Legal: IRS Addresses Section 501(c)(3) Certification Programs

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The Internal Revenue Service has long maintained the position that professional certification programs are consistent with tax-exempt status under Section 501(c)(6) of the Internal Revenue Code and usually not consistent with Section 501(c)(3) status. A Private Letter Ruling issued in 2004, although it is not legal precedent binding on other tax-exempt organizations, confirms this position while adding insight from the IRS with regard to the rules applicable to unrelated business income subject to tax. That particular insight has implications for nonprofit organizations that generate revenue from certification programs and certain other activities. In this column, Jeff Glassie explains the new IRS pronouncement and a few of its implications for associations.

Edited by Jerald A. Jacobs

Professional certification programs administered by nonprofit organizations are generally considered by the Internal Revenue Service to be consistent with the tax-exempt purposes of Section 501(c)(6) rather than Section 501(c)(3) organizations. While a Private Letter Ruling last year confirms that distinction, it also has implications related to how the IRS views the applicability of unrelated business income tax (UBIT) with regard to revenue generated by certification programs, peer reviews, professional referrals, and other activities. Following is background on the IRS's position on such matters and a discussion of the implications of the recent Private Letter Ruling.

The long-standing IRS position

Section 501(c)(3) status is reserved for entities organized and operated exclusively for charitable, educational, scientific, and similar purposes. If more than an insubstantial part of an organization's activities are not in furtherance of such public purposes, Section 501(c)(3) status will not be granted.

Although professional certification clearly has many public benefits--promotion of enhanced practice, improved competence, safety to customers, and so forth--the IRS has held in a number of revenue rulings that certification primarily provides a private benefit to the certified professionals and mostly furthers the common business interests of those individuals. Thus, an organization that conducts a certification program will not be eligible for Section 501(c)(3) status. Limited exceptions have been identified in cases where a certification program has significant, demonstrable public benefits, such as in the area of boat safety, or where a clear lessening of the burdens of government exists. The latter might apply, for example, when federal or state law requires a privately conferred certification. In effect, professional certification programs generally qualify for tax-exempt status under Section 501(c)(6), the classification available to trade associations, professional societies, and other business leagues.

The recent ruling

The situation in the recent ruling by the IRS involved a large Section 501(c)(3) organization that conducted numerous activities, including operating a professional certification program. Consistent with prior holdings, the IRS found that the certification activities were not substantially related to exempt purposes of the organization under Section 501(c)(3). In a shift from prior rulings, the IRS considered the program to be a "regularly carried on" trade or business, thereby subjecting revenues from the program to the unrelated business income tax.

The IRS also ruled that the certification program was insubstantial in comparison to the extensive activities of the organization and, hence, would not jeopardize its Section 501(c)(3) status. This also appears to be a significant departure from previous IRS positions, in which any sort of a substantial or significant certification program would be held inconsistent with 501(c)(3) status and, thus, not appropriate to be conducted by such an organization. As a result of previous rulings, many Section 501(c)(3) organizations have spun off certification programs into Section 501(c)(6) entities as a reasonable way to protect the tax-exempt status of the main organization.

Implications of the ruling

In this ruling, the IRS took the position that even though certification programs are consistent with, appropriate for, and related to Section 501(c)(6) activities, a Section 501(c)(3) organization may conduct one as long as it is an insubstantial part of the organization's overall activities. Revenue from such activities, however, would likely be subject to UBIT.

This position may have several important implications for any Section 501(c)(3) organizations conducting activities that might be characterized as predominantly in furtherance of (c)(6) but not (c)(3) purposes, including not only certification but also peer review activities, professional referral programs, industry advocacy efforts, and the like.

For example, a Section 501(c)(3) organization that is already conducting insubstantial certification programs, peer reviews, and other activities consistent with 501(c)(6) status, may be able to continue doing so without spinning the programs into a (c)(6) organization. But, at the same time, such groups must consider whether the IRS will view the revenue from such programs as taxable. It is likely, in fact, that many 501(c)(3) organizations have not been treating revenue from such exclusively (c)(6) activities as subject to UBIT, but rather considering them simply insubstantial, and hence, not taxable. The recent ruling seems to be a departure from prior IRS precedent on this issue.

Associations should take care, however, when declaring their programs insubstantial, as the ruling does not discuss what specific factors led the IRS to conclude that the program referenced in the Private Letter Ruling was insubstantial, that is, whether revenues, budget amounts, size of staff, or other factors were determinative. Neither does the IRS direct that such a program be carved out and separated from the Section 501(c)(3) organization.

This ruling gives rise to many questions regarding taxability of predominantly professional or business activities by Section 501(c)(3) organizations and seems

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to offer new options for such organizations that intend to conduct certification programs. As always, we await further guidance from the IRS. It is emphasized, too, that a Private Letter Ruling such as this one is explicitly not considered to be precedent binding upon other exempt organizations beyond the one for which the ruling was issued.

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