H. IRC 501(k) -- CHILD CARE ORGANIZATION

1. Introduction

In 1984, Congress added subsection (k) to section 501 of the Internal Revenue Code. IRC 501(k) provides that certain child care organizations will be treated as educational organizations under IRC 501(c)(3). This provision effectively enabled child care centers to qualify for exemption under IRC 501(c)(3) without having to demonstrate that they meet the Service's definitions of "educational" or "charitable."

The Service announced in October, 1986 that it would begin writing regulations under IRC 501(k). However, the implementation of the Tax Reform Act of 1986 caused a reordering of priorities and the regulations project was abandoned in December of 1986. Due to this lack of published authority, the key Districts have been forwarding almost all IRC 501(k) applications to the National Office even when the facts appear to meet the statutory requirements. It is hoped that with the guidance provided in the IRM, the Districts will be able to work such cases themselves. However, applications that appear to warrant denial under IRC 501(k) based on a finding that the organization's services are not available to the general public should still be sent to the National Office. (See IRM 7664.31.)

This section will outline recent developments in the area of IRC 501(k), specifically the addition of several G.C.M.'s. For a background discussion of the child care area, the 1986 CPE text includes an extensive review of developments prior to the 1984 enactment of IRC 501(k).

2. IRC 501(k)

IRC 501(k) provides that, effective for taxable years beginning after July 18, 1984, organizations that provide for the care of children away from their homes will be treated as educational organizations under IRC 501(c)(3) if: (1) substantially all of the care provided by the organization is for purposes of enabling individuals to be gainfully employed, and (2) the services are available to the general public.

A. Gainful Employment Requirement

The section applies if the services provided are for purposes of enabling individuals to be gainfully employed. This requirement is met if the parents of the children being cared for would be unable to work unless they found another means of caring for their children during their time at work. Although we have no direct guidance in interpreting the term "gainful employment," it is useful to consider the regulations under IRC 21 (and the regulations under that section's predecessor, IRC 44A), which provides an income tax credit for household and dependent care services expenses:

> "The expenses must be incurred while the taxpayer is gainfully employed or is in active search of gainful employment. The employment may consist of service either within or without the home of the taxpayer and may include self-employment...Volunteer work for a nominal salary does not constitute gainful employment." (Reg. 1.44A-1(c)(1)(i).)

Individuals will also be considered to be "gainfully employed" if they are full-time students. (Reg. 1.44A-2(b)(3).)

"Substantially all" of the care provided must be for enabling individuals to work. A "substantially all" test is generally found to be met where at least 85% of the services are provided for proper purposes. (See, for example, Revenue Ruling 73-248, 1973-1 C.B. 295 (IRC 512(b)(2)); and section 53.4942(b)-1(c) of the Foundation and Similar Excise Taxes Regulations.) Therefore, if a child care organization provides care for a group of children, at least 85% of whose parents are thereby able to work, the organization will meet section (1) of IRC 501(k). Cases involving child care centers that provide less than 85% of their services to children of working parents should be forwarded to the National Office for consideration.

B. <u>"Available to the General Public" Requirement</u>

The statute provides that child care services must be available to "the general public." Generally, this requirement will be satisfied even if enrollment is limited to children within a geographic area. Child care organizations may also restrict admission to children of certain ages. An organization that provides care only to children of the employees of a specific employer will not meet IRC 501(k)'s public availability test. However, see discussion below on federal child care centers and VEBA's. Enrollment may not be limited to children of a certain race, as discussed in G.C.M. 39757 (September 27, 1988).

G.C.M. 39757 concludes that an organization that meets the requirement of IRC 501(k) need not satisfy the racial nondiscrimination guidelines of Rev. Proc. 75-50, 1975-2 C.B. 587. However, if a child care center maintains a racially discriminatory policy, the Service will interpret that policy as failing the test of IRC 501(k)(2), which requires that services be available to "the general public." A discriminatory day care center will also be precluded from exemption under IRC 501(c)(3) under the holding in Bob Jones University v. United States, 461 U.S. 574 (1983). G.C.M. 39757 states:

> "Child-care organizations are specifically given "educational purposes" for sections 501(c)(3) and 170(c)(2) purposes via section 501(k). Moreover, section 501(k) specifically requires that the child-care services be "available to the public." Accordingly, although a section 501(k) organization which is not seeking classification under section 170(b)(1)(A)(ii) need not meet the guidelines and requirements of Rev. Proc. 75-50, under the holding of Bob Jones and the specific statutory language of section 501(k), the Service must nevertheless ensure that such organizations are not racially discriminatory.
>
> "The determination of whether a section 501(k) organization is racially discriminatory depends on the facts and circumstances of the particular case. The following are some examples that may indicate a racially discriminatory policy: (1) racially restrictive statements in the organization's brochures, catalogues, advertisements or governing instruments; (2) complaints or actions filed with local, state or federal agencies or a court alleging racial discrimination as to students, faculty, or administrative personnel; and (3) affiliation with an organization which advocates or practices racial discrimination."

C. Non-Private Foundation Classification

A child care organization that is recognized as exempt under IRC 501(c)(3) via IRC 501(k) must also be categorized as a public charity or a private foundation under IRC 509. Most child care centers meet the requirements of IRC 509(a)(2) since they typically receive most of their funding from fees for services.

3. Child Care Organizations With Employment Preferences

Some child care centers that do not meet the provisions of IRC 501(k) because they provide care only to children of employees of specific employers may qualify for exemption on another basis.

A. Federal Child Care Centers

In G.C.M. 39613 (January 28, 1987), Chief Counsel determined that a day care center in a federal building, whose creating legislation required it to give priority to children of federal employees, was exempt under section 501(c)(3) of the Code on the basis of "lessening the burdens of government." The G.C.M. concluded that the provision of child care facilities to government employees is an exempt activity because the federal government has demonstrated its willingness to provide support in the day care area, and because there has been an objective manifestation by the government that these federal child care centers serve to lessen its burden. G.C.M. 39613 states:

> "The manner for lessening a governmental burden in this case is the provision of an employee benefit available in lieu of additional compensation. The availability of convenient child care services also supports significant employer objectives, for example, the recruitment and retention of employees, the improvement of their morale, and a lowering of their rates of tardiness and absenteeism. The federal government has indicated that these objectives are important to it in its role as employer....
>
> "Generally, defraying the general or specific expenses of a city, county or state, or the payment of part of the government's debt is considered a municipal or governmental purpose, relief of which is considered a charitable activity.... The defraying of general or specific expenses or the payment of debt is considered to be in the social interest of the community because it tends to reduce taxation and is "assisting the municipal government and conferring a benefit upon the entire community."

Chief Counsel found the fact that a preference was given to enrolling federal employees' children was particularly relevant in determining that the center lessened a governmental burden:

> "The existence of the preference of federal employees prevents the center from qualifying under section 501(k) because the services

provided are not available to the general public to the extent required by section 501(k)(2). However, the preference is a significant factor in determining whether the center qualifies under section 501(c)(3) as an organization that lessens the burdens of government. In a case, as here, where the child care services are required by statute to be provided to a group of individuals at least 50 percent of whom are federal employees, and are permitted to be provided to the general public only on a space available basis, the preference for federal employees supports a conclusion that the center qualifies under section 501(c)(3) as an organization that lessens the burdens of government."

While G.C.M. 39613 discusses a federal facility, its principles would appear to apply equally to other government child care centers, such as those provided by state and local governments.

B. Child Care Centers of Private Employers

IRC 501(c)(9) provides exemption for voluntary employees' beneficiary associations (VEBA's) that provide for the payment of certain benefits to their members. Section 1.501(c)(9)-3(e) of the Income Tax Regulations provides that among the permissible benefits is the provision of child care facilities for preschool and school-age dependents. Therefore, a VEBA may maintain exemption under IRC 501(c)(9) where it provides day care solely to employees of a particular company. However, it should be noted that VEBA's must meet strict prohibitions against discrimination between highly compensated employees and non-highly compensated employees in order to qualify under IRC 501(c)(9).

4. School Classification

As recently as ten years ago, the lines between schools and day care centers were blurred. However, with the rapid expansion and growing demand for the provision of child care, the Service has changed its approach in this area. Initially, child care centers that sought exemption under IRC 501(c)(3) were forced to meet the stricter requirements imposed on private schools, and more importantly, had to prove that they provided an educational service rather than simply a custodial service. With the enactment of IRC 501(k), most child care centers will probably take the simpler route to exemption under that subsection.

However, a child care organization that meets the criteria for qualification as a school under IRC 170(b)(1)(A)(ii) may still choose to do so, rather than come under the less stringent test of IRC 501(k). To be classified as a school, a day care organization must have a primary purpose of educating the children, and custodial services must be merely incidental. (See San Francisco Infant School, Inc. v. Commissioner, 69 T.C. 957 (1978), acq. 1978-2 C.B. 2; Michigan Early Childhood Center, Inc., 3T TCM 808 (1978).) It must meet the requirements of section 170(b)(1)(A)(ii) relating to faculty, curriculum, and enrolled student body. See Rev. Rul. 73-430, 1973-2 C.B. 362. The child care organization that wishes school classification must also fulfill the racial nondiscrimination requirements of Rev. Proc. 75-50.

Also, the child care organization that seeks to be categorized as a school under IRC 170(b)(1)(A)(ii) must serve the community as a whole rather than designated individuals. If, for example, an organization charges a lower rate of tuition for children of employees of a particular company than for non-employees' children, it will be found to serve private interests of those employees rather than the interests of the general public. (See Baltimore Regional Joint Board Health and Welfare Fund and Amalgamated Clothing and Textile Workers Union v. Commissioner, 69 T.C. 554 (1978).) However, as discussed above, an organization that operates primarily for the benefit of a group of employees, may qualify for exemption as a voluntary employees' beneficiary association under IRC 501(c)(9).

5. Charitable Classification

A child care center may qualify under IRC 501(c)(3) as a charitable organization if it enrolls children on the basis of financial need. (See Office Decision 340, 1919 C.B. 202; Rev. Rul. 68-166, 1968-1 C.B. 255; Rev. Rul. 70-533, 1970-2 C.B. 112.)

6. Day Care-Related Organizations

Certain organizations formed to provide services related to the child care area have also been considered for exemption under IRC 501(c)(3).

A. Sponsoring Organizations

G.C.M. 37781 (December 8, 1978), provides that payments made by sponsoring organizations pursuant to the Child Care Food Program to family and group day care home operators to reimburse the operators for the cost of providing

meals to needy children are includible in the operators' gross incomes. Although it addresses a taxable income issue, the G.C.M. is helpful in that it discusses the federal Child Care Food Program's activities and relationship with the sponsoring organizations that provide assistance to child care centers. Such assistance includes consultations to ensure that meals meet prescribed standards, training of food service personnel, and visits to monitor compliance by providers of child care. G.C.M. 37781 states:

> "...A sponsoring organization is a public or private nonprofit organization that agrees with the State agency to be responsible for the management of a nonprofit food program in one or more child care centers or family or group day care homes.
>
> "A sponsoring organization can only participate in the Program after it has entered into a formal written agreement with the State and submitted a management plan to the State agency. The management plan includes detailed information on the administrative structure and procedures which will be used by the sponsoring organization to operate food programs in the child care centers and family and group day care homes under its jurisdiction. In the written agreement with the State, the sponsoring organization accepts final financial and administrative responsibility for the conduct of the food service and for each affiliated family and group day care home and child care center."

In this description of the relationship between the sponsoring organization and the State, Chief Counsel provides a basis for recognizing such an organization as exempt under IRC 501(c)(3). In many states, the sponsoring organizations act as intermediaries between nonprofit child care centers and State or federal agencies. In many states, a day care center cannot obtain federal funds for meal reimbursement without the involvement of a sponsoring organization. Therefore, the role of these sponsoring organizations may, based on the individual case, be described as one of lessening the burdens of government.

B. Child Care Referral Services

G.C.M. 39622 (April 10, 1987), holds that providing day care referral and information services to the community at large does not result in unrelated business taxable income, but the provision of specialized child care assistance to

employers and other commercial enterprises would result in unrelated business income.

This G.C.M. involves an organization described in IRC 501(c)(3) whose principal activity is the operation of several child care centers. The organization also provides day care referral, counselling, and management services to both the community at large, and to commercial enterprises. Chief Counsel considered the provision of such services to the community at large:

> "We agree with your view that providing day care center referral and assistance information to the general public for a nominal charge is charitable and educational within the meaning of section 501(c)(3) ... We agree further that providing these services to the community contributes importantly to the organization's exempt purposes and is substantially related to the operation of day care centers. Therefore, providing day care referral and information services to the community at large does not constitute unrelated trade or business activity within the meaning of section 513(a)."

The G.C.M., however, went on to consider the provision of these services to individual employers:

> "In this case, the exempt organization will provide the services ordinarily provided by ***, a for-profit organization, and charge the for-profit for the cost of these services. This arrangement provides a direct benefit to the for-profit organization because it is able to satisfy the needs of a specific business customer requiring information about day care in the *** area. Unlike the provision of information and referral services to the general public, the services in this transaction result in significant private benefit to the for-profit organization. Therefore, this activity...is neither an exempt activity nor substantially related to the organization's exempt purpose and the income generated from these services gives rise to unrelated business taxable income. The consulting services are provided under a contract which requires the organization to operate in a prescribed manner, similar to other for-profit entities in the business of providing comparable services."