msk

irs rules that providing consulting services to nonprofits at cost is not an exempt purpose

MSK Client Alert

March 2012

practice areas

nonprofit organizations

To qualify for tax exemption as a charitable organization under Internal Revenue Code section 501(c)(3), the entity must be organized and operated exclusively for certain specified exempt purposes. Two 2011 private letter rulings denied exemptions for organizations providing consulting services, even though the consulting services were carried on without making a profit and were provided only to other charitable organizations.

A charitable organization may operate a trade or business only if the trade or business furthers the organization's **exempt** purpose and no more than an insubstantial part of the business activities further a **nonexempt** purpose. A trade or business that would normally be carried on for profit does not become a qualifying charitable purpose merely because that activity is provided to other charities or because fees are only charged at cost. The activity must itself advance an allowable exempt purpose and not be of the type commonly carried on for profit.

The allowable exempt purposes include:

- Relief of the poor or distressed or of the underprivileged
- Advancement of religion
- Advancement of education or science
- Lessening the burdens of government
- Promotion of social welfare

Factors that show a substantial nonexempt commercial purpose:

- Competition with commercial firms
- Lack of financing in the form of voluntary contributions from the public
- Presence of net profits
- Failure to offer any free or below-cost services
- Failure to limit its clientele to exempt organizations

See B.S.W. Group, Inc. v. Comm'r, 70 T.C. 352 (1978).

In **Private Letter Ruling 201141021**, a company proposed to provide consulting services to governmental units and nonprofit organizations by handling the construction and maintenance of telecommunication networks used by those clients. The client (such as a county) would pay the consulting company a fee that covered the consultant's costs, with no built-in profit margin. The ruling held that the consulting services were not in furtherance of an exempt purpose just because they were to be provided to exempt organizations at cost. The services were of a type normally carried out for profit and did not themselves further an exempt purpose.

In **Private Letter Ruling 201128028**, an organization affiliated with a prominent hospital sought to provide consulting services, for a fee, to other hospitals who wanted to improve their overall performance. The consultants would operate much like ordinary business consultants in the hospital context. For example, consultants would be sent on-site to evaluate areas of possible improvement, then share best-practice methodologies and train employees of the customer hospital. The areas of evaluation spanned the entire breadth of a hospital organization, from staffing to patient care to advertising to selection of chief executive officers.

The IRS determined that the consulting services were not in furtherance of an exempt purpose because they bore many of the hallmarks of nonexempt purposes set forth in the *B.S.W.* case. The fact that "health" was involved did not qualify the consulting activities as exempt "promotion of health" because no health-care services were provided directly to patients. The fact that "education" was included in the services provided does not qualify as the "advancement of education" because the training was for the benefit of private entities (the client hospitals) rather than the general public and also because the training comprised only a small part of the services provided.

The ruling concluded that, while the organization's activities could eventually result in the improvement of health care available for the general public, the organization's primary purpose was to provide its "paying clients with management, advisory and consulting services, which are not inherently charitable activities."

An example of a consulting service that did further an exempt purpose is in **Revenue Ruling 71-529**, referenced in both private letter rulings. In that ruling, the organization provided assistance in the management of the endowment or investment funds of its member colleges and universities that controlled the organization, for a charge. The fees collected from this endeavor, however, totaled less than 15% of the organization's cost in

providing them (which the organization was able to do because a large share of its budget was covered by grants from unrelated foundations). The service was held to be an "essential function for tax-exempt organizations for a charge 'substantially below cost.'"

How can the recent unfavorable private letter rulings be reconciled with this earlier favorable published revenue ruling? The key may be found in **Revenue Ruling 72-369**, which distinguished Revenue Ruling 71-529. The facts of the 1972 ruling were closer to the private letter rulings: the organization provided consulting services to unrelated nonprofits at cost. In ruling that the organization did not qualify for exemption under section 501(c)(3), the Service observed:

This case is distinguishable from the situation where an organization controlled by a group of exempt organizations and providing investment management services for a charge substantially less than cost solely to that group qualifies for exemption …

In the two private letter rulings, one could argue that communications systems and improved performance of health-care systems are "essential functions" of the government units and nonprofit organizations for which consulting services are performed – at least as much as the investment management involved in Revenue Ruling 71-529. The key distinguishing factors seem to be that the organization in the revenue ruling was actually controlled by the colleges and universities for which the consulting services were performed and that those services were not priced just at cost, but way below cost.

The adverse determinations in these recent private letter rulings, coming forty years after these distinctions were made in the two revenue rulings (and later confirmed in the *B.S.W.* case), illustrate the strict test that is applied to a nonprofit organization when its main activity is assisting other nonprofits to determine if it qualifies for tax exemption as a charitable organization.

Please call any member of our Charitable Sector Practice group if you have any questions about this alert.

los angeles
t 310.312.2000
f 310.312.3100

new york
t 212.509.3900
f 212.509.7239

washington, dc
t 202.355.7900
f 202.355.7899