

C. INTERNET SERVICE PROVIDERS

Exemption Issues Under IRC 501(c)(3) and 501(c)(12)

by
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1. Introduction

Internet Service Providers (ISPs) operate to facilitate communication via the Internet. The Internet is an interconnected global network. The network can carry three types of information: data, video, and voice. To obtain access to the Internet, End Users (i.e., customers) connect to an ISP. Connection is established either through the End User's modem which sends data over the telephone lines of local telephone companies or through a dedicated connection using high speed digital lines between a local area network at the customer's premises and the Internet. ISPs connect End Users to Internet Backbone networks. Backbone providers route traffic between different ISPs and interconnect with other Backbone providers. Once connected to the Internet, End Users can send and receive information through these connections.

Services provided over the Internet include electronic mail which allows users to send and receive messages using a common addressing system, public domain shareware, news, information, and research material, and engage in electronic commerce.

2. Descriptive Internet Terminology

It is important in working applications for exemption or doing examinations of ISPs to keep certain concepts in mind and to be somewhat familiar with certain terminology relating to this particular industry. Furthermore, the application of an ISP and attachments to its financial statements will usually contain a bewildering list of equipment used in the performance of its activities.

The Internet is a global network of computers communicating with each other under a common set of computer communication software standards (protocols) known commonly as the Transmission Control Protocol/Internet Protocol (commonly abbreviated "TCP/IP"). Many operating systems, including Windows 95(tm) and Windows NT(tm) have these protocols built-in.

An "Intranet" by comparison is an internal network within a particular organization, which may or may not be connected to the Internet. The Intranet may or may not use the same communications protocols as the Internet. Intranets are usually found in business, government, and corporate settings as a means of internal communication within the organization. Further, these organizations while seeking Internet access from their Intranets,

may control outsider access to their Intranets, through the use of blocking software/protocols commonly known as "firewalls," between their Intranet server and their server present on the Internet (commonly known as a "Proxy" server).

The Internet functions as a "packet data" network with a common addressing system. Data is sent over the Internet in discreet packets each of which contains a destination and origination address, its place (first, middle, last) among the total packets sent, and the data itself. The packet finds its way to its destination on the Internet by means of a common addressing system known as domain name service (DNS) and through the use at every address of a device called a Router which has in memory its own address and directions to other addresses. The packets of data upon reaching their addressed destination are then re-assembled into a unified whole. Data packets may travel by various routes (not necessarily the same, shortest or most efficient) before reaching their final destinations.

An End User obtains an Internet connection by signing up for service with the ISP. The Service Contract between the End User and the ISP will specify duration of service, type of connection, speed of connection, featured services, and, of course, the fee for the Service package. Most End User service connections are by way of a telephone line and modem on the End User's PC. This type of connection is commonly known as a "dial-up" connection although in business settings there may be an actual hard wire connection between the End User's PC and the ISP.

An ISP has certain essential equipment to perform its functions: some form of device to accept incoming calls from and connect the End User (typically a modem), a server (computer) wherein resides the programs essential to running the ISP, a Router -the device which sends the End User output to the correct computer (address) on the Internet, and finally a Customer Service Unit/Digital Signal Unit (abbreviated CSU/DSU) which is nothing more than a black box device to connect the ISP to other ISPs, through the conventional telephone system.

An ISP also has an essential contract or contracts with one or more "upstream providers" in order to connect its customers to the Internet.

The ISP is not, per se, an information content provider, although several of the largest ISPs used by End Users today started as content providers and later connected themselves to the Internet (eg: America Online(tm), Compuserve(tm), and Prodigy(tm)). The ISP, however, does provide certain essential services and functions to the end user including: user account and password authentication, an address service-domain name service (DNS)-which allows the user to find locations and other users on the Internet, Electronic Mail (E-Mail), mailing list and news services (known more commonly as ListServ and Usenet), and the popular graphical user interface, known as the World Wide Web (abbreviated WWW).

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The End User is provided with software by the ISP, depending upon the service contract terms, to allow access to certain features of the ISP. Typical software is the so-called Internet "browser," (Netscape(tm) or Microsoft Internet Explorer (tm)) but may also include certain operating system add-ons to enable a TCP/IP protocol (Winsock), or even a proprietary software package such as that employed by America Online(tm). Upon dialing up and logging into the ISP, the End User is typically presented with the ISP's "homepage" (graphical opening menu) from which the End User may proceed to access the Internet by selecting a particular address ("opening a location").

An increased area of interest for End Users today is to create their own presence on the Internet (sometimes referred to as establishing a "Web presence", or doing "Web publishing") in the form of their own "homepage", or "Webpage". This End User created page usually resides on the ISP's equipment. This End User homepage may have its own address or be a sub-address of the ISP.

Businesses utilizing the ISP, however, usually require an expanded "Web presence". The business may have an electronic order system for use by the general public in addition to a Web homepage or homepages. Depending upon how sophisticated this is, the business may have its own server (computer) connected to the ISP's server, with its own software maintained remotely by the ISP. This is known as "server co-location."

The EO specialist and examiner should keep these concepts in mind when dealing with ISPs and should ask that any unfamiliar terminology be explained. Further, since the specialist, or examiner, is dealing with a service provider entity it is essential to review all pertinent contracts dealing with the provision of the various services to End Users and the terms of all network connections contracts and equipment purchase contracts which the ISP has entered into with its vendors. The operational relationships of the ISP to other entities should also be explored. Finally, the specialist or examiner should determine the types of services offered the End Users and who the End Users are.

3. Types of ISPs

We have used the term "End User ISP," above to distinguish the type of ISP we usually see on application from other types of ISPs which are clearly large commercial entities and will not be applying for exemption. It is important however that the specialist and examiner be aware that these entities exist and that they are also called ISPs by virtue of the fact they provide interconnection to smaller ISPs and sometimes access to End Users.

The largest of the ISPs are US National Backbone Providers. These include a number of familiar names including: AT&T WorldNet(tm), GTE Internetworking(tm), IBM Global Network(tm), MCI Communications(tm), Sprint IP Services(tm), and Worldcom, Inc.(tm), to name just a few. These are national providers of large volume connections (referred to

commonly as "backbone operators" and/or "upstream providers") and they are interconnected with each other at various locations around the US, which are known as Network Access Points (NAPs) or Metropolitan Area Exchanges (MAEs). These backbone providers fill the role for the Internet that is comparable to the role of the traditional long distance telephone (interconnection) carrier. The backbone operators also connect to various foreign providers in Canada and South America, Europe and Asia, thereby assuring essential connectivity. There are approximately 40 of these companies with a nationwide presence. These backbone operators, although national in coverage, will have local access numbers or local connections. These local access points, usually local telephone numbers, are called "Points of Presence" (POPs). The End User ISP will have a connection contract with one or more of these "upstream providers." While it is possible for an end user to have a connection directly to a national backbone operator, usually the cost is prohibitive since these providers are dealing in high volume connections.

4. Exemption Issues – Background – The End User ISP

Confusion has arisen in the treatment of End User Internet Service Providers because of the variety of services being provided by them and the difficulty of classifying ISPs based upon the various types of services (activities) into a particular exemption category.

A number of exemption applications have been received wherein the ISP has been created by various public institutions in response to perceived public needs. These institutions include town governments located in rural areas, library systems, both large and small, public education groups and school systems setting up separate organizations to carry out ISP activities, including colleges and universities extending their internet access throughout their local communities. A number of applications have also been received from a more amorphous group of entities which can be described generally as small nonprofit or user cooperatives. Because of the multiplicity of factual situations, it is impossible to address each situation. However, there are some general rules which we should keep in mind in working these applications.

5. The "Pure" End User ISP – A Business

As a general rule, providing communication services of an ordinary commercial nature in a community, even though the undertaking is conducted on a nonprofit basis, is not regarded as conferring a charitable benefit on the community unless the service directly accomplishes one of the established categories of charitable purposes. See our prior discussion in the FY 1996 EO CPE, Article A., Computer-Related Organizations, pages 9-12.

Internet services, absent certain circumstances, do not directly accomplish any of the established categories of exempt purposes. ISP activities are directed toward assisting individuals in obtaining Internet access services for a fee. Providing such services on a regular basis for a fee is a trade or business ordinarily carried on for profit.

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While it may be argued that exploring the Internet is an educational activity for the individual, the ISP is in the business of providing access service to that individual and not in the business of advancing education.

Further, unless there are some facts indicating a mutual organizational existence with end-user, democratic control, the ISP would also not qualify for exemption as a like organization to a mutual or cooperative telephone company under 501(c)(12).

6. The End User ISP, Exemption Under IRC 501(c)(3)

In the past, ISPs have filed for exemption under section 501(c)(3) of the Code and have usually been denied exemption because they are viewed as carrying on a trade or business for profit, or conferring an unmixed private benefit, or both.

Exemption, however, is possible under IRC 501(c)(3) for certain varieties of ISPs. The ISP may be exempt as the adjunct or integral part of a University, Public School, Library System, Local Government, and/or an incorporated program activity of any of the above. The essential characteristics must show public accountability and control, dependence on government grants rather than user fees, and "free" use to students, library patrons, and the general public.

Under this theory of exemption, the ISP is a wholly controlled subsidiary organization of the recognized exempt entity. See, for example, Rev. Rul. 78-41, 1978-1 C.B. 148.

Another possible basis for exemption for ISPs under IRC 501(c)(3) would be for organizations which are "lessening of the burdens of government". This is an alternative basis for exemption where it can be shown that there is a dominant governmental role in its creation.

Rev. Ruls. 85-1, 1985-2 C.B. 177, and 85-2, 1985-1 C.B. 178, set out a two-part test for determining whether an organization's activities are lessening the burdens of government. First, it is necessary to determine whether the governmental unit considers the organization's activities to be its burden. The second part of the test is whether these activities actually lessen the burdens of government.

An activity is a burden of the government if there is an objective manifestation by the governmental unit that it considers the activities of the organization to be its burden. The interrelationship between the governmental unit and the organization may provide evidence that the governmental unit considers the activity to be its burden. Whether the organization is actually lessening the burdens of government is determined by considering all of the relevant facts and circumstances.

An "umbrella" organization for the provision of Internet access to governmental entities, public institutions, or public libraries may also be exempt under section 501(c)(3), under the more general concept of improving governmental efficiency in the delivery of public services. See: *The Council for Bibliographic and Information Technologies v. Commissioner*, 63 TCM 3186 (1992). See also Rev. Rul. 70-79, 1970-1 C.B. 127.

Ordinarily the ISP will not be exempt as an organization whose activities advance education. The specialist or examiner must be careful to distinguish, on a factual basis, the ISP from other types of entities engaged in similar activities which have been found to advance education. Two examples are found in Rev. Ruls. 74-614, 1974-2 C.B. 164 and 81-29, 1981-1 C.B. 329. These revenue rulings concern the operation of computer networks. In the first, the operation of a regional computer network among colleges and universities, and in the second, the operation of a network among libraries. Both situations are distinguishable from the ISP and do not support the conclusion that an ISP advances education. The ISP does not advance education in this manner because its activities are directed to access to a network, the Internet, and not the operation of a limited educational network.

The following are some examples and the analysis applied to each in determining whether the applicant ISP is entitled to exemption under section 501(c)(3):

Examples:

Example 1: The A organization is formed by a major University in the Town of X. Most of the Town of X is the University, which is the town's principal industry and employer. The University formed A as a wholly owned subsidiary organization to provide Internet services to its student body. The University decided, as a public service and to advance education, to provide Internet access to the elementary and secondary public schools in the town of X, the X town library, and the town of X government offices. A provides internet access free to its student body and for a substantially reduced fee to all others in the Town of X. The A organization is an adjunct or integral part of the University and qualifies for exemption under section 501(c)(3) of the Code.

Example 2: The B organization's main purpose is to sponsor workshops and publish a newsletter over the Internet containing topics relating to solar energy. Workshops and newsletters can be easily accessed by the public at no charge at B's Internet address. A limited number of individual users were permitted to use B's Internet access through individual accounts for a fee. B will be primarily supported through grants and public contributions. B was held exempt under section 501(c)(3) of the Code as an educational organization. (Note that the user fees derived from the individuals who obtained Internet access through B would be income from an unrelated trade or business, absent additional facts showing relatedness.)

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Example 3: The C organization, funded by a government grant from the Town of Y, was established to act as a clearinghouse for information and a resource center to assist local government, public schools, and the University in the Town of Y. The Town of Y perceived the need for quality Internet access services to its citizens, passed enabling ordinances, and applied for state grant assistance. A five-year project was initiated by a consortium of private-sector/public-sector organizations to establish a high-technology information highway system (ISP) available to all members of the community, but in particular to local government departments, students within the public schools of Y and the University in the Town of Y. The governing body includes officials from the Town of Y, the University and various private sector entities. The government of the Town of Y and the state government have oversight and controlling input in the C organization through their grant support and board membership. In addition to the grants, C also received donations from various private foundations. C is exempt under section 501(c)(3) of the Code because it lessens the burdens of government.

Example 4: The D organization's main purpose is to own and maintain an Internet access site for disadvantaged businesses, individuals and communities in the City of Z. D is primarily supported through user fees. Even though D states that its services are provided to disadvantaged businesses of Z, it is not operated exclusively for the relief of the poor, distressed, or underprivileged, as other individuals not in these charitable classes have accounts with D. Further, D is not controlled by its users and they have no voice in its operation. Finally, there was no showing by D that it restricted the Internet access services it provided to disadvantaged users in a particular economically-depressed area of Z or that the D service area in Z was in fact an economically depressed area.

D's activities are directed toward assisting individuals in obtaining its Internet services for a fee. This is not an exempt activity under section 501(c)(3) of the Code. D's providing Internet access services for a fee in these circumstances is a trade or business ordinarily carried on for profit. This precludes exemption under section 501(c)(3).

7. The End User ISP, Exemption Under IRC 501(c)(12)

Section 501(c)(12) of the Code provides for exemption from Federal income tax of mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations, if 85% or more of their income consists of amounts collected from members of the sole purpose of meeting losses and expenses.

In certain circumstances, an End User ISP can qualify for exemption under section 501(c)(12) as a "like organization" under section 501(c)(12). This is by no means the first time that this rationale has been employed.

For example, in Rev. Rul. 57-420, 1957-2 C.B. 308 it was held that an organization providing a two-way radio system for its members on a cooperative basis qualified for exemption under section 501(c)(12) of the Code as a "like organization" because it had a purpose similar to that of a mutual telephone company. All members were required to lease or purchase their own radio equipment, and all mobile units had to comply with the minimum specifications of the Federal Communications Commission. Each unit was equipped with a selective calling system which operated in conjunction with a centrally located base station. The association was operated for the mutual benefit of its members and without profit. Contributions to capital and operating expenses were accepted only on a cost sharing basis and all costs were prorated on an equitable basis among members receiving services. Any profits after authorized charges, expenses, and costs were refunded to members on a unit basis at the close of the fiscal year.

And in Rev. Rul. 83-170, 1983-2 C.B. 97 it was held that a cooperative organization furnishing cable television service to its members qualified for exemption under section 501(c)(12) of the Code as a "like organization" because it operated on a true mutual and cooperative basis within the meaning of section 501(c)(12), provided that 85% or more of its income consists of amounts collected from members for the sole purpose of meeting losses and expenses. It was also held that cable television corporations were similar in nature to public utilities.

The Service has recently determined that End User ISPs provide a service similar to the two-way radio system held to be exempt in Rev. Rul. 57-420, and therefore qualify for exemption under section 501(c)(12), subject to certain conditions explained below.

End User ISPs must function with true democratic control by members and operate on a true mutual and cooperative basis within the meaning of section 501(c)(12).

Rev. Rul. 72-36, 1972-1 C.B. 151, sets forth four requirements cooperative companies must meet in order to exempt under section 501(c)(12):

1. The rights and interest of members in the company's savings must be determined in proportion to their business with the company;
2. Records must be kept as are necessary to determine at any time each member's right and interest in its assets;

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3. A member's rights and interests must not be forfeited upon withdrawal or termination of membership; and
4. Upon dissolution, gains from the sale of appreciated assets must be distributed to all persons who were members during the period which the asset was owned by the company in proportion to the amount of business by those members during the period insofar as is practicable.

Further, the End User ISP must receive 85% or more of its income from amounts collected from members for the sole purpose of meeting losses and expenses.

Finally, it has been determined that the lack of regulation of the ISP as a public utility does not jeopardize exemption under section 501(c)(12). The factual analysis of the organization described in Rev. Rul. 83-170, cited above, as being similar to that of a public utility corporation, should not be viewed as requiring public regulation of the ISP under state public utility statutes. (It should be noted in passing that while ISPs are presently unregulated, a number of states are considering bringing the ISP within the ambit of the public utility statutes.)

The following examples illustrate the analysis employed in determining whether the applicant ISP is exempt under section 501(c)(12):

Examples:

Example 1: The E organization is an ISP and provides and maintains a high-speed, digital communications network through which members may access the Internet. E provides to its members a leased line for connection to the upstream "Backbone" Internet Provider. E is the only mutual ISP in its service area. E functions with true democratic control by members and otherwise operates on a true mutual and cooperative basis within the meaning of section 501(c)(12) of the Code. E is providing a service (Internet connection) which allows its members to communicate with others in a manner similar to the two-way radio system held to be exempt in Rev. Rul. 57-420, cited above. Therefore, E is exempt under section 501(c)(12).

Example 2: The F organization's primary activity is establishing a home page with the purpose of promoting its community on the Internet. The Internet provides the community with information about its schools, government, libraries, businesses, community calendar events, churches, genealogy records, service clubs, etc. The service is \$12 per month for approximately 700 members. F meets the criteria outlined in Rev. Rul. 72-36, cited above, and its

only support is user fees derived from its members. F is exempt under section 501(c)(12) of the Code as a "like organization".

Example 3: The G organization operates in the same manner as Example 2 above. G's primary activity is to establish an ISP. It offers a Christian-based ISP to members across the United States for a fee. G also meets the criteria of Rev. Rul. 72-36 and its only support is from user fees. G is held exempt as a "like organization" under section 501(c)(12) of the Code.

8. Additional Issues

A. Case Development

The specialist in development of the exemption application may turn to the public source, the Internet, in search of information concerning the ISP. Typically, the ISP will provide its home address on the Internet and invite a perusal of the homepage. The specialist should be mindful that in using this or any other source of public information, such information cannot be included in the exemption application file unless and until the applicant organization has received the material in question from the specialist and has had an opportunity to comment upon it. This is especially so in the case of exemption applications under section 501(c)(3) of the Code which are subject to the declaratory judgment provisions of section 7428. In the event of litigation on the issue of exemption under section 501(c)(3), the review by the courts is on the administrative record and not "de novo". Therefore, it is important to make the administrative record as complete as possible by exchanging public source documentation bearing upon the exemption issue with the applicant.

B. Unrelated Trade or Business Activity

The use of a graphical interface by most ISPs leads to its natural exploitation as an advertising medium. Most ISP Webpages contain some active or passive "placards", as well as running "banners", both forms of advertisements, as well as a host of "links", related references, which when selected will lead to other Web sites, other locations on the Internet. It is often difficult to determine where promotion of the organization or the organization's purposes leave off and advertising for income begins, especially where the ISP has upon its Webpage a variety of advertisers who appear to tie-in to the organization's purposes or the ISP's provision of services.

In determining what on the Web page is advertising a rough rule of thumb is that if it is an active or passive placard, or a running banner and income is being derived, it is advertising. If the Web page shows merely a displayed link then it may not be advertising, but only if related to activities or purposes of the organization.

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An analysis of whether such items are advertising must be done on an individual facts and circumstances basis. The specialist or examiner should be looking for ISP contractual relationships with the displayed companies' products to determine whether unrelated trade or business income exists. One private letter ruling has considered the issue to date and then only in passing. See: PLR 9723046, dated March 12, 1997. No conclusion was reached in the letter concerning the extent of the advertising income (other than to acknowledge that it existed in this case), and thus the issue was reserved and not ruled upon. The main activity of the organization on the Internet was found to be related and thus did not adversely affect the private foundation's exempt status, or violate certain Chapter 42 provisions.

C. Non-Member Income

No cases have been seen to date which specifically involve ISPs and the issue of member versus non-member income under section 501(c)(12). The issue is sure to arise as ISPs will seek to enhance their revenue through the provision of additional Internet services.

For example, telephonic communication through the Internet is one area of activity being examined by various regulatory authorities including the Federal Communications Commission.

Further, there are some moves afoot to impose an interexchange carrier fee upon ISPs that provide such "Webphone" services in order to provide infrastructure improvements to the Internet. This fee is sure to be allocated among the various ISPs as soon as the regulatory mandate exists and the technical details involving billing and collection can be resolved.

How the ISPs' additional "Webphone" revenue and the resultant interexchange fees billing and collection will be treated from the standpoint of member/non-member income classification is not entirely clear. A recent case, Golden Belt Telephone Association, Inc. v. Commissioner, 108 T.C. 498 (1997) would seem to suggest that income derived from such activities is not treated as either member or non-member income but instead is excluded from the 85% member income test. See also Rev. Rul. 81-291, 1981-2 C.B. 131, which indicates that certain types of income received or accrued from servicing incoming long-distance calls are to be excluded from the test.

9. Conclusion

End User ISPs, which are usually businesses, may in certain factual circumstances, be exempt under IRC 501(c)(3) or under IRC 501(c)(12).

Exemption under IRC 501(c)(3) depends upon the ISP's relationship to other IRC 501(c)(3) entities or government entities, their End Users, and the nature and extent of their activities.

Also, the End User ISP may be exempt as a "like organization" under section 501(c)(12) of the Code similar to mutual or cooperative telephone companies. These ISPs must meet the four requirements under Rev. Rul. 72-36 as stated above, and meet the 85% membership income test, to have the benefit of this exemption provision.

One distinguishing factor between ISPs applying for exemption under section 501(c)(3) and 501(c)(12) to keep in mind is that an ISP applying for exemption under section 501(c)(3) which is supported primarily by user fees, would be denied exemption based on private benefit and operating a business for profit. The same ISP may qualify under section 501(c)(12) if it meets the requirements of Rev. Rul. 72-36 and the membership income test.

Application documentation obtained from public sources, including the Internet, and not directly from the applicant, must be provided to the applicant for review and comment in order to be included in the administrative record.