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

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TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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Date:

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Contact Person:

Identification Number:

Telephone Number:

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Employer Identification Number:

Legend:

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Dear Sir or Madam:

We have considered the letter dated July 25, 2001, and subsequent correspondence submitted on your behalf by your attorney, who requested a ruling on the proper treatment of revenues generated from a manufacturing work activity program. This program was created specifically for the development of disabled individuals.

You ("M") are exempt from federal income tax under section 501(a) of the Internal Revenue Code ("Code") as an organization described in section 501(c)(3). M is also classified as a public charity under sections 509(a)(1) and 170(b)(1)(A)(vi).

M, which is located in the State of N, provides habilitative training services to developmentally and physically disabled infants, children and adults (collectively referred to as "clients"). The services offered are designed to enable every individual to prepare for a more independent life in the least restrictive environment while developing to their fullest potential in all areas. M accomplishes these goals by providing: (1) an integrated preschool program, (2) educational services to school-age children which are contracted through the local school districts, (3) educational and work-related training to high school children and adults, and (4) supervised living programs for adults.

M generates funding for these programs through fundraising, private tuition payments, contributions from the general public, contracts for service agreements with federal and state sources, and monies generated by the clients in the work activity center. Services are provided to all clients without discrimination by race, creed, age, gender, or religion. M bills the

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government for services provided to clients who are eligible for governmental assistance. Also, M provides services to clients who are ineligible for governmental assistance and are otherwise unable to pay for these needed services.

The work activity center was implemented in the late 1970's to provide clients with the opportunity to learn work skills. M has contracted for many years with local industries to assemble manufacturing components. Clients receive habilitative training in a controlled work environment and are paid wages from the receipts earned on these industry contracts. Although M has been issued a sheltered workshop certificate by the United States Department of Labor to enable M to pay clients' wages below the minimum wage requirements based on each client's productive capacity, the work activity center is merely a component of M's education and training program.

The work activity center functioned as an assembly department of a local manufacturing industry. The industry delivered its inventory components to M, the clients assembled those components into a finished product, and the industry picked up the finished products. In addition, the industry owned the fixtures and equipment used to assemble the finished goods. Payment under these contracts was at a rate for labor assembly only per finished unit.

Revenues generated by these contracts were set aside as follows:

1. Client wages and related payroll taxes,
2. Workers' compensation insurance on client wages,
3. Health insurance benefits for clients,
4. Capital expenditures, including buses for transportation, additional buildings for the work activity center, and buildings for client recreation, and
5. Supplement operation costs of all programs of M.

Approximately two years ago, M's largest industry contractor notified M of changes in the industry's corporate structure and operations. The industry's regional distribution center in O closed, and all distribution operations moved to P. In order to make these corporate structure changes, the contractor began to require its vendors (including M) to purchase and warehouse all parts required by present and future contracts. In essence, if M were to continue to assemble products for this industry, M would be required to purchase and warehouse component parts, which previously had been owned and warehoused by the industry. Quotas for finished products would vary based on peak production seasons for the industry contractor.

In order for M to continue to provide work related training services and jobs to more than 90 clients in the program, a substantial monetary contract was required. Since M is located in a rural community of less than 5,000 in Q, there were no other industries immediately available to fulfill this need. The educational job training services provided to the clients in the work activity center are funded through government programs, but that funding covers only the costs of staff trainers and instructors, utilities and other general overhead. For the year ended June 30, 2000, billable work activity training units of service were only 18% of the total units provided resulting in funding for only 43% of work activity staff salaries. Without industry contracts, training opportunities for the clients could not exist, and billable services for training under government funding would not exist. This would result in termination of work activity staff and loss of funding for non-variable overhead.

Client wages enable many of the client families to provide necessary personal living expenses not covered by other sources of income. Loss of the current contract would seriously erode the ability of M to provide work-related training to all clients.

With an increasing amount of M's financial resources coming from governmental sources and the uncertainty of the federal and state programs' continued strength, M has been searching for ways to become more self-reliant and less government-reliant.

Although purchasing inventory and warehousing that inventory would mean additional overhead for M, it would also be the means to increase job opportunities to M's clients and teach them new work skills to develop their individual capabilities and increase their quality of life. These skills could be used in other off-site businesses in the public sector.

Realizing the loss of the work activity center would seriously jeopardize the financial stability of all of M's programs, Its Board of Directors approved the following activities:

1. Purchase of land for expansion,
2. Construction of a warehouse,
3. Establish a line of credit with a local bank to facilitate inventory purchase,
4. Negotiate new contract unit rate to offset ownership costs of inventory in addition to labor assembly costs,
5. Phase-in inventory to meet major industrial contractor's requirements, and
6. Obtain a written commitment from the major industry regarding repurchase of any unused or obsolete parts, recognizing M's inexperience with inventories.

M negotiated a new contract with the major contractor and purchased 18 acres of land. Construction began on a warehouse for the purpose of meeting the new contract requirements. The land cost x and the construction of the warehouse totaled more than 5x. M was required to use the contractor's entire stock of old inventory and to begin purchasing new inventory as the old was used. Approximately two years ago M began to purchase parts inventory for assembly, and clients continued to assemble those parts as they had in years past. Client training also began in the areas of inventory control, movement and warehousing procedures.

Before the change in operations, the number of M's clients totaled between 65 and 70. Since the change in operations, M has more than 90 clients working in the work activity center. M also employs between 12 and 15 non-clients, who are senior citizens and who perform work only when required by M in order to meet a production or assembly deadline that could not be met utilizing only M's clients. The use of non-clients may range from a few hours during a single day, up to two or three days in a week, but only if there are not sufficient clients available to meet a deadline. All such work has been far less than full-time and sporadic in nature. The senior citizens are paid the same hourly wage as M's clients.

In reality, the only change that has taken place in the work activity center is the ownership of the inventory and its warehousing. Although gross revenues and capital expenditures have increased with this change in operations, net revenues have not changed significantly. Also, the work activity program has remained unchanged. Its goal is still to provide clients with the opportunity to learn work skills, to provide habilitative training in a controlled environment, and to

enable every client to prepare for a more independent life in the least restrictive environment.

The capital expenditures involved in the acquisition of land and construction of a warehouse building have necessitated several actions. The loan agreement for the land purchase has been negotiated with no interest or principal payment due until the year 2004. Loan funds for the warehouse have been obtained through the Department of Housing and Urban Development Community Block Grant for Economic Development in the form of a loan to be passed through the N Department of Economic Development. M must create 18 new, permanent, full-time jobs within a two-year period at an average hourly wage of $6.50 per hour. Some new equipment was required to be purchased or leased.

M has requested a ruling that revenues generated from its manufacturing work activity program will not be treated as unrelated business taxable income under section 512(a) of the Code, and, accordingly, will not be subject to the tax imposed by section 511.

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

Section 511 of the Code imposes a tax on the unrelated business taxable income of organizations exempt from federal income tax under section 501(c) of the Code.

Section 512(a)(1) of the Code defines the term "unrelated business taxable income" as gross income derived by an organization from an unrelated trade or business regularly carried on by it, less the allowable deductions which are directly connected with such trade or business.

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 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 exempt function.

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.

Section 1.513-1(a) of the Income Tax 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(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 or 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, 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.

U.S. v. American College of Physicians, 475 U.S. 834 (1986), states that the proper focus under the "substantially related" requirement is on the conduct of the exempt organization, specifically, whether the business activity is conducted in a manner calculated to further the organization's exempt purpose or function.

Rev. Rul. 73-127, 1973-1 C.B. 221, describes a nonprofit organization formed to operate a cut-rate retail grocery store in a poverty area, to provide free grocery delivery service to residents who need it, to participate in the federal food stamp program, and to provide job training for unemployed residents. The store is operated by a staff of employees experienced in the retail food industry. The store has a smaller markup than competing stores, but otherwise is operated in a manner similar to for profit businesses in the area.

About four percent of the store's earnings are allocated for use in a continuous training program for the hard-core unemployed. The training program includes lectures, demonstrations of retail store techniques, and on-the-job training. A trainee receives a small salary during the training period. At the conclusion of his training, he is qualified for employment in the retail food industry.

Rev. Rul. 73-127 states that the organization's purpose of providing job training for the hard-core unemployed is charitable and educational within the meaning of the common law concept of charity, section 501(c)(3) of the Code, and sections 1.501(c)(3)-1(d)(2) and 1.501(c)(3)-1(d)(3)(i)(a) of the regulations. However, the organization's purpose of operating a cut-rate retail grocery store in a poverty area is not a charitable purpose under the legal authority just cited. While the store operation is used in part "as a vehicle for the training program," nevertheless, it is "conducted on a scale larger than is reasonably necessary for the performance of the organization's training program and was not intended to, nor does it in fact, serve solely as a vehicle for carrying out the training program." Held, the organization does not qualify for exemption under section 501(c)(3).

Rev. Rul. 73-128, 1973-1 C.B. 222, notes that while charitable organizations may engage in commercial endeavors for the production of income to be used for carrying on charitable programs and activities, the manufacture and sale of commercial items as an end in itself does not constitute a charitable purpose. However, the provision of vocational training and guidance to the unskilled and under-employed may qualify as a charitable purpose so long as the manner of its achievement is otherwise charitable. Rev. Rul. 67-22, 1967-1 C.B. 125 and Rev. Rul. 68-504, 1968-2 C.B. 211 are cited. Rev. Rul. 73-128 goes on to state that with respect to the organization described,

> ...the facts clearly support the conclusion that the manufacturing and merchandising operation is the means of accomplishing the organization's declared charitable objectives. Thus, there is a clear and distinct causal relationship between the manufacturing activity and the training of individuals for the purpose of improving their individual capabilities. There is likewise no evidence that the scale of the endeavor is such as to suggest that it is being conducted on a larger scale than is reasonably necessary to accomplish the organization's charitable purpose.

Rev. Rul. 75-472, 1975-2 C.B. 208, concerns an exempt organization that operated a halfway house and at the same time operated a furniture shop. Any profits realized from the furniture shop operations were applied toward the cost of operating the halfway house. The furniture shop's activities were related to the organization's purposes; therefore, the organization did not have unrelated trade or business income.

Rev. Rul. 76-94, 1976-1 C.B. 171, held that the operation of a retail grocery store by an exempt organization, as part of its therapeutic program for emotionally disturbed adolescents, was not unrelated trade or business income within the meaning of section 513 of the Code.

In order to determine whether amounts derived from M's manufacturing work activity program are subject to the unrelated business income tax, it is necessary to apply the standards contained in sections 511 through 513 of the Code and the accompanying regulations. M agrees that its work activity program is a trade or business within the meaning of section 513(c) and is regularly carried on as required by section 512(a)(1). Thus, the central question in this case is whether the work activity program is substantially related to M's exempt purpose or function.

M's stated exempt purpose is to provide habilitative training services to developmentally and physically disabled infants, children and adults, which is a charitable and educational purpose within the meaning of section 501(c)(3) of the Code. M has various programs that help individuals prepare for an independent life, one of which is the work activity program. The function of the work activity program is to provide clients with the opportunity to learn work skills, to provide habilitative training in a controlled environment, and to enable every client to prepare for a more independent life in the least restrictive environment. All of the available information indicates that the work activity program as described above contributes importantly to M's charitable and educational purpose, as required by section 1.513-1(d)(2) of the regulations, and therefore is substantially related to M's exempt purpose or function. The work activity program is a means to help develop M's clients and is similar to the situations described in Rev. Ruls. 73-128, 75-472 and 76-94, supra.

M's activities are distinguishable from those described in Rev. Rul. 73-127, supra. Unlike the grocery store that was the subject of Rev. Rul. 73-127, M's work activity program is conducted on a scale that is reasonably necessary to accomplish its charitable purpose, and such program does serve solely as a vehicle for carrying out M's charitable and educational purpose. The expansion of the program, as detailed above, is consistent with M's exempt purpose, and the training services offered by M to its clients have not changed significantly because of the expansion.

Based on the foregoing, we rule that the revenues generated from M's manufacturing work activity program will not be treated as unrelated business taxable income under section 512(a) of the Code, and, accordingly, will not be subject to the tax imposed by section 511.

This ruling is based on the understanding that there will be no material changes in the facts upon which it is based.

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

Robert C. Harper, Jr.

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