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

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TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Date:
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Contact Person:

Identification Number:

Telephone Number:

T:EO:B2

Uniform Issue List: 501.03-00
512.01-01
513.04-00

Employer Identification Number:

LEGEND:
B =
C =

Dear Sir or Madam:

We have considered your letters dated July 17, 2000, and November 7, 2001, in which you requested certain rulings with respect to B's operation of C as explained more fully below.

B is exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code (the "Code") and is classified as a publicly supported organization under section 509(a)(2). B's purpose is to promote the interest of, and to educate, the general public in decoy carvings and baymen's artifacts, to acquire artifacts for display in its museum, and to conserve natural resources and wildlife. B began operating C in May 2000 as a re-creation of a 19th- and early 20th-century local maritime village, and as an extension of its original museum. B's purpose in operating C is to preserve, present, and interpret the maritime history, heritage, and environment of the local coastal area and the contributions of its baymen. C currently consists of 14 existing structures and 2 structures under construction on a site of 14.5 acres. C will consist of at least 26 structures on 39 acres upon completion.

A reconstructed yacht club will house, free to the public, a number of maritime exhibits and related literature. It will also sell admission tickets to C and is designed to restrict access to the remainder of the village to members and those with admission tickets. The second floor will house exhibits and may house a gift shop. The third floor will be used as classroom space and may be rented out as a meeting hall when not used as a classroom.

A restaurant will be open to C's patrons and the public on a year-round basis, and will be staffed by volunteers and paid employees. The restaurant will not be advertised directly to the public, but only through the C brochure. The restaurant is not directly visible from the main road, and no convenient parking exists other than the C lot. The primary purpose of the restaurant is to provide patrons with a convenient eating place and allow them more time to appreciate the exhibits and presentations given at C. Food selection is primarily simple seafood dishes; however general fare is also available.

The gift shop is also staffed both by volunteers and paid employees. It offers items such as miniature boats and lighthouses, books on maritime history, waterfowl decoy carving and finishing supplies and kits, and paintings portraying different aspects of the baymen's life. It also sells clothing containing the C logo, materials and supplies needed for classes offered at C, and various knick-knacks and guest amenities.

The income from these activities will be used in furtherance of B's activities in the operation of C.

The following rulings are requested:

1. Whether the operation of C, including the restaurant, gift shop, and hall rental, affects B's tax-exempt status under section 501(c)(3) of the Code, and whether the restaurant, gift shop, and hall rental are considered unrelated trades or businesses under section 513 of the Code.

2. Whether the sale of items from the gift shop at C constitutes an unrelated trade or business under section 513 of the Code.

Section 501(c)(3) of the Code exempts from federal income tax organizations that are organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes.

Section 1.501(c)(3)-1(c)(1) of the Federal Income Tax Regulations (the "regulations") provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

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

Section 512(a)(1) of the Code provides that the term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less 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 512(b)(3) of the Code excludes from the definition of unrelated business taxable

income all rents from real property.

Section 1.512(b)-1(c)(2)(i) of the regulations provides that, in general, rents from real and personal property, and the deductions directly connected therewith, are excluded in computing unrelated business taxable income.

Section 1.512(b)-1(c)(5) of the regulations provides that for purposes of section 1.512-1(c), payments for the use or occupancy of rooms and 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, or in tourist camps or tourist homes, motor courts or motels, or for the use of occupancy of space in parking lots, warehouses, or storage garages, does not constitute rent from real property. Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually and customarily rendered in connection with the rental of rooms or other space for occupancy only.

Section 513(a) of the Code provides that the term "unrelated trade or business" means any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501, except that such term does not include any trade or business: (1) in which substantially all the work in carrying on such trade or business is performed by the organization without compensation; or (2) which is carried on, in the case of an organization described in section 501(c)(3), by the organization primarily for the convenience of its members, students, patients, officers, or employees; or (3) which is the selling of merchandize, substantially all of which has been received by the organization as gifts or contributions.

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

Section 1.513-1(c)(1) of the regulations provides that in determining whether gross income from a trade or business 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 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, and the accomplishment of the organization's exempt purposes.

Section 1.513-1(d)(2) of the regulations provides that trade or business is "related" to exempt purposes, in the relevant sense, only where the conduct of the business activities has causal relationship to the achievement of exempt purposes, and is "substantially related," for purposes of section 513 of the Code, only if the causal relationship is a substantial one. Thus, for the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes. Where the production or distribution of the goods or the performance of the services does not contribute importantly to the accomplishment of the exempt purposes of an organization, the income from the sale of the goods or the performance of the services does not derive from the conduct of related trade or business. Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends in each case upon the facts and circumstances involved.

Rev. Rul. 73-104, 1973-1 C.B. 263, describes an organization that operates an art museum. The museum offers for sale to the general public greeting cards that display printed reproductions of selected works from the museum's collection and from other art collections. The organization sells the cards in the shop it operates in the museum. It also publishes a catalogue in which it solicits mail orders for the greeting cards. In addition, the shop sells the cards at quantity discounts to retail stores. The ruling states that the sale of greeting cards displaying printed reproductions of art works contributes importantly to the achievement of the museum's exempt purposes by stimulating and enhancing public awareness, interest, and appreciation of art. Moreover, a broader segment of the public may be encouraged to visit the museum itself to share in its educational functions and programs as a result of seeing the cards. The fact that the cards are promoted and sold in a clearly commercial manner at a profit and in competition with commercial greeting card publishers does not alter the fact of the activity's relatedness to the museum's exempt purpose. Accordingly, it is held that these sales activities do not constitute unrelated trade or business under section 513 of the Code.

Rev. Rul. 73-105, 1973-1 C.B. 264, describes an organization that operates an art museum devoted to the exhibition of American folk art. It operates in a shop in the museum that offers for sale to the general public reproductions of works in the museum's own collection and reproductions of artistic works from the collections of other art museums, and instructional literature concerning the history and development of art and, in particular, of American folk art. Also sold in the shop are scientific books and various souvenir items relating to the city in which the museum is located. The ruling states that the sale of reproductions of works from the museum's own collections and reproductions of artistic works not owned by the museum

contribute importantly to the achievement of the museum's exempt educational purpose by making works of art familiar to a broader segment of the public, thereby enhancing the public's understanding and appreciation of art. The same is true with respect to literature relating to art. Accordingly, it is held that these sales activities do not constitute unrelated trade or business under section 513 of the Code. On the other hand, scientific books and souvenir items relating to the city where the museum is located have no causal relationship to art or to artistic endeavor and, therefore, the sale of these items does not contribute importantly to the accomplishments of the organization's exempt educational purpose. The fact that some of the items could, in a different context, be held related to the exempt educational purpose of some other exempt educational organization does not change the conclusion that in this context they do not contribute to the accomplishment of this organization's exempt educational purpose. Additionally, the sales of such items does not lose identity as a trade or business merely because the museum also sells articles which do contribute importantly to the accomplishment of its exempt function. Accordingly, it is held that the sale of those articles having no relationship to American folk art or to art generally constitute unrelated trade or business under section 513 of the Code.

Rev. Rul. 74-399, 1974-2 C.B. 172, describes an organization that operates an art museum. The museum's facilities include a dining room, cafeteria, and snack bar. The eating facilities are open to the museum staff, employees, and members of the public visiting the museum and are of a size commensurate with accommodation of these special groups of patrons. The facilities are accessible from the museum's galleries but not directly accessible from the street. The patronage of the eating facilities by the general public is not directly or indirectly solicited nor are the facilities contemplated or designed to serve as a public restaurant but merely to serve the exempt purposes of the museum. Profits, if any, are dedicated to the furtherance of the purposes for which the museum is organized and operated. The ruling states that the operation of the eating facilities within the museum premises helps to attract visitors to the museum exhibits. Because there are places of refreshment in the museum, visitors are able to devote a greater portion of their time and attention to the museum's collection, exhibits, and other educational facilities than would be the case if they had to interrupt or terminate their tours of the museum to seek outside eating facilities at mealtime. The eating facilities also enhance the efficient operation of the entire museum by enabling the museum staff and employees to remain on its premises throughout the workday. Thus, the museum's operation of the eating facilities is a service that contributes importantly to the accomplishment of its exempt purposes. Accordingly, the operation of the eating facilities by the museum under the particular circumstances is substantially related to the museum's exempt purposes and consequently is not unrelated trade or business within the meaning of section 513 of the Code.

Rev. Rul. 69-178, 1969-1 C.B. 158, describes an organization exempt from Federal income tax under section 501(a) of the Code, but subject to the tax imposed by section 511, that permits its members and outside individuals and groups to use its hall for a fee. The individuals or groups normally use the facilities for a single afternoon or evening, but at the most for periods of two or three days. The agreement to use the facilities is usually verbal. Only utilities and janitorial services are provided. The ruling states that, since the charges are made for the use and occupancy of space in real property and only utilities and janitorial services are provided, the receipts constitute rental income. The fact that the use is only for short periods of time does not

destroy the character of the receipts. Accordingly, it is held that the income received constitutes rent from real property within the meaning of section 512(b)(3) of the Code and thus is excluded in determining unrelated business taxable income.

Analysis

Issue 1:

Whether the operation of C, including the restaurant, gift shop, and hall rental represents a substantial nonexempt purpose that would cause the revocation of B's exempt status under section 501(c)(3) of the Code.

B is organized and operated for educational purposes. Its activities educate the general public about decoy carvings, baymen's artifacts, and the conservation of natural resources and wildlife. The operation of C enhances B's educational purposes. C is a re-creation of a typical local maritime village. Through the re-creation of historical structures representing the various trades and crafts unique to the local maritime region, through the exhibit of baymen's tools, decoys, and boats, and through demonstrations, instructional classes, and workshops, C educates the public about the maritime history and environment of the area and about the contributions of its baymen. In so doing, C is furthering the exempt purposes of B.

Among the activities engaged in at C are the operation of a gift shop and a restaurant, and the rental of meeting space. These activities attract visitors to C and produce income used to fund the operation of C. Therefore, these activities help to further B's exempt purposes. Since the operation of C by B is for the primary purpose of furthering B's educational purposes, and the operation of a gift shop and restaurant, and the renting of meeting space is in furtherance of those purposes, the operation of C, (including the restaurant, gift shop, and hall rental), by B will not cause the revocation of B's exempt status under section 501(c)(3) of the Code.

Issue 2:

Whether the sale of items from the gift shop constitutes unrelated trade or business under section 513(a) of the Code.

Although B is exempt from federal income tax under section 501(c)(3) of the Code, it is still subject to tax on income derived from any unrelated trade or business regularly carried on by it. B's gift shop sales activities constitute a trade or business which is regularly carried on within the meaning of section 513 of the Code. The real issue is whether Taxpayer's sales activities are substantially related to its exempt purposes.

To determine if the sale of an item by a museum is related to its exempt purpose, it is necessary to ascertain the museum's primary purpose for selling the item. Where the primary purpose behind the production and sale of the item is utilitarian, ornamental, a souvenir in nature, or only generally educational in nature, it should not be considered substantially related

within the meaning of section 513(a) of the Code. However, where the primary purpose behind the production and sale of the item is to further the organization's exempt purpose, the sale is related, and income earned from that sale is exempt.

A number of factors must be considered in analyzing the primary purpose underlying the sale of each item to determine whether sales activities are related. These factors include the degree of connection between the item and the museum's collection, as well as the extent to which the item relates to the form and design of the original item. Size and location, as well as the accuracy of the representation relative to the article sold must be taken into account. The overall impression conveyed by the article is another factor. If the dominant impression one gains from viewing or using the article relates to the subject matter of the original article, picture, or likeness, substantial relatedness would be established. If the non-charitable use or function predominates, the sale would be unrelated.

Items that are reproductions or adaptations of articles displayed in B's collections and exhibits would generally constitute related trade or business. The sale of merchandise that either enhances the public's understanding or appreciation of local maritime history, heritage, and environment contributes importantly to B's exempt purpose and would constitute related trade or business. Items sold that are only generally educational, but that do not promote an understanding or appreciation of local maritime history, heritage, and environment, have no causal relationship with B's function and would constitute unrelated trade or business under section 513 of the Code. Similarly, items sold that are only utilitarian in nature, such as clothing, souvenirs, and guest amenities have no causal relationship with B's exempt function, and would be unrelated trade or business under section 513 of the Code.

Issue 3:

Whether the operation of the restaurant by B constitutes unrelated trade or business under section 513(a) of the Code.

As discussed in Rev. Rul. 74-399, *supra*, the operation of an eating facility that helps to attract visitors to a museum and enhances the efficient operation of the entire museum by enabling the staff and employees to remain on its premises throughout the workday may contribute importantly to the accomplishment of the museum's exempt purposes and would not constitute unrelated trade or business. This is particularly true where patronage of the eating facilities by the general public is not directly or indirectly solicited and where the facilities are not designed to serve as a public restaurant but merely to serve the exempt purposes of the museum.

B's operation of the restaurant is similar to that of the organization in Rev. Rul. 74-399. Although the restaurant is accessible directly from the street, it is not advertised directly to the public, and is not visible from the main road. The restaurant is not designed to serve as a public restaurant, but only as a convenient eating place for visitors and employees of C. Consequently, B's operation of its restaurant in this manner is a service that contributes importantly to the accomplishment of B's exempt purposes, and is not unrelated trade or business within the meaning of section 513 of the Code.

Issue 4:

Whether the rental of meeting space constitutes unrelated trade or business under section 513 of the Code.

B's receipts from the rental of meeting space constitutes rental income within the meaning of section 512(b)(3) of the Code, and, thus, is excluded is determining B's unrelated business taxable income so long as any services B might render in connection with the rental of the meeting space are those usually and customarily rendered in connection with the rental of rooms or other space for occupancy only.

Accordingly, we rule that:

1. B's operation of C, including the restaurant, gift shop, and hall rental, is an activity in furtherance of B's exempt purposes and would not cause the revocation of B's exempt status under section 501(c)(3).

2. The sale of items that contribute importantly to the accomplishment of B's exempt purposes, such as reproductions or adaptations of articles in B's collections and exhibits, or the sale of articles that promote the understanding or appreciation of local maritime history, heritage or environment generally would not constitute unrelated trade or business under section 513(a) of the Code. On the other hand, the sale of items that do not contribute importantly to the accomplishment of B's exempt purposes, such as articles that are only generally educational but do not promote an understanding or appreciation of local maritime history, heritage, or environment, as well as the sale of items that are only utilitarian in nature, such as clothing, souvenirs, and guest amenities, would constitute unrelated trade or business under section 513(a) of the Code.

3. The operation of the restaurant by B would not constitute unrelated trade or business under section 513(a) of the Code.

4. The receipts from the rental of meeting space would constitute rental income within the meaning of section 512(b)(3) of the Code, and, thus, would be excluded in determining B's unrelated business taxable income.

Because this ruling letter could help resolve any questions, please keep it in your permanent records.

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

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,

Terrell M. Berkovsky

Terrell M. Berkovsky
Manager, Exempt Organizations
Technical Group 2