Internal Revenue Service
Appeals Division
31 Hopkins Plaza
Room 1310
Baltimore, MD 21201

Release Number: 200711041
Release Date: 3/16/07
UIL Code: 501C.00-00
Date: December 14, 2006

Department of the Treasury

Person to Contact:

Employee ID Number:
Tel:
Fax:
Refer Reply to:
AP:FE:AP4:BAL:RAL
In Re:
Proposed Denial of Tax Exempt
Status Under IRC Section 501(c)(3)
Tax Periods Ended:

Form Number:
1120
Taxpayer Identification Number:

Last Day to File a Petition with the United States Tax Court:

CERTIFIED MAIL

Dear :

This is a final adverse determination as to your exempt status under section 501(c)(3) of the Internal Revenue Code. It is determined that you do not qualify as exempt from Federal income tax under Section 501(c)(3) of the Internal Revenue Code.

Our adverse determination was made for the following reason(s):

You have failed to establish that you are organized and operated exclusively for exempt purposes specified under Section 501(c)(3) of the Internal Revenue Code. More than an insubstantial part of your proposed activities are in furtherance of non-exempt purposes and benefit private interests. You are organized and operated primarily to serve private interests rather than public interests. Furthermore, your organizational structure provides a potential for inurement.

Contributions to your organization are not deductible under Code section 170. See Rev. Proc. 82-39, 1982-2 C.B. 759, for rules concerning the deduction of contributions made to your organization between July 10, 2003 and the date that public announcement is made in the Internal Revenue Bulletin, stating that contributions to your organization are no longer deductible.

You are required to file Federal income tax returns on the form indicated above. Processing of income tax returns and assessment of any taxes due will not be delayed in the event that you file a petition for declaratory judgment under Code section 7428.

If you decide to contest this determination under the declaratory judgment provisions of Code section 7428, a petition to the United States Tax Court, the United States Court of Claims, or the district court of the United States for the District of Columbia must be filed before the 91st (ninety-first) day after the date this determination was mailed to you. Contact the clerk of the appropriate court for rules for filing petitions for declaratory judgment. To secure a petition form from the United States Tax Court, write to the United States Tax Court, 400 Second Street, N.W., Washington, D.C. 20217.

We will notify the appropriate State officials of this final adverse determination of your exempt status, as required by Code section 6104(c).

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Charles Fisher
Appeals Team Manager

cc: (Power of Attorney)

Internal Revenue Service
Director, Exempt Organizations
Rulings and Agreements

Department of the Treasury
P.O. Box 2508 – TE/GE
Cincinnati, OH 45201

Date:

Employer Identification Number:

Person to Contact – I.D. Number:

Contact Telephone Numbers:
Phone
FAX

LEGEND:

UIL No.: 501.33-00
501.36-06

A= President
B= Individual
M= Applicant
N= Related Limited Liability Company
O= Related Limited Partnership
P= Private Foundation
Q= State
R= Date
S= City
T= Date
U= Unrelated Organization #1
V= Unrelated Organization #2
W= Unrelated Organization #3

Dear :

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 judgement 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,

Lois G. Lerner
Director, Exempt Organizations
Rulings and Agreements

Enclosures

ENCLOSURE 1

ISSUE: Is M qualified for recognition exemption under section 501(c)(3) Internal Revenue Code of 1986 as an educational organization?

FACTS: M was incorporated in the state of Q on R. M does not have any current operations but is planning on operating in the city of S as opposed to the state of incorporation. Article Third of M's Certificate of Incorporation states:

> The purposes for which the Corporation is organized are as follows:
>
> A. To operate exclusively for charitable and educational purposes, including, but not limited to, the following:
>
> 1. To educate the public and investors on issues of ethical and responsible business practices;
>
> 2. To encourage small, emerging business entrepreneurs and venture capital-backed businesses to follow "best Practice" corporate responsibility standards; and
>
> 3. To support corporate responsibility by investing in a venture capital fund that will invest in socially responsible companies.

M's bylaws indicate it is governed by a board of directors. Section 2(a) of the bylaws indicates the number of directors constituting the board of directors shall be fixed by resolution of the board of directors. Section 3(d) of the bylaws states: "One-third of the number of directors...shall constitute a quorum for the transaction of business at any meeting of the Board of Directors."

M submitted resolutions, dated Sep. 22, 2003, appointing A to a one year term as Chairman of the Board of Directors and further resolved to appoint A as the President and Treasurer of M for a 3 year term. No other persons were appointed to the board of directors.

As part of the application process, M submitted a conflict of interest policy, adopted on Sep. 22, 2003. Article II, section 2 of said policy states: "A Financial Interest is not necessarily a conflict of interest. Under Article II, Section 2, a person who has a Financial Interest may have a conflict of interest only if the Board of Directors, or a designated committee of the Board, decides that a conflict of interest exists."

M's Mission Statement states:

> The Corporation was established to educate the public, investors and entrepreneurs on issues of ethical and responsible business practices, to publicize model "best practices" for business to follow...and to encourage small, emerging business entrepreneurs and venture capital-backed businesses to follow best practice models of corporate

> responsibility. The Corporation will organize educational seminars and make widely available educational materials on proper corporate governance. Focusing on corporate executives, members of boards of directors, venture capitalists and other investors, including the general public, the Corporation's activities will be developed to educate target audiences about how to run an ethically responsible corporation, how to analyze and monitor the ethical standards of start-up ventures and how to encourage ethical corporate governance. In addition, as part of its educational efforts, the Corporation will demonstrate that higher ethical standards and responsible corporate governance can have a positive effect on corporate profits. The Corporation will invest in a venture fund that, in turn, will invest in start-up businesses that are following the Corporation's best practices model. The Corporation will use these "ethical investments" as a way to encourage businesses to operate using the highest ethical and business standards and to focus attention on "model" business ventures.

As stated in its application, M was formed in response to various corporate scandals that occurred during . An attachment to the application indicates the rationale for the genesis of M's formation:

> The results of corporate misbehavior are devastating. Lost jobs, plummeting share prices and falling pension fund values are just some of the consequences innocent investors and employees have suffered as a result of the corporate scandals. A report issued by U estimated that these corporate misdeeds cost the general public $. The V estimated that individual retirement accounts lost over $ in as a result of falling share prices. W demonstrated that firefighters, policemen, teachers and other state and municipal workers lost more than $ when the stock value of corporations in the midst of governance scandals dropped, pulling the value of the workers' pension portfolios down as well. Some companies have gone out of business with workers losing their jobs. Questionable accounting practices also cost the government billions of dollars in lost tax revenues.

Page 5 of M's attachment to the Form 1023 application states:

> (M) will conduct forums, lectures, seminars and other programs for directors, investors, executives and other employees in start-up ventures and venture capitalists—educating participants about responsible and ethical corporate governance and showing them the negative effects of corporate scandals on profitability and the community at large. (M) will encourage start-up businesses to adopt the Corporations best practices model...and will demonstrate through investments in an ethically responsible venture capital fund that these best practices can be successfully implemented.

In addition, page 5 of M's attachment to the Form 1023 application states:

> As an investor in the venture capital fund, (M) will invest 'seed venture capital' in qualifying businesses. By furnishing seed capital, (M) will support entrepreneurs who have participated in (M)'s seminars and training on responsible corporate governance, have demonstrated a commitment to responsible corporate management and have committed to implementing the best practices model. (M) will invest in the venture fund only to encourage enterprises that are models of ethical corporate governance.

As indicated on Page 5 of M's Form 1023 attachment, the venture capital fund "will provide loans to, or equity investments in, early stage development and business planning efforts of enterprises implementing the best practices model." A significant portion of the organization's funds will be invested in the venture capital fund. Profits from the investments as well as with other funds will be used to operate forums, seminars and other educational programs.

An attachment to the Form 1023 application describes M's proposed revenues as follows:

	Tax Year	Tax Year	Tax Year
Gifts, grants and contributions	$	$	$
Gross investment income	-	-	-
TOTAL	$	$	$

An attachment to the application indicates that M has projected expenses of $ for tax year . Of this amount, $ is projected to be for salaries and $ is for "educational programs." For tax year , M has projected total expenses of $ with $ projected to be for salaries and $ for educational programs. Similarly, for tax year , total expenses are projected to be $ with $ allocated to salaries and $ for educational programs.

Correspondence dated April 14, 2004 from M indicates that a related organization, O (a limited partnership), was organized on T; however, because M's activities will not be conducted until it receives exemption, a partnership agreement has not been adopted. Another related organization, N (a limited liability company), will be the general partner. Although M expects to be a limited partner in O, the partnership does not currently have any limited partners. The letter referenced above also states: "Other nonprofit organizations and institutional investors that are interested in the charitable and educational missions of (M) may invest in the (O) Partnership as limited partners."

Correspondence dated May 18, 2004 from M states: "The (O) Partnership will be managed by (N), its general partner. (M) will have a majority interest in (N) and will be its managing member. Thus, M will have ultimate responsibility for managing the Partnership, including the establishment of investment criteria and final authority over the acceptance of investments recommendations..."

Further on in its letter of May 18, 2004, M states: "As a limited partnership, all of the (O) Partnership's activities will be managed by its general partner. The limited partners will have no rights to manage any aspects of the Partnership. (M)'s ability to direct the affairs of the Partnership is derived not from its limited partnership interest, but from its management of the Partnership's general partner."

In addition the correspondence states: "As a limited partner, (M)'s risk will be limited to its capital contributions. Although state law provides that the general partner of a limited partnership is personally liable for the debts of the partnership, (M), in its role as a general partner, will protect its assets by holding its general partner interest through a limited liability company. Members of a limited liability company have no personal liability for the obligations of the entity. Thus, (M)'s liability is limited strictly to the amount it invests in the (O) Partnership."

M's letter of May 18, 2004 goes on to state that each limited partner will be required to contribute at least $ to the O partnership and that expectations are that the limited partners will contribute amounts ranging from $ to $. In addition, the number of limited partners in O will be no more than 99 but that less than 50 partners are expected.

M's correspondence of April 14, 2004 states: "The amount of capital invested in each qualifying business will vary depending on the funds available to the (O) Partnership, the needs of the qualifying business and how the potential investment serves (M)'s charitable and educational missions.

The letter further states:

> The (O) Partnership will look for clear opportunities to demonstrate that responsible corporate governance can positively impact a company's profits...The (O) Partnership will look for entrepreneurial qualities that include commitment, drive and a clear mission of responsible corporate governance. Additionally, the (O) Partnership will establish firm investment criteria, and such criteria will be subject to the approval of (M)...Finally, the (O) Partnership will conduct appropriate professional due diligence, including a thorough review and analysis of the prospective recipient's business plan, financial data, past achievements and future goals to determine whether an investment is feasible. As stated above, (M) will have ultimate authority to determine which businesses will receive capital.

Further, the April 14, 2004 letter states: "The (O) Partnership will provide capital in the form of loans and equity investments, with equity investments being in the form of

capital. Any loans will be convertible to equity, at the option of the (O) Partnership, and contain a market rate of interest."

O's partnership agreement has not been formally executed. At the time, M did not have a proposed partnership agreement drafted. M's correspondence of May 18, 2004 indicates:

> Consistent with the recent Internal Revenue Service ("IRS") guidance provided in Revenue Ruling 2004-51, the partnership agreement will contain several key provisions. First the agreement will provide that the (O) Partnership will only make investments that further (M)'s exempt purposes, i.e., investment that demonstrate that ethical corporate governance can positively affect a business's profits. Thus, (M)'s charitable purposes will be furthered by its participation in the (O) Partnership. Second, the agreement will provide that all returns of capital, allocations of profits and losses and distributions from the (O) Partnership will be made in proportion of the partners' respective ownership interests. Such ownership interests will be proportionate to the value of each partner's respective capital contribution to the (O) Partnership. The partnership agreement will prohibit any payments from businesses in which the (O) Partnership invests to businesses affiliated with the partners of the (O) Partnership. Finally, the agreement will provide that the affairs of the (O) Partnership will be managed by its sole general partner, (N), which will be controlled by (M), its managing member. Through its role as the managing member of (N), (M) will have control over all aspects of the Partnership, including its investment decisions.

On October 7, 2004, the Service requested M to provide copies of its financial statements and balance sheets as well as percentage breakdowns of actual time and money spent on its educational and investment activities during tax years and . M's letter of January 28, 2005 indicates M has not initiated its educational and investment activities, and that it does not have any financial activities or assets pending receipt of its tax-exempt status from the Service. The letter iterates that M anticipates "90-95% of its overall activities will relate to its educational programs." Because M has had no activities, it was unable to provide copies of financial statements, balance sheets and the percentage breakdowns for the tax years in question.

In addition, the Service's letter of October 7, 2004, requested M to provide proposed budgets as well as percentage breakdowns of time and money that will be spent on its educational and investment activities during fiscal periods ending December 31, and . M's letter of January 28, 2005 again iterates that 90-95% of its overall activities will relate to its educational programs. The proposed budgets indicate M's executive director will

receive $ per annum for tax years and and M's managing director will receive $ per annum for tax years and . M's projected surplus for and is projected to be $ per annum.

In response to the Service's letter of October 7, 2004 requesting information concerning M's operation of the capital venture fund, M's response of January 28, 2005 states:

> (M) will not "spend" funds in connection with the venture capital fund (the "Fund"). Rather, (M), in furtherance of its charitable and educational purposes, will invest in the Fund excess capital (i.e. money not needed for current educational programs). All profits from such investments will be used by (M) to fund its educational programs. Similar to a mutual fund, the Fund will collect a small investment fee, standard for the industry, of 2.5% of funds under management. A portion of these investment fees collected by the Fund (.5-1%) will be contributed by the Fund to (M) to fund its educational programs.

In addition to the aforementioned, copies of the following were included with (M)'s correspondence of January 28, 2005:

1) Letter from a proposed grantor (P), a private foundation

2) Draft Limited Partnership Agreement for O Partnership

3) Draft Certificate of Formation for (N) LLC

4) Limited Liability Company Agreement of (N) LLC

A review of the draft partnership agreement of (O) partnership indicates that the primary purpose of O, as stated in Article 1, section 3(a), "...is to promote social responsibility by corporations and encourage enterprises that are models of ethical corporate governance."

The draft partnership agreement of O reflects that N will be the general partner and M as well as "any other firms, corporations or other Persons who execute a counterpart of this agreement..." will be limited partners.

In the draft Limited Liability Company Agreement, Article 1, section 2 states: "...The primary purpose of the Company to manage (O) Partnership." This section goes on to state:

> Through such investments, the (O) Partnership will demonstrate the financial benefits of ethical governance and not primarily with a profit motive. In furtherance of, and consistent with, these purposes, the (O) Partnership will seek to generate returns for its

> Partners, principally through long-term capital appreciation, by making, holding and disposing of privately negotiated equity and equity-related investments, in both private and publicly-traded companies, but only in those companies that have agreed, in the General Partner's sole discretion, to operate with responsible and ethical business practices or otherwise agree to operate in accordance with the Principles of Corporate Responsibility...

Article 1.4 of the draft partnership agreement states: "The (O) Partnership may only make investments that further the purposes of (M)..." It also states that payments from businesses in which the partnership invests to businesses affiliated with any of the partners will be prohibited.

Article 2.5(a) of the draft partnership agreement states: "The (O) Partnership shall make distributions to the Partners from time to time in such amounts as the General Partner shall determine. All such distributions shall be made *pro rata* among the Partners in accordance with their ownership interests and capital contributions..."

Article 3.1 of the draft partnership agreement states:

> The management, policies and control of the (O) Partnership shall be vested exclusively in the General Partners. The authority vested in the General Partner shall be exercised by (M), the managing member of the General Partner. By virtue of its control over the General Partner, (M) shall have ultimate approval authority over all of the (O) Partnership's business, including but not limited to the (O) Partnership's investment decisions, personnel decisions of the (O) Partnership, investment criteria, and (O) Partnership contracts in excess of $20,000.

Section 2.1 of the draft Limited Liability Company Agreement of (N) states: "The Member shall be the sole and managing member of (N) and shall own one hundred percent (100%) of the membership interests." Said article also states M is the member.

Section 2.2 of the same draft agreement states, "(M) may admit new members, but only if the Member consents in writing to the terms and conditions of such admission."

In a letter from P, dated January 7, 2005, addressed to M, P "indicates [an] intention...to provide a grant of $ to M upon the approval of your non-profit status. This grant follows on the $ already provided to M for start-up organizational expenses." The letter further states: "We look forward to working with you and your colleagues in your efforts to support ethical and responsible business; to promote the study and teaching of ethical and responsible business practices; and to introduce the best practices to small and emerging growth businesses." The signature line reflects P's two trustees: A and B. A is M's sole board member, its president and treasurer. B appears to be A's spouse. P's letterhead indicates it has the same address as M.

Included with M's correspondence of Jan. 28, 2005 are proposed budgets for tax years and . Revenues of $ are projected for each year. In terms of expenses, M is projected to incur total expenses of $ each year with $ allocated to salaries and $ allocated to seminars and lectures. The proposed budgets do not show any funds allocated for M's minimum $ investment as a limited partner in the O Partnership.

LAW: Section 501(c)(3) of the Internal Revenue Code of 1986 provides for the exemption from federal income tax of organizations organized and operated exclusively for charitable and educational purposes.

Section 1.501(c)(3)-1(a)(1) of the Income Tax Regulations states that, in order to be exempt as an organization described in section 501(c)(3) of the Code, an organization must be both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational test or the operational test, it is not exempt.

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 one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Section 1.501(c)(3)-1(c)(2) of the Regulations 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.

Section 1.501(c)(3)-1(d)(1) of the Regulations provides, in part, that an organization may be exempt under section 501(c)(3) of the Code if it is organized and operated for exempt purposes. However, it is not organized and operated exclusively for an exempt purpose unless it serves a public as opposed to a private interest. Thus, an organization must establish that it is not operated for the benefit of designated individuals.

Section 1.501(c)(3)-1(d)(3)(i) of the Regulations defines educational as (a) The instruction or training of the individual for the purpose of improving or developing his capabilities; or (b) The instruction of the public on subjects useful to the individual and beneficial to the community.

In *Better Business Bureau* v. *United States*, 326 U.S. 279 (1945), the Supreme Court of the United States held that the presence of a single non-exempt purpose, if substantial in nature, will destroy a claim for exemption regardless of the number or importance of truly exempt purposes.

In *Bubbling Well Church of Universal Love, Inc.* v. *Commissioner*, 74 T.C. 531 (1980) aff'd 670 F.2d 104 (9th Cir. 1981), the court determined that an organization (church) controlled

by three family members did not qualify for exemption under section 501(c)(3). The court stated:

> While this domination of petitioner by the three Herberts, alone may not necessarily disqualify it for exemption, it provides an obvious opportunity for abuse of the claimed tax-exempt status. It calls for open and candid disclosure of all facts bearing upon the petitioner's organization, operations, and finances so that the Court, should it uphold the claimed exemption, can be assured that it is not sanctioning an abuse of the revenue laws. If such disclosure is not made, the logical inference is that the facts, if disclosed, would show that petitioner fails to meet the requirements of section 501(c)(3).

In *American Campaign Academy* v. *Commissioner*, 92 T.C. 1053 (1989), the petitioner argued that that the prohibition against private benefit is limited to situations in which an organization's insiders are benefited. The Service's position was that the Academy substantially benefited the private interests of Republican party entities and candidates, thereby advancing a nonexempt private purpose. The court disagreed with the petitioner's view and stated that an organization's conferral of benefits on disinterested persons may cause it to serve a private interest within the meaning of section 1.501(c)(3)-1(d)(1)(ii) of the Regulations. The court went on to define private benefit as: "...nonincidental benefits conferred on disinterested persons that serve private interests."

Activities that appear to further exempt purposes may serve private interests. In *Westward Ho* v. *Commissioner*, T.C.M. 1992-192 (1992), an organization was created by 3 individuals to provide funds to indigent and antisocial persons. The court concluded that the organization's true purpose was to provide the 3 individuals (who happened to be restaurant owners) with a more desirable business environment by removing disruptive homeless persons from the area.

In Rev. Rul. 70-186, 1970-1 C.B. 128, an organization was formed to preserve a lake as a public recreational facility and to improve the conditions of the water to enhance its recreational features. Its financing came from lake front property owners, members of the community and municipalities. The Service held that the benefits from the organization's activities flow principally to the general public through well maintained and improved public recreational facilities. Any private benefits derived by the lake front property owners do not lessen the public benefits flowing from the organization's operations.

In Rev. Rul. 71-529, 1971-2 C.B. 234, the Service held that an organization that was controlled by a group of unrelated 501(c)(3) organizations and which provided investment management services for a charge substantially below cost qualifies for exemption under section 501(c)(3) of the Code.

In Rev Rul. 72-369, 1972-2 C.B. 245, the Service held that an organization that was formed to provide managerial and consulting services at cost to unrelated 501(c)(3) organizations was not exempt under section 501(c)(3) of the Code.

In Rev. Rul. 75-286, 1975-2 C.B. 210, an organization was formed by the residents of a city block to preserve and beautify that block, to improve all public facilities within the block, and to prevent the physical deterioration of the block. Membership in the organization is restricted to residents of the block and those owning property of operating businesses there. The Service held that the organization did not qualify for exemption under section 501(c)(3) because it operated to serve private interests by enhancing members' property rights.

In Rev. Rul. 76-206, 1976-1 C.B. 154, an organization was formed to promote the broadcasting of classical music in a particular community. The organization carried on a variety of activities designed to stimulate public interest in the classical music programs of a for-profit radio station. The Service held that although the organization's broad purpose of promoting interest in classical music and encouraging programming of classical music provides a public benefit, the activities served the private economic interests of the for-profit radio station to a substantial degree.

Section 5.02 of Rev. Proc. 90-27, 1990-1 C.B. 514, provides that exempt status will be recognized in advance of operations if the proposed operations can be described in sufficient detail to permit a conclusion that the organization will clearly meet the particular requirements of the section under which exemption is claimed. A mere restatement of purposes or a statement that proposed activities will be in furtherance of such purposes will not satisfy this requirement. The organization must fully describe the activities in which it expects to engage, including the standards, criteria, procedures, or other means adopted or planned for carrying out the activities; the anticipated sources of receipts; and the nature of contemplated expenditures. Where the organization cannot demonstrate to the satisfaction of the Service that its proposed activities will be exempt, a record of actual operations may be requires before a ruling or determination letter will be issued.

Section 6110(k)(3) of the Code states, unless the Secretary otherwise establishes by regulations, a written determination may not be cited as precedent.

APPLICANT'S POSITION: M relies on various court decisions, revenue ruling and private letters rulings as a basis for engaging in investment activities. It has cited the following law in its application:

In PLR 200213027, the Service held that an organization's exempt status was not adversely affected by programs that promoted community and economic development for a specific county. Through the development, construction, ownership and leasing of an industrial park in a blighted area, which attracted businesses that favored low-skilled workers who resided within a depressed county, the organization's exempt status under IRC 501(c)(3) will not be affected since they not only relieved poverty, but also combated community deterioration.

In Rev. Rul. 74-587, 1974-2 C.B. 162, the Service held that financial investments, such as low-cost or long-term loans or the purchase of equity interests in the various businesses, may qualify as a charitable activity under section 501(c)(3) depending on the

circumstances. The organization in this ruling combats community deterioration in certain economically depressed areas by providing funds and working capital to corporations or individual proprietors who are not able to obtain funds from conventional commercial sources because of the poor financial risks involved in establishing an operating enterprise in these communities. Preference is given to businesses that will provide training and employment opportunities for the unemployed or under-employed residents of the area.

In Rev. Rul. 76-419, 1976-2 C.B. 146, an organization purchased undesirable land in a community to develop an industrial park and lease space to tenants at favorable, below-market terms. In exchange, the tenants were required to hire and train unemployed members of the community too work in the tenant's businesses. The Service ruled favorably that the organization's activities were charitable.

M states that its purposes for investment in the venture capital fund are substantially similar to the taxpayer's purposes in *Golden Rule Church Association* v. *Commissioner*, 41 TC 719 (1964), Nonacq. 1964-2 C.B. 8. In *Golden Rule*, the facts indicate that the church believed that God's laws were intended to apply to man's business, social, and private lives, not just his spiritual life. To persuade people to apply the church's teachings to their business lives, the church determined that it had to demonstrate by illustration or example that the teachings could be applied successfully. Accordingly, a committee of the church either acquired or created various small businesses to be operated as illustrations of the applicability of the "golden rule" to daily life. The court found that the taxpayer was an exempt organization and stated that, although an activity may be carried on for the purpose of producing income, it may be carried on exclusively for other purpose. The Service, however, disagrees with the ruling in *Golden Rule* and published its nonacquiescence in volume 1964-2 of the *Cumulative Bulletin*.

M also cites *Dumaine Farms* v. *Commissioner*, 73 T.C. 650 (1980), Acq. 1980-2 C.B. 1, Nonacq. 1980-2 C.B. 2, in support of its position. In *Dumaine Farms*, the court considered whether the organization was merely a commercial farm or whether its demonstration project served valid exempt purposes. Of importance to the court in deciding that the farm was organized for exempt purposes was the fact that profitability was not a goal in and of itself, but merely incidental in showing that an ecologically sound farm could be profitable. The Service acquiesced in the issues relating to whether the petitioner was operated for exclusively in furtherance of exempt purposes and whether the petitioner served private rather than public interests. The Service nonacquiesced in the issue relating to whether petitioner was organized exclusively for exempt purposes.

In response to the Service's letter of June 4, 2004 stating it was considering denying M's application, M responded in its letter of July 20, 2004:

> (M)'s investment activities will require little time and attention in comparison to its educational activities. In addition, (M) will begin its investment activities only after (M) raises sufficient funds to conducts its educational activities and (M) has excess funds to invest...(M) should not be penalized for its intention to invest its

> excess funds only in business ventures that are committed to ethical corporate governance. (M) will not be devoting a significant amount of time, effort or resources to managing these investments. Given these facts, there is no justification for determining that (M)'s investment activities will be substantial in comparison to its exempt, educational activities...

M cited *World Family Corp.* v. *Commissioner*, 81 TC 958, 966 (1983), Acq. 1984-2 C.B. 1, Nonacq. 1984-2 C.B. 1, in its letter of July 20, 2004. In this case, the court held that the "organization may still be regarded as 'operated exclusively' for exempt purposes" despite the presence of non-exempt activities, which constituted only 10% of their overall activities. The court determined the organization's non-exempt activities were insubstantial and further noted that the organization would not engage in the non-exempt activities in the near future and that the organization's 'preeminent priority' would be its exempt purposes.

M also argues that its educational activities lessen the burdens of government and cites Rev. Rul 85-1, 1985-1 CB 177 and Rev. Rul. 85-2, 1985-1 C.B. 178 in support of its contention. Page 11 of its attachment to the Form 1023 application states: "...the reformation of corporate behavior as a governmental burden is demonstrated in several ways. First, settlements in corporate misbehavior cases have required the settling corporation to agree to change its behavior." Examples were provided to show of settlements that were reached by the SEC and the New York State Attorney General's Offices with various brokerage houses requiring that provisions be designed to eliminate conflicts of interest.

Secondly, in its attachment, M states: "The importance of ethical governance to the government is also demonstrated by the various pieces of legislation that have been enacted in the last year or two." The Sarbanes-Oxley Act was one legislative act presented in the attachment. In that act, "...Congress directed the SEC to adopt rules to increase the accountability of CEOs and CFOs, improve the quality of financial reporting and raise professional, legal and ethical standards for analysts, auditors, audit committees, boards and attorneys...[in order] to restore investor confidence in companies and markets..." By promoting an ethical corporate culture and educating investor on how to identify and punish bad behavior, the organization believes that they will help the SEC and other governmental bodies as indicated on Page 13 of the same attachment.

SERVICE'S POSITION: The Service does not dispute M's educational activity of educating the public regarding responsible and ethical corporate governance. If this was M's sole activity, M would probably meet the operational test and be recognized as exempt under section 501(c)(3).

However, there are a number of reasons that lead the Service to conclude that M has not established that it will not be operated for the benefit of private interests. Said reasons include:

1. A lack of operational activities since incorporation in
2. A one member board of directors.

3. A quorum defined as "one-third" of the number of directors.
4. A conflict of interest policy that states: "...a person who has a financial interest may have a conflict of interest only if the board of directors...decides that a conflict of interest exists."
5. Agreeing to execute a partnership agreement only on the condition that M has a determination letter from the Service stating it is exempt under section 501(c)(3) of the Code.
6. Private benefits being conferred to for-profit businesses with "seed venture capital."
7. M's requirement as a limited partner, to contribute anywhere from $ to $ to the O Partnership. Said contribution has not been accounted for in any of M's proposed budgets.

The law cited by M in support of its position that it should be recognized as exempt under section 501(c)(3) in many cases is not on point with M's activities. For example, in Rev. Rul. 74-587, the recipients of the organization's financial assistance were corporations and individual proprietors who were not able to obtain funds from conventional commercial sources because of the poor financial risks involved in establishing an operating enterprises in poor and blighted communities. In contrast, M uses a venture capital fund as a vehicle to invest in for-profit companies that agree to abide by M's best practices model. M states it will use the profits of these investments to conduct its educational activities. However, before any educational activities can occur, the for-profit companies in which M invests must first return a profit. In addition, these for-profit companies are not operating in blighted areas as opposed to the individuals and companies mentioned in the revenue ruling. Nor are these for-profit companies furthering any educational purpose.

M also contends that its activities lessen the burdens of government and cites Rev. Rul. 85-1, 1985-1 C.B. 177 and Rev. Rul. 85-2, 1985-1 C.B. 178 as support. In order to determine whether an organization's activities lessen the burdens of government, the Service uses a two part test. The first part concerns whether the governmental unit considers the activities to be its burden. Secondly, the activities must actually lessen such burdens of the government.

An activity is a burden to the government if there is an objective manifestation by a governmental unit that it considers the activities of the organization to be its burden (see Rev. Rul. 85-2). M has not supplied any such objective manifestation. M refers to various legal settlements between brokerage houses and the Securities and Exchange Commission as well as the New York State Attorney General's Office. The settlements required the said brokerage houses to "change its behavior" such as eliminating conflicts of interest and severing the links between their research and investment banking. The Service contends these legal settlements are not an objective manifestation of a burden by a governmental unit but are merely settlements of various criminal complaints. M also cites the Sarbanes-Oxley Act of 2002 (P.L. 107-204) as an objective manifestation.

The Service has used several factors to determine whether an objective manifestation exists. One is a statute that specifically creates an organization and clearly defines the organization's structure and purposes (see GCM 39852). In this case, M clearly was not created by statute.

Another factor to consider is whether there is an interrelationship between the organization and the governmental unit. The stronger the control a government has over the activities of the organization, the better the evidence of an objective manifestation. Here, there is no interrelationship between M and a governmental unit. There are no government officials on M's board of directors. In fact, M is a closely held organization with a one person board.

An additional factor to consider is the sources of funding. If an organization regularly receives funding from a governmental unit in the form of general grants, that may indicate the government considers the activity to be its burden. In Rev. Rul. 85-2, the organization was supported in part by grants from a juvenile court, a governmental unit. This is not the case with M. It hasn't received any government grants nor has received any type of funding from anyone because it appears M will only become operational once it receives a determination letter from the Service stating it is exempt under 501(c)(3) of the Code.

The second part of the two part test requires that the activities must actually lessen the burdens of government. M has not shown that its substantial investments in for-profit companies that adopt its best practices are lessening the burdens of any governmental unit.

CONCLUSION: Based on all the information submitted in the application, its attachments and subsequent correspondence, the Service has determined that M has not met the operational test under section 1.501(c)(3)-1(c) of the Regulations. More than an insubstantial part of M's activities are not in furtherance of an exempt purpose. In addition, M has not established that it not operating for the benefit of private interests per section 1.501(c)(3)-1(d)(1)(ii). Per *Better Business Bureau*, the presence of a single non-exempt purpose, if substantial in nature, will destroy a claim for exemption regardless of the number or importance of truly exempt purposes. Accordingly, M is not recognized as exempt under section 501(c)(3) of the Code.