

Taxation of Income from Services Provided to Other Tax-Exempt Organizations

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We are often asked whether payment for services from one tax-exempt organization to another gives rise to taxable income. On May 15, 2008, the Internal Revenue Service ("IRS") issued Private Letter Ruling ("PLR") 200832027, which examines the potential unrelated business taxable income ("UBTI") consequences from the receipt of fees by an organization exempt from federal income tax pursuant to Section 501(c)(3) of the Internal Revenue Code of 1986, as amended (the "Code"), for the provision of grant-making, administrative and clerical services to separate tax-exempt organizations. Please note that a PLR is binding authority only for the taxpayer to whom it is issued and cannot be relied upon by other taxpayers as precedent. However, a PLR is a useful guide to the IRS's views on a particular matter.

PLR 200832027 concerns a community trust, the primary purpose of which is to support charitable grant-making activities in a particular area and which planned to provide certain services for a fee to other grant-making organizations. The IRS viewed those services as falling into three distinct categories: grant-making, administrative and clerical. The IRS ruled that the receipt of reasonable fees charged by the organization for providing grant-making services to separate tax-exempt organizations that serve the same community would not constitute UBTI, but that the receipt of reasonable fees charged for providing administrative and clerical services would.

In PLR 200832027 the IRS stated that an organization described in Code Section 501(c)(3) which provides services for a fee would have UBTI if three conditions are satisfied. After finding that the proposed services generate fees and would be regularly carried on, the IRS focused on the third condition, that is, whether the services were or were not substantially related to the organization's tax-exempt purpose. The factors considered by the IRS included (i) the relationship between the proposed services and the accomplishment of the organization's tax-exempt purpose; (ii) whether the services would be conducted on a larger scale than was reasonably necessary to achieve the organization's tax-exempt purpose; and (iii) whether the services would be provided at substantially below cost. The IRS also considered whether other commercial entities were providing similar services, but did not find this fact determinative. However, the IRS did state that where commercial alternatives were available, it became more difficult to demonstrate that a service was substantially related to the organization's tax-exempt purpose.

The IRS ruled that the proposed grant-making services would contribute importantly to the accomplishment of the organization's tax-exempt purpose and were narrowly tailored. However, the IRS found that the proposed administrative and clerical services would not contribute importantly to the accomplishment of the organization's tax-exempt purpose and would be conducted on a larger scale than was reasonably necessary. The administrative and clerical services consisted of activities requiring office staff skilled, educated and trained in business

administration and management, personnel management and office procedures; a required skill set that the IRS found not unique to the charitable sector or the organization itself. The IRS also viewed unfavorably the fact that the fees charged for the administrative and clerical services would not be substantially below cost. The IRS then concluded that the receipt of reasonable fees charged by the organization for providing grant-making services to separate tax-exempt organizations that serve the same community would not constitute UBTI, but that the receipt of reasonable fees charged for providing administrative and clerical services would.

If you would like a copy of this ruling or have questions about this subject, please contact Victoria Bjorklund (vbjorklund@stblaw.com), David Shevlin (dshevlin@stblaw.com), Jennifer Reynoso (jreynoso@stblaw.com), Jennifer Franklin (jfranklin@stblaw.com) or any other member of the firm's Exempt Organizations Group.

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