEVANT STATUTE AND REGULATIONS

Code Section 501(c)(3) and the related Regulations provide that in order to be exempt as an organization described in Section 501(c)(3), an organization must be both organized and operated exclusively for one or more exempt purposes.

The term "exempt purpose or purposes" is defined as any purpose specified in Section 501(c)(3), as defined and elaborated in Reg. Section 1.501(c)(3)-1(d). That regulation attempts to explain "charitable", educational", "scientific", etc. (thankfully not the topic of this nugget).

Reg. Section 1.501(c)(3)-1(e) provides that an organization may meet the requirement of Section 501(c)(3) although it operates a "trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt 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. 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 the exempt purposes.

Code Section 513 defines 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 of the organization's exempt purposes.

Code Section 502 and the accompanying regulations concern feeder organizations, and provide that an organization "operated for the primary purpose of carrying on a trade or business for profit" is ineligible for exemption under Code Section 501. In determining the organization's 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

organization's activities that are specified in the applicable paragraph of Section 501.

Further, Reg. Section 1.502-1(b) provides that:

> If a subsidiary organization of a tax-exempt organization would itself be exempt on the ground that its activities are an integral part of the exempt activities of the parent organization, its exemption will not be lost because as a matter of accounting between the two organizations, the subsidiary derives a profit from its dealings with its parent organization, for example, a subsidiary organization which is operated for the sole purpose of furnishing electric power used by its parent organization, a tax-exempt educational organization, in carrying on its educational activities. However, the subsidiary organization is not exempt from tax if it is operated for the primary purpose of carrying on a trade or business which would be an unrelated trade or business (that is, unrelated to exempt activities) if regularly carried on by the parent organization.

Code Section 509(a)(3) provides an alternative to the public support tests of Sections 509(a)(1) and (2), and confers non-private foundation status on an organization that is organized and operated exclusively (read primarily) for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified organizations described in Section 509(a)(1) or (2); which is operated, supervised, or controlled by or in connection with one or more such organizations; and is not controlled directly or indirectly by one or more disqualified persons (other than foundation managers and Section 509(a)(1) or (2) organizations).

Section 502 was modified and Sections 511-513 were enacted in 1950 to change the previously existing destination of income test, so that wholly owned subsidiaries involved in a commercial

enterprise could no longer claim exemption on the grounds that they turned over all their profits to a charity. See C.F. Mueller Company v. Commissioner, 190 F.2d 120 (1951). Similarly, the unrelated business income generating activities of charities also became subject to taxation.

HOSPITALS AND HEALTH CARE ORGANIZATIONS: PRIME EXAMPLES

Countless numbers of hospitals reorganized themselves in the 1980's, dividing up existing functions, expanding into new areas, and creating a system with a Section 509(a)(3) parent, and various exempt, and perhaps also non-exempt subsidiaries. (The mechanics of 509(a)(3) generally were met through use of the "operated, supervised, and controlled in connection with" variant found in the regulations.) Typically, the parent acts as the sole member of the related entities (and sole shareholder of any taxable entities). The parent plans, coordinates and supervises the subsidiaries; the hospital, clinics and other medical facilities each become a separate exempt subsidiary; real estate is held in a Section 501(c)(2) title-holding company; management and support services for the related entities are transferred to and consolidated in another exempt subsidiary; and fundraising for the entire group often times is placed in a separate exempt subsidiary. See for examples Private Letter Rulings 8317117-19 (January 28, 1983), 8326166 (no date), 8325148 (no date), 8548083

(September 6, 1985), 8552089 (October 2, 1985), 8631089 (May 7, 1986) and 8917073 (no date).

The hospital reorganization rulings justify the exempt nature of the separate entities (particularly the new parent holding corporation, the fundraising corporation and the management services corporation) because pursuant to Reg. Section 1.502-1(b), they are deemed to be an integral part of the original hospital that now is dividing its functions among separate entities. However, in order to even reach the integral part portion of the feeder organization regulations, it must first be concluded that the entity in question (1) is not organized and operated exclusively for charitable, etc. purposes, and (2) is "operated for the primary purpose of carrying on a trade or business for profit."[1]

Both points in the above sentence are closely entwined with determining the primary purpose of the organization. However, the Service's approach, particularly with health care organizations is to jump immediately into a Section 502 analysis.

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[1]This is at odds with the Tax Court's statement in Associated Hospital Services v. Commissioner, 74 TC 213 (1980) where, in deciding that a hospital laundry service operated at cost and owned by four tax exempt hospitals was not entitled to exemption per the integral part test, stated: "The issue for our decision is whether petitioner is a feeder organization under Section 502, and, if not, whether it is exempt from tax under Section 501(a) by virtue of being an exempt organization under Section 501(c)(3)". Id., at 214.

General Counsel Memorandum 39003 (June 24, 1983) presents one of the more detailed analyses of Section 502[2] by Chief Counsel through its review of a proposed denial of exemption to a trust established by a religious order for the purpose of providing property and liability insurance coverage at cost[3] to participating 501(c)(3) organizations, all of whom are part of church's group exemption, and who as a group had the power to remove trustees. Further, assets remaining upon dissolution of the trust would be returned to the participating 501(c)(3)'s. The GCM simply accepts the proposed adverse ruling's conclusion that the trust has a substantial nonexempt commercial purpose or is operated for the primary purpose of carrying on an unrelated

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[2]Attached for your perusal are some of the internal memoranda drafted by Chief Counsel's office and the Exempt Organization Council that explore Section 502 and the primary purpose test and that formed the basis for the release of Rev. Ruling 64-182, 1964-1 (Part 1) C.B. 186. The two paragraph revenue ruling (see attached) articulated, but did not explain the notion of the "commensurate in scope" test found in Reg. Section 1.501(c)(3)-1(e)(1).

[3]None of these cases or rulings squarely address the cost/below cost concept (a topic of another paper). Suffice it to say that every time the Service "allows" the use of a cost-based approach, it subsequently attempts to narrow the application of the ruling. For example, Rev. Rul. 69-572, 1969-2 C.B. 119 (exemption approved for organization created to construct a building to house member agencies of a community charged rent at a level equal to operating costs, which rental rate is substantially below commercial rents) was subsequently distinguished away by Rev. Rul 71-529, 1971-2 C.B. 234 and Rev. Rul. 72-369, 1972-2 C.B. 245 together which required a donative intent which could be satisfied only by providing the services at <u>substantially</u> below cost. Similarly in GCM 39003, Chief Counsel distances himself from Rev. Rul. 75-282, 1975-2 C.B. 201 (which granted exemption to an entity created to raise funds and make mortgage loans to churches) by noting that the ruling was "not formally considered by this office".

trade or business, "viz., the provision of insurance services at cost...." Thus, the GCM only addresses whether there is an "out" under Section 502; that is, does the trust meet the integral part test? And in order to make that determination, the GCM, having assumed a nonexempt commercial purpose, shifts the discussion to whether the trust operates for the primary purpose of carrying on a trade or business for profit. The GCM, citing the Tax Court in the Associated Hospital Services case,[4] then defines the statutory phrase "for profit" as intended to describe the commercial nature of a Section 502 organization's activities; i.e., the kind of trade or business "ordinarily carried on for

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[4]The Tax Court came extremely close to invalidating portions of the Section 502 regulations; the Service's denial of exemption to the hospital laundry service was sustained solely because Congress had visited and revisited the regulations a number of times since enactment in its consideration of proposals to specifically exempt hospital laundry services under Section 501(e). (The Supreme Court the following year, in a per curiam decision ruled hospital laundry services not entitled to exemption because of the reenactment doctrine. HCSC - Laundry v. U.S., 450 U.S.1 (1981)).

However, in its discussion of the two words "for profit", the Tax Court stated:

> Unlike the abuse situations like Mueller, which sections 502 and 511 were clearly meant to foreclose, we are here dealing with a closed circle. The "profit" does not derive from outside sources and flow to the exempt organizations, as in the Mueller line of cases. Nor does it flow from vendors to potentially nonexempt destinations, as in B.S.W. Group, Inc. v. Commissioner, supra, and Federation Pharmacy Services, Inc. v. Commissioner, 72 T.C. 687 (1979). We would therefore question whether the profit, if any, derived by petitioner was any different from the profit between an exempt parent and its wholly owned subsidiary exempted by the respondent in regulation sec. 1.502-1(b).
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> Id. at 229

profit, regardless of whether the particular business in question is operated in a manner designed to return only operational costs or a profit." In other words, having a primary purpose of operating a trade or business for profit includes operating a trade or business with the primary purpose of doing so not for profit.

Given the facts of GCM 39003, it is difficult to square its denial of exemption to the church controlled (albeit loosely) insurance trust with the granting of exemption to a conference of churches that borrows funds from individuals and makes below market loans to member churches (Rev. Rul. 75-282, 1975-2 C.B. 201), or a trust created by a hospital for the accumulation of funds to be used to satisfy malpractice claims against the hospital (Rev. Rul. 78-41, 1978-1 C.B. 148) or, to the fundraising or management services arm of a commonly controlled hospital network. (And, as the trust's activities support, benefit, or perform the functions of a designated class of beneficiaries, this may be one of those situations where a little tinkering could satisfy the IRS in Section 509(a)(3) terms).

The seeming discrepancy between GCM 39003 and these other rulings could, as a practical matter, be ignored if the GCM was perceived as an aberration. However, its approach has acquired clout as the National Office has attempted to grapple with the rapidly changing world of health care delivery.

THE GEISINGER HEALTH PLAN CASES

In order to appreciate the Geisinger Health Plan ("GHP") rulings and cases, a little background may be helpful.

GHP was incorporated in 1984 as a Pennsylvania nonprofit corporation and is part of the Geisinger system, a collection of nine related organizations which includes the Geisinger Foundation, the Geisinger Medical Center ("GMC"), Geisinger Clinic ("Clinic"), Geisinger Wyoming Valley Medical Center ("GWV"), Geisinger System Services (a management services corporation), Marworth (operator of detoxification and rehabilitation facilities), and two professional liability trusts. All of these entities (aside from GHP) are tax exempt under Section 501(c)(3).

As described in the Tax Court and Court of Appeals cases, the Geisinger system is a large health care network, the fundamental purpose of which is to provide health care services to residents of mostly rural northeastern and northcentral Pennsylvania. The system's service area covers 27 counties and 2.1 million people.

GHP was created to operate a nonstaffed prepaid plan that would provide health services to enrollees[5], primarily through

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[5]The fact that it is nonstaffed is very important to the IRS, and was relied upon heavily by the Third Circuit, but I think that issue is a red herring. (David Seay might disagree.)

utilization of the facilities and programs in the Geisinger System.

GHP was denied Section 501(c)(3) status by the IRS (see GCM 39830 (August 24, 1990)). GHP then was determined to be an exempt organization by the Tax Court (Geisinger Health Plan v. Commissioner, T.C. Memo 1991-649), which decision was reversed by the Third Circuit (985 F.2d 1210 (1993)), and remanded back to the Tax Court for a finding on the integral part test of Section 502.

The Third Circuit's denial of exemption rests completely on its acceptance of the Service's position that it is virtually impossible for a nonstaffed HMO to qualify for Section 501(c)(3) status on its own (also the topic of a separate paper). The case was remanded to the Tax Court to address and clarify the integral part test because the appeals court believed that the Tax Court "silently intermingled the roles played by GHP and other entities in the Geisinger System, thus effectively grounding its decision in the integral part doctrine."

The Tax Court then discussed the integral part test at length only to conclude that "the organization itself is either entitled to exemption or is not entitled to an exemption". Thus, the Third Circuit's ruling that GHP's activities served the private purposes of its subscribers meant that GHP's activities

could not be sufficiently connected to its affiliates so as to justify the application of the integral part test.

Both the Third Circuit and the Tax Court on remand appear to start with a conclusion and then reason towards it. The Third Circuit decided that the nonstaffed HMO could not, almost per se, be exempt, and therefore avoided the relatedness aspect of the trade or business being carried on. The Tax Court considered itself bound by the Third Circuit's conclusion as to exempt status, and it too neglected to pursue a relatedness approach. Reg. Section 1.50(c)(3)-1(e) seems applicable to GHP. GHP can be viewed as operating a trade or business as a substantial part of its activities, but this trade or business is substantially related to and furthers the Geisinger system's exempt purpose of providing quality health care to a significant part of rural Pennsylvania.

It surely is arguable that if the exempt purpose of the parent 501(c)(3) Geisinger Foundation and the other entities within the Geisinger system is the provision of health services to a significant portion of rural Pennsylvania, then the use of another model delivery system as part of that network is in furtherance of those exempt purposes. Put another way, is GHP qualitatively different from an organization that provides information and services to the public on a sliding scale basis?

Or, from an organization that provides management services or fundraising services? These are the type of fact patterns that I think require reconciliation.

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

Sec. 501

[Summary not available]

FULL TEXT

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

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

32689

CC:I:I-795
S:RCW

Rev. Rul. 64-182

BACKGROUND

OCT 9 1963

In re [redacted]

HAROLD T. SWARTZ

Assistant Commissioner (Technical)

Attention: Director, Tax Rulings Division

By memorandum (T:R:EO:6-JN) dated November 23, 1962, the above-captioned case was transmitted to this office with a proposed ruling letter for our concurrence or comment. A supporting memorandum was included.

The proposed ruling letter notes that section 1.501(c)(3)-1(e) of the regulations permits a section 501(c)(3) organization to operate a trade or business as a substantial part of its activities only "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." The proposed ruling letter further states that "the exception to the term trade or business of rentals from real property provided in section 502, and the exception to the term unrelated trade or business of rentals from real property provided in section 512, apply only to passive rental activity and not to the active, competitive management, operation and maintenance of an office building such as the [redacted] where all types of services are rendered the tenants . . ."

In the opinion of this office the central problem in the instant case does not turn on the question whether the exceptions in sections 502 and 512 of the Code pertaining to the rental of real property extend only to passive, as distinguished from active, rental activities, a question on which we therefore need express no opinion for present purposes. Instead, we believe this case presents a basic question as to the proper application of the "primary purpose" test enunciated in both paragraph (c) and paragraph (e) of the regulations contained in section 1.501(c)(3)-1. That is so because there is no doubt that the operation and maintenance of an office building such as the [redacted] is necessarily an unrelated trade or business "as defined in section 513", a section which does not contain any corresponding exception as to the rental of real property.

The "primary purpose" test as it applies to this case is extensively discussed in an attached Interpretative Division Memorandum dated September 18, 1963. As that discussion shows, and as both your office and this office are aware in connection with other cases, the "primary purpose" test is one which presents a number of fundamental problems for which the current regulations do not give us adequate guidance. Those problems are currently under active consideration in the Exempt Organizations Council and the Council has considerable interest in the instant case as one which best illustrates some of the problems that require basic clarification, by way of amendment of the regulations or otherwise. It is accordingly suggested that the case be submitted to the Council for its consideration along with any observations that your office may care to submit on the subject.

[redacted] the attorney representing [redacted] has requested an opportunity for further conference if any difficulty is encountered in issuing a favorable ruling.

(Signed) R. P. Hertzog

R. P. HERTZOG
Acting Chief Counsel
Internal Revenue Service

Enclosure:
Adm. file

RCWilbur:hdes
9-30-63

APR 27 1964

CC:I:I-795
RMC/RMH

See G. C. M. No. 32689 of which this has been made a part

In re: [redacted]

HAROLD T. SWARTZ

Assistant Commissioner (Technical)

Attention: Director, Tax Rulings Division

In October of last year this office suggested (G.C.M. 32689 dated October 9, 1963) that this case be submitted to the Exempt Organization Council for consideration since it involves fundamental problems concerning the proper application of the "primary purpose" test enunciated in both paragraph (c) and paragraph (e) of section 1.501(c)(3)-1 of the regulations. An Interpretative Division memorandum dated September 18, 1963, discussing the application of the "primary purpose" test in this case was made a part of our forwarding memorandum.

The matter was referred to the Council which set forth its views in a memorandum from Mr. Rogovin to Mr. Swartz dated February 11, 1964. You now request our review and consideration of the legal sufficiency of the position recommended by the Council. You have also forwarded a proposed revenue ruling for our comment.

The Council assumes that the test of section 1.501(c)(3)-1(e) of the regulation is controlling and states that the basic question is how trade or business activities of an organization are to be equated with charitable activities in determining-

the "primary purpose" of the organization. The Council has reached two basic conclusions, namely:

(1) That the amount of expenditures of an organization for charitable purposes must be taken into consideration in equating business activities with charitable activities under the test of the regulation, and

(2) That if, when such factor is taken into consideration, an organization is shown in fact to be carrying on a real and substantial charitable program reasonably commensurate in financial scope with its financial resources and its income from its business activities and other sources, it cannot be said that an organization's "primary purpose" is other than charitable, insofar as application of the "primary purpose" test of the regulation is concerned.

It is pointed out that the primary purpose test set forth in the regulations under consideration is separate and apart from section 502 and has no application in any case in which the organization is a feeder within the meaning of that section.

In the [redacted] case the Council's conclusion is that there is no basis for denial of exemption under the "primary purpose" test if the facts show that the organization is engaged in carrying on a real and substantial charitable program reasonably commensurate with its resources.

Review of the Council's memorandum in this case has been intensified and facilitated by the simultaneous consideration and review of the Exempt Organization Council's study entitled "The Amount of Unrelated

Business Activity That a Section 501(c)(3) Organization May Engage in and the Scope of the Feeder Provision: §502". This office has concluded that the position recommended by the Council in the instant case is a satisfactory and legally supportable solution to the problem in this area, and it should be adopted as the interim position of the Service pending clarification of the regulations. This office agrees with the reasoning contained in the Council's memorandum, which is attached for future reference in relation to the instant memorandum, and believes it fully warrants the conclusions reached. Accordingly, even though these conclusions may represent a change in the position of the Service in some cases and even though it may be doubted these results were contemplated by the drafters of the pertinent regulations, the reasoning of the Council, the need to resolve the apparent inconsistencies of the regulations, and the need for a clear and readily administrable rule strongly recommend the conclusions reached. In the opinion of this office, the language and legislative history of the statutes involved permit the proposed interpretation of the regulations. Indeed, the proposed interpretation in result more nearly accords with the "exclusive" requirements of section 501(c)(3).

As indicated above, the problem with respect to the applicability of section 1.501(c)(3)-1(e) is not reached if the [redacted] becomes a section 502 feeder on the acquisition of the building. In the opinion of this office the Foundation would not be a feeder since the term trade or business as used in section 502 does not include the rental by an organization of its real property. There does not appear to be any basis for distinguishing the exclusion of rental income under section 502 from the rental exclusion under section 512(b)(3).1/

1/ By this we mean that if a particular form of rental income would qualify within the meaning of the exclusion provided in section 512 it would equally qualify as "rental by an organization of its real property" within the meaning of section 502. Also, it would appear that notwithstanding the exception of business lease income for purposes of section 512, the fact that a particular form of rental constituted a business lease within the definition of section 514 would not mean that it was not a form of rental within the scope of the exception of section 502.

This office has previously considered the tax consequences of the receipt of rentals from an office building which is actively operated by an organization exempt for purposes specified in section 501(c)(3) of the Code. In G.C.M. 30873, September 17, 1958, In re: [redacted] A-628270, we considered the active operation of several office buildings and apartment houses by an exempt foundation. We recognized therein that the receipt of rentals from an office building actively operated by the lessor would not be a mere passive receipt of "rental" income, and that it made no difference whether the active operation of the office building itself was through the employment of an agent. Reference was made to Regulations §1.512(b)-1 (c)(2) which provides:

> "(2) Payments for the use or occupancy of rooms or other space where services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services . . . do not constitute rentals from real property . . . Payments for the use or occupancy of entire private residences or living quarters in duplex or multiple housing units, or of offices in an office building, etc., are generally rentals from real property."

That G.C.M. took cognizance that the operation of an office building such as [redacted] would be the operation of a very large going business. Nevertheless, the G.C.M. concluded that in the absence of an amendment to the above-quoted section of the regulations, it would appear difficult to sustain the position that the rental derived by a foundation from an office building was unrelated business taxable income within the meaning of section 512.

A similar view was adopted in G.C.M. 31406, September 11, 1959, In re: [redacted] A-630081, with respect to rental operations

carried on by a fund. In that case, rental income was received from 105 separate dwelling units. We felt in that case that the services provided were not of a type considered rendered to the occupant. The consideration paid was for the use of the property and was regarded as the type of rental income contemplated by the Code and the regulations.

Directly bearing on the question is the following discussion as to the meaning of the House bill in which Mr. Killian, president of the Massachusetts Institute of Technology, Colin Stam, Chief of Staff of the Joint Committee on Internal Revenue Taxation, and Senators Taft and Milliken participated:

> "Senator Taft: Suppose, however, that a corporation attempts to run an office building with 100 or 150 tenants in it, and the operation of the business, and the operation of selling light, heat, etc.; is that unrelated business?
>
> Mr. Killian: I think there are probably a lot of real estate holdings of that kind where a charity holds a complete office building.
>
> Senator Taft: Ordinarily, in my experience it is leased as a whole to somebody to run.
>
> Mr. Killian: That is usually the case.
>
> Senator Taft: What do you think would be the effect of this law if they actually tried to operate the office building? Is that unrelated business?
>
> Mr. Killian: I think they could very easily handle that by passing it along to another agency to operate. I think the universities have a remedy on that.

Senator Taft: Mr. Stam, what do you think about that?

Mr. Stam: That would be out because they are getting money from rents and it is pretty difficult to distinguish between a case where the university operates directly and where it just collects rents through an agent.

Senator Taft: So that under the terms of the bill passed by the House that operation would not be unrelated; that would be an investment rather than an unrelated business?

Mr. Stam: That is right.

Senator Milliken: Even though the university itself ran the building?

Mr. Stam: That is right.

Senator Taft: Where the income is all from rents?

Mr. Stam: Yes."

(Hearings, Committee on Finance, 81st Cong., 2d Sess., H.R. 8920, p. 382-384.)

Thus, in view of the legislative history of the Revenue Act of 1950 referred to above, we think it clear that Congress intended that rental income as such was to be excluded from the tax on unrelated trade or business income, without regard to the trade or business character of the rental activity, provided the income therefrom is in fact rent within the meaning of section 512 and the regulations thereunder, and not within the "business lease" exception of section 512(b)(4). As

indicated in section 1.512(b)-1 of the regulations, however, the exclusion so provided for was not intended to apply with respect to payments denominated "rent" by the parties, which are not in fact rent in the actual or customary sense of the term. The significance of this is that Regulations §1.512(b)-1(c)(2) provides in part as follows:

> "* * * Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. The supplying of maid service, for example, constitutes such service; whereas the furnishing of heat and light, the cleaning of public entrances, exits, stairways and lobbies, the collection of trash, etc., are not considered as services rendered to the occupant." (Emphasis supplied.)

Counsel for the instant organization asserts in his brief, dated September 15, 1962, p. 26, that the services rendered to the tenants are usual and customary for an office building of the type represented by the [redacted] Building. Minor alteration of tenant premises under the auspices of the [redacted] management are necessary for the security, appearance and utility of the building, and are no different from the services rendered to tenants of other large office buildings. Income from telephones in the lobbies and vending machines must be regarded as incidental compared to the larger amount of gross receipts from the actual rental of space in the [redacted]

Accordingly, we are of the view that if the subject organization should acquire and operate the [redacted] in the same manner as it is now being operated, the organization will not, for that reason, fall within the ambit of section 502, nor will such real estate acquisition

and operation adversely affect the organization's existing section 501(c)(3) status.

A conference report in the administrative file dated March 13, 1964 states that the organization in the instant case now seeks a ruling only on the question whether the acquisition and operation of the [redacted] would adversely affect its exemption. Consequently the ruling need not cover questions on business leases and unreasonable accumulations. In view of this, we have confined our present consideration of this case to the basic exemption question referred to above. Our conclusion on this question is that the instant Foundation should continue to be held exempt notwithstanding its acquisition and operation of the [redacted] provided the Foundation carries on a real and substantial charitable program reasonably commensurate in financial scope with its financial resources and its income from its business activities and other sources.

We concur in substance in the proposed revenue ruling but have prepared a revised draft which is submitted for your consideration. We believe this draft brings out more clearly the issue being determined.

The administrative file is returned herewith.

Sheldon S. Cohen

SHELDON S. COHEN
Chief Counsel
Internal Revenue Service

Enclosure:
Adm. file

Attachment:
Exempt Organization Council Memorandum
(EOC/OP 1964-1)

EOC/OP 1964-1

FEB 11 1964

TO : Mr. Harold T. Swartz
Assistant Commissioner (Technical)

ATTN: Director, Tax Rulings Division

FROM : Mr. Mitchell Rogovin
Chairman, Exempt Organization Council

In re : [redacted]

This memorandum concerns the question of application of the "primary purpose" test imposed by section 1.501(c)(3)-1(e)(1) of the regulations as a limitation on qualification of 501(c)(3) organizations engaged in carrying on a trade or business, which has arisen in the above case. At the recommendation of Chief Counsel, the files in the matter were referred to the Exempt Organization Council by memorandum of Tax Rulings Division dated October 23, 1963, for an expression of views.

[redacted] ruled qualified for charitable exemption and contributions, now proposes to undertake ownership and operation of an important office building in the downtown area of [redacted] and use the income therefrom to finance its charitable activities. 1/ The operation will be a major undertaking, involving the conduct of a substantial unrelated

1/ The Foundation is an [redacted] not for profit corporation, organized for charitable, educational and scientific purposes. The building is a 44-story commercial office building, known as the [redacted]. It is stated to have a valuation of approximately [redacted] and annual gross rentals and service fees in excess of [redacted]

trade or business. 2/

THE ISSUE:

The question is whether such undertaking will defeat the Foundation's qualification as a charitable organization by reason of constituting the "primary purpose" for which the organization will be operated, within the meaning of the cited regulation. 3/

CONCLUSION:

Assuming the test of the regulation is controlling, then the basic question, in our opinion, is how, or in what respects, trade or business activities of an organization are to be equated with charitable activities in determining the "primary purpose" of the organization within the intendment of the regulation.

The basic conclusions we reach herein are:

(1) That the amount of expenditures of an organization for charitable purposes must be taken into consideration in equating business activities with charitable activities under the test of the regulation, and

charitable expenditures must be considered

2/ See in this connection the assumptions outlined on pages 3-5,App.post.

3/ The regulation in question provides, in effect, that an organization may engage in unrelated trade or business without defeating qualification for exemption under section 501(c)(3), provided it is not organized and operated for the "primary purpose" of carrying on such business. See page 5 App.post. for full text.

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(2) That if, when such factor is taken into consideration, an organization is shown in fact to be carrying on a real and substantial charitable program reasonably commensurate in financial scope with its financial resources and its income from its business activities and other sources, it cannot be said that an organization's "primary purpose" is other than charitable, insofar as application of the "primary purpose" test of the regulation is concerned.

SIGNIFICANCE OF CONCLUSIONS:

The underlying significance of the first conclusion is this: Except as limited by the feeder provision of section 502, expenditure of funds for charitable uses or which accomplish a charitable result, by an organization organized and otherwise operated exclusively for charitable purposes, is a charitable purpose or activity for which exemption is granted under section 501(c)(3). Also, the real measure of such activity as a charitable undertaking is not its size in terms of physical facilities involved in its conduct. It is its importance in terms of charity.

The primary purpose test of the regulations, therefore, cannot be applied simply as a question of relative size of business activity and charitable activity in terms of physical facilities. Instead, if there is to be an equating of the two activities, it must be in terms which have some relevance at least as a measure of the importance of the charitable activity involved. The amount of money expended for charitable objects is one reasonable indicator of the relative magnitude and importance of a charitable activity, at least for purpose of comparison with business activity. In fact, it is perhaps the only common denominator that can be applied. It is not only permissible, but necessary, therefore, that the amount of such expenditures be taken into consideration as a measure of the charitable activity.

The underlying significance of the second conclusion is that if the "primary purpose" test is to have any relevance to the statutory requirements of exemption, or is to be administered with any degree of uniformity, it must be applied realistically as essentially a test of proof. As such, it becomes a test of whether there is a real, bona fide, or genuine charitable purpose, as manifested by the charitable accomplishments of the organization, and not a mathematical measuring of business purpose as opposed to charitable purpose.

An important underlying aspect of both conclusions is that if the primary purpose limitation on business activities under the test of the regulation has any basis in statute, it is as an administrative interpretation of the requirements of exemption of section 501(c)(3), not section 502. As such it is a requirement apart from any limitation imposed by statute on exemption of organizations engaged in carrying on a trade or business by the feeder provisions of section 502. Its application is not governed by section 502, therefore, and the limitation in that section on recognition of expenditure of funds as a charitable purpose or activity consequently is not controlling in the application of the "primary purpose" test. 3a/

In fact the limitation on business activity of 501(c)(3) organizations by the primary purpose test

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3a/ The significance of this is that the charitable activities involved in any application of the primary purpose test, are charitable activities of a type which are not excluded by section 502 as a basis of qualification under section 501(c)(3). In other words, they are charitable activities of a type which have passed the test of section 502. Consequently, in equating the relative importance of the business activities and charitable activities of an organization for purpose of applying the limitation on business activities under the primary purpose test no part of the charitable activities involved may be disregarded by reason of any claim that recognition of such activities as charitable is barred by section 502.

has no application in any case in which the organization is a feeder within the meaning of section 502. If an organization is a feeder within the meaning of that section, its exemption is precluded by that fact by operation of section 502, without regard to section 501(c)(3). The question of limitation on the extent to which such organization may engage in business without defeating qualification under section 501(c)(3), therefore, is never reached in such case, and the primary purpose test has no application.

The foregoing are the strictly technical aspects of the problem. The practical aspects of the conclusions reached here, however, can be summarized briefly as follows:

(1) The primary purpose limitation on business activities of 501(c)(3) organizations imposed by the regulation in question is popularly supposed to have some independent significance as a statutory requirement of exemption apart from the feeder provisions of section 502. It also apparently is regarded as having some independent criteria of its own for its application aside from the extent of the charitable accomplishment achieved with the income involved. If the analysis here is correct, it has neither in terms of actual operation. What occurs in its application, if any meaningful equation of business activities and charitable activities is really attempted, is essentially nothing more than an evaluation of charitable purpose in terms of extent and character of the uses to which the business income is put.

(2) In other words, if the primary purpose test as to business limitations is applied as analysis shows it must be applied, it is essentially nothing more than a test of proof of charitable purpose, and as a practical matter imposes no greater substantive limitation on

business activities of 501(c)(3) organizations than is already imposed by statute under the feeder provision of section 502.

(3) The practical result, therefore, is that under the primary purpose limitation on business activities of 501(c)(3) organizations, imposed by section 1.501(c)(3)-1(e) of the regulations, an organization may meet the requirements of exemption under section 501(c)(3) although it operates an unrelated trade or business as a substantial part of its activities, provided it is not a feeder organization within the definition of section 502, and provided there is clear proof of charitable purpose manifested in its actual operations.

Applying the basic conclusions herein to the facts in the [redacted] case, the controlling question in our opinion is whether, taking into consideration the character of the organization's charitable activities and the expenditures of the organization for charitable purposes, it can be said that it will be engaged in carrying on a real and substantial charitable program reasonably commensurate with its resources, in the sense of Conclusion (2) above. If the facts show that it will, then we conclude herein that there is no basis for denial of exemption under the primary purpose test.

Further discussion and analysis of the basis of our conclusions are set forth in the attached Appendix.

The administrative file is returned herewith.

MITCHELL ROGOVIN
Chairman,
Exempt Organization Council

Enclosures
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