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Internal Revenue Service  
Director, Exempt Organizations  
Rulings and Agreements

Department of the Treasury  
P.O. Box 2508 - Room 7008  
Cincinnati, OH 45201

Date: JUN 15 2004

Employer Identification Number:

Person to Contact - I.D. Number:

Contact Telephone Numbers:

WL: 501.00-00

Dear Sir or Madam:

We have considered your application for recognition of exemption from Federal income tax under the provisions of section 501(c)(3) of the Internal Revenue Code of 1986 and its applicable Income Tax Regulations. Based on the available information, we have determined that you do not qualify for the reasons set forth on Enclosure I.

Consideration was given to whether you qualify for exemption under other subsections of section 501(c) of the Code. However, we have concluded that you do not qualify under another subsection.

As your organization has not established exemption from Federal income tax, it will be necessary for you to file an annual income tax return on Form 1041 if you are a Trust, or Form 1120 if you are a corporation or an unincorporated association. Contributions to you are not deductible under section 170 of the Code.

If you are in agreement with our proposed denial, please sign and return one copy of the enclosed Form 6018, Consent to Proposed Adverse Action.

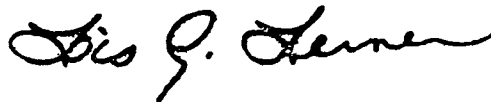
You have the right to protest this proposed determination if you believe it is incorrect. To protest, you should submit a written appeal giving the facts, law and other information to support your position as explained in the enclosed Publication 892, "Exempt Organizations Appeal - Procedures for Unagreed Issues." The appeal must be submitted within 30 days from the date of this letter and must be signed by one of your principal officers. You may request a hearing with a member of the office of the Regional Director of Appeals when you file your appeal. If a hearing is requested, you will be contacted to arrange a date for it. The hearing may be held at the Regional Office or, if you request, at any mutually convenient District Office. If you are to be represented by someone who is not one of your principal officers, he or she must file a proper power of attorney and otherwise qualify under our Conference and Practice Requirements as set forth in Section 601.502 of the Statement of Procedural Rules. See Treasury Department Circular No. 230.

If you do not protest this proposed determination in a timely manner, it will be considered by the Internal Revenue Service as a failure to exhaust available administrative remedies. Section 7428(b)(2) of the Internal Revenue Code provides, in part, that:

A declaratory judgment or decree under this section shall not be issued in any proceeding unless the Tax Court, the Claims Court, or the district court of the United States for the District of Columbia determines that the organization involved has exhausted administrative remedies available to it within the Internal Revenue Service.

If we do not hear from you within the time specified, this will become our final determination. In that event, appropriate State officials will be notified of this action in accordance with the provisions of section 6104(c) of the Code.

Sincerely,



Director, Exempt Organizations  
Rulings and Agreements

Enclosures:  
Enclosure I  
Form 6018  
Publication 892

Issues

- 1) The un-conformed amendment to the organization's Articles of Incorporation cause the organization to fail the organizational test under Section 501(c)(3) of the Code.
- 2) The undue control of the organization by a related board causes the organization to serve private interests and thus fail the operational test under Section 501(c)(3) of the Code.
- 3) The ownership of the school property by some of the related board members and the payment of rent, for which market value has not been determined, and the creation of improvements by the organization on the property owned by the board members causes the organization to fail the operational test under Section 501(c)(3) of the Code.

Facts

You incorporated in the State of \_\_\_\_\_ on \_\_\_\_\_ to engage in any lawful activity for which corporations may be formed under Chapter 2, Title 12 of the revised statutes. (Non- profit Corporation Law).

Page 2 of your Form 1023 states, \_\_\_\_\_ will operate this childcare center providing care for children of working parents and will educate children in grades preK-3 through the 8th grade.

Page 9 of your Form 1023 indicates that the organization has assets consisting of a mortgage loan of \$ \_\_\_\_\_ and other assets of \$ \_\_\_\_\_. Page 9 further indicates that the organization has other liabilities of \$ \_\_\_\_\_. A schedule provided indicates that the following assets, totaling \$ \_\_\_\_\_ were purchased by the school in January of \_\_\_\_\_

Equipment	\$
Furniture	
Toys	
Outside Equipment	

No other information exists in the file to explain the information indicated on page 9. Also, no appraisal was received to indicate that the items purchased in January of \_\_\_\_\_ were purchases at market value in an arms-length transaction. While it is not totally clear, it appears that the organization was attempting to put the value of the school and property owned by the related board members on their balance sheet.

An attachment to the Form 1023 states, "The following are the board of directors for Clark Child Care Development:"

President -  
 Vice President -  
 Secretary - - non-related  
 Treasurer - - non-related  
 Member - - non-related

Your letter dated November 7, 2003 indicates that \_\_\_\_\_ is in fact the father of \_\_\_\_\_  
 Thus 3 of the 5 members of your board are related.

Your brochures disclosed that \_\_\_\_\_ formerly named \_\_\_\_\_  
 was established in \_\_\_\_\_. The information in the file indicates that at  
 some time after the school's creation the name was changed to the "  
 In the spring of \_\_\_\_\_ the school changed ownership. According to  
 your brochure the "school is now owned and directed by \_\_\_\_\_ and \_\_\_\_\_, two  
 of the related board members.

Your letter dated November 7, 2003 revealed that you operate a school with before/after  
 school day care. The school has \_\_\_\_\_ students between the ages of \_\_\_\_\_ to \_\_\_\_\_. The school  
 year tuition ranges from \$ \_\_\_\_\_ to \$ \_\_\_\_\_. You offer an optional lunch program on  
 a monthly basis, which can be paid by check. If the check is returned for non-sufficient  
 funds the child cannot participate in your lunch program but the school will "give the  
 child a sandwich if the lunch bill is not paid."

An attachment titled "Agreement" dated April 30, \_\_\_\_\_ states, "

In support of this "agreement" you submitted a Credit Sale document between  
 \_\_\_\_\_ represented by \_\_\_\_\_ as the  
 seller/mortgagee and \_\_\_\_\_ as the purchaser/mortgagor.

The sale is made and accepted for \$ \_\_\_\_\_, paid by the purchaser as follows: No -  
 cash down and the balance represented by one Promissory note of said purchaser date  
 April 30 \_\_\_\_\_ payable to the order of the Bearer for the sum of \$ \_\_\_\_\_ with interest of  
 \_\_\_\_\_ % per annum from the date until paid, in \_\_\_\_\_ consecutive monthly payments of  
 \$: \_\_\_\_\_ Additional terms revealed:

1)

2)

3)

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in improvements were made by  
to the property owned by

In your letter dated February 23, 2004 you stated that you resolved the inurement issue because the organization owns the property. In support of that statement you submitted an unsigned "Settlement Statement" between \_\_\_\_\_ and the \_\_\_\_\_

You also submitted a \_\_\_\_\_ between \_\_\_\_\_ and the \_\_\_\_\_ The term of the lease is for \_\_\_\_\_ and ending on \_\_\_\_\_ for a lump sum payment of \$ \_\_\_\_\_

In your letter dated May 17, 2004 as a response to our service position letter addressing the inurement issue of the property, you submitted another \_\_\_\_\_

This document is identical to the document submitted between \_\_\_\_\_ and the \_\_\_\_\_ with the exception of paragraphs one and two being altered to reflect the names of the lessor and lessee.

Therefore, no property appraisal has been submitted by your organization that shows that the purchase price of \$ \_\_\_\_\_ is reasonable and at market value. Furthermore, no lease appraisal has been submitted that indicates that the lease agreement between the school and the related board members is reasonable and at market value.

Law

Section 501(c)(3) of the Internal Revenue Code provides for exemption from Federal income tax for organizations, which are organized and operated exclusively for charitable, religious, and educational purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(a)(1) of the Income Tax Regulations provides that in order to qualify for exemption under section 501(c)(3), an organization must be both organized and operated exclusively for one or more exempt purposes. Failure to meet either the organizational or operational test will disqualify an organization from exemption.

Section 1.501(c)(3)-1(b)(1) of the Income Tax Regulations specifies that an organization is organized for one or more exempt purposes, if its Articles of Incorporation limit the purposes of such organization to exempt purposes.

Section 1.501(c)(3)-1(b)(4) of the Regulations provides that an organization is not organized exclusively for one or more exempt purposes unless its assets are dedicated to an exempt purpose. An organization's assets will be considered dedicated to an exempt purpose if, upon dissolution, such assets would, by reason of a provision in the organization's articles or by operation of law, be distributed for one or more exempt purposes, or to the Federal government, or to a State or local government, for a public purpose.

Section 1.501(c)(3)-1(c)(1) of the Regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities, which accomplish such purposes. An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

The inurement proscription contained in Regulations 1.501(c)(3)-1(c)(1) states that an organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals. Inurement is likely to arise where the financial benefit represents a transfer of the organization's financial resources to an individual solely by virtue of the individual's relationship with the organization, and without regard to the accomplishment of exempt purposes. Inurement of income is strictly forbidden under section 501(c)(3) without regard to the amount involved. This proscription applies to persons who because of their particular relationship with an organization have an opportunity to control or influence its activities. Such persons are considered "insiders" for purposes of determining whether there is inurement of income. Generally, an organization's officers, directors, founders, and their families are considered "insiders".

Section 1.501(c)(3)-1(d)(1)(ii) of the Income Tax Regulations states that an organization is not organized or operated for any purpose under section 501(c)(3), unless it serves a public rather than a private interest. Thus to meet the requirements of this subparagraph, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization or persons controlled, directly or indirectly, by such private interests. Moreover, even though an organization may have exempt purposes, it will not be considered as operating exclusively for such purposes, if more than an insubstantial part of its activities serve private interests.

In Better Business Bureau v. United States, 326 U.S. 279-283, (1945), the court held that the existence of a single non-exempt purpose, if substantial in nature, would destroy exemption under section 501(c)(3) regardless of the number or importance of truly exempt purposes. To qualify for exemption under section 501(c)(3), the applicant organization must show (1) that it is organized and operated exclusively for religious or

charitable purposes and, (2) that no part of the net earnings inures to the benefit of a private individual or shareholder.

In Bubbling Well Church of Universal Love v Commissioner, U.S. Court of Appeals 9th Circuit No. 80-7358 11-27-81 affirmed 74 TC 531, the tax court reviews an organization that states it is a church operating exclusively for religious purposes. Three members of one family, who also serve as the sole members of the Board of Trustees and/or directors, established the church. The organization had no affiliation with any denomination or ecclesiastical body and was not subject to any outside influence in the control of the organization's affairs. The court stated that under the circumstances described, the family was in a position to perpetuate control of the organization's operations indefinitely, prepare its budget and had complete control of the organization's finances and made the decisions on how the funds were spent. Since the organization had no connection with any denomination or outside body, it was not subject to any outside influence in the conduct of the church's affairs.

In Kolkey v. Commissioner, 27 T.C. 37 (1956), exemption was denied a corporation where the purchase price of an asset exceeded the fair market value of the property. The courts held that this arrangement inured to the benefit of insiders.

Leon A. Beeghley v. Commissioner, 35 T. C. 490 (1960), provided that where an exempt organization engages in a transaction with a related interest and there is a purpose to benefit the private interest rather than the organization, exemption may be lost even though the transaction ultimately proves profitable for the exempt organization.

Operating for the benefit of private parties constitutes a substantial nonexempt purpose. Old Dominion Box Co. v. United States, 477 F. 2d 340 (4<sup>th</sup> Cir. 1973), cert. Denied 413 U. S. 910 (1973).

In Texas Trade School v. Commissioner, 59-2 U. S. 9786; 4 A.F.T. R. 2d, exemption was denied to a corporation where "insiders" benefited from the use of the organization's funds through improvements to property owned by executive committee who were also members of the Board of Directors.

Revenue Ruling 76-91, published in Cumulative Bulletin 1976-1, on page 140, provides that where the purchaser is controlled by the seller or there is a close relationship between the two at the time of the transaction, the presumption is that the agreement cannot be made because the elements of an arm's length transaction are not present.

#### Application of the Law

Our review of your application indicates that your articles of incorporation do not meet the organizational test required to be recognized as tax exempt under section 501(c)(3) since this document does not limit your purposes exclusively to one or more purposes described in this section. You also have not made any provision for the distribution of

your assets to qualified section 501(c)(3) organizations in the event your organization dissolves. The amendment found in the file that contained language conforming to the requirements of Section 501(c)(3) was not conformed. **Therefore, you have failed the organizational requirements of Section 501(c)(3) of the Code.**

Section 1.501(c)(3)-1(d)(1)(ii) of the Income Tax Regulations states that an organization is not organized or operated for any purpose under section 501(c)(3), unless it serves a public rather than a private interest. An organization must establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization or persons controlled, directly or indirectly, by such private interests. Five individuals control your organization. It was later disclosed that the President, Vice President and Treasurer are all related. Thus, 3 related individuals control your organization. As in Bubbling Well Church of Universal Love, the Alverezs and Mr. Age are in a position to perpetuate control of the organization's operations indefinitely, prepare its budget, have complete control of the organization's finances and make all decisions on how the funds were spent. **Therefore, the undue control of the organization by a related board causes the organization to serve private interests and thus fail the operational test.**

You first submitted a "credit sale" document in which the property used by \_\_\_\_\_ is being purchased at \$ \_\_\_\_\_ "as is" by \_\_\_\_\_

You stated that the bank appraised the property before issuing the loan but are unable to provide a copy of the bank appraisal or any other independent appraisal to support the purported value of the property. Thus, we hold that the purchase price far exceeds the fair market value of the property. Kolkey v. Commissioner, Supra.

You submitted two "Lease of Property with Option to Purchase" documents. The first between \_\_\_\_\_ and \_\_\_\_\_ and the second between \_\_\_\_\_ signed by \_\_\_\_\_ who is not an officer or director of the organization. The terms of the each lease requires a lump sum payment of \$ \_\_\_\_\_. The second lease is an avenue for the \_\_\_\_\_ to reimburse them for the money expended in the first lease. No lease appraisal has been provided. We hold that the transactions between the \_\_\_\_\_ and the \_\_\_\_\_ are not arms-length thereby serving their private interest. Revenue Ruling 76-91, Supra.

No formal appraisal was received regarding the asset purchases of \$ \_\_\_\_\_ by the \_\_\_\_\_ organization.

You expended the income of the organization to improve property owned by \_\_\_\_\_. Regardless of the amount expended this is inurement and prohibited under 501(c)(3) of the Code. Hence, your organization is similar to Leon A. Beeghley v. Commissioner, Old Dominion Box Co. v. United States and Texas Trade School v. Commissioner, Supra.



Therefore, the ownership of the school property by the related board members, the payment of rent to the related board members and the creation of improvements by the organization on the property owned by the related board members causes the organization to fail the operational test.

Conclusion

Although you may have some educational activities, the failure of both the organizational and operational tests defeats exemption. Inurement and private benefit to the related board members, who are also the property owners, is substantial. As in Better Business Bureau v. United States, 326 U.S. 279-283, (1945), the existence of a single non-exempt purpose, if substantial in nature, destroys exemption under section 501(c)(3) regardless of the number or importance of truly exempt purposes.

Based on the evidence submitted, we have determined that you have not met your burden of proof to show that you are organized and operated exclusively for an exempt purpose and that you do not serve the private interests of your creators and founders.