



DEPARTMENT OF THE TREASURY

INTERNAL REVENUE SERVICE

TE/GE: EO Examination

625 Fulton Street, Room 503

Brooklyn, NY 11201

TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

Date: July 18, 2008

Release Number: **200842050**

Release Date: 10/17/08

UIL Code: 501.03-01

Legend

ORG = Organization name

ORG

ADDRESS

XX = Date      Address = address

Taxpayer Identification Number:

Person to Contact:

Identification Number

Contact Telephone Number:

LAST DATE FOR FILING A PLEADING  
WITH THE TAX COURT, THE CLAIMS  
COURT, OR THE UNITED STATES  
DISTRICT COURT FOR THE DISTRICT  
OF COLUMBIA: October 16, 20XX

Dear

This is a final determination regarding your exempt status under section 501(c)(3) of the Internal Revenue Code (IRC). Recognition of your exemption from Federal income tax as an organization described in Internal Revenue Code section 501(c)(3) is retroactively revoked to January 1, 20XX because it is determined that you are not operated exclusively for an exempt purpose.

IRC 501(c)(3) exempts from taxation organizations which are organized and operated exclusively for charitable or educational purposes, no part of the net earnings of which inure to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation and which do not participate in, or intervene in, any political campaign on behalf of (or in opposition to) any candidate for public office.

We have determined that you are not operating exclusively for any charitable purpose, educational purpose, or any other exempt purpose. Our examination reveals that you are not conducting charitable activities, educational activities, or any other exempt activities pursuant to IRC section 501(c)(3), and that you failed to meet the "operational test" under Treas. Regs. 1.501(c)(3)-1(c).

We are revoking your exemption from Federal income tax as an organization described in section 501(c)(3) of the Internal Revenue Code effective January 1, 20XX.

Contributions to your organization are no longer deductible under section 170 of the Internal Revenue Code.

You are required to file Federal income tax returns on Form 1120. These returns should be filed with the appropriate Service Center for all years beginning January 1, 20XX.

Processing of income tax returns and assessment of any taxes due will not be delayed should a petition for declaratory judgment be filed under section 7428 of the Internal Revenue Code.

If you decide to contest this determination in court, you must file a pleading seeking a declaratory judgment in the United States Tax Court, the United States Court of Federal Claims, or the United States District Court for the District of Columbia before the 91<sup>st</sup> day after the date this final determination was mailed to you. Please contact the clerk of the appropriate court for rules regarding filing pleadings for declaratory judgments and refer to the enclosed Publication 892. You may write to these courts at the following addresses:

You have the right to contact the office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. You may call too-free and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate at: Internal Revenue Service.

We will notify the appropriate State Officials of this action, as required by section 6104(c) of the Internal Revenue Code.

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

Sincerely Yours,

Marsha A. Ramirez  
Director, EO Examinations

Enclosure:  
Publication 892

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service <b>Explanation of Items</b>	Schedule No. or Exhibit
<b>Name of Taxpayer</b> ORG		<b>Year/Period Ended</b> 20XX12

**LEGEND**

ORG = Organization name      XX = Date      XYZ = State      CPA = CPA  
CO-1 = 1<sup>st</sup> company      Dir-1 & DIR-2 = 1<sup>st</sup> & 2<sup>nd</sup> director.

**Issue:**

Does ORG satisfy the operational test of Reg. §1.501(c)(3)-1(c), which requires exempt organizations to be engaged primarily in exempt activity.

**Facts:**

ORG was incorporated in the State of XYZ on February 23, 19XX. It applied for and received recognition as a 501(c)(3) not for profit organization on January 31, 19XX. It has operated as such since that time.

ORG's exempt purpose as stated on its application is as follows:

"Training program for economically and socially deprived children, job training and substance abuse services."

ORG's exempt purpose as stated in its Articles of Incorporation are as follows:

1. To engage in the development of economically and socially deprived children in the areas, of among other things, job training, education, health, housing, etc.
2. To provide substance abuse services.
3. To engage in any other lawful purpose and business; and
4. To do anything permitted by Section      of the Corporations and Associations Article of the Annotated Code if XYZ.

In the year under examination and the prior and subsequent years, this organization has engaged primarily in commercial activity. No amendments have been filed with the IRS stating that the organization has changed the nature of their exempt purpose.

ORG owns a commercial property that generates unrelated business income. This income is generated from commercial rentals and parking lot income.

In the current, prior and subsequent years ORG had revenue and expenses as follows:

	<u>20XX</u>	<u>20XX</u>	<u>20XX</u>	<u>20XX</u>	<u>Percentage</u>
Program Revenue	\$				
UBI Rental Revenue	\$				

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Program expense \$  
 UBI Rental expense \$

In addition to the above UBI activity, ORG has invested substantial assets in the formation of a for profit corporation, CO-1. The business activity of this corporation is property development and commercial real estate rental. ORG's 20XX independent audit report issues a consolidated report for these two entities. Per the audit report, ORG is the sole shareholder of CO-1. This equity position establishes that ORG exercises control of this for profit corporate entity.

A parent's exempt status may be jeopardized if the commercial activities of its subsidiary can be considered to be, in fact, activities of the parent. If the parent corporation so controls the affairs of the subsidiary that it is merely an instrumentality of the parent, the corporate subsidiary may be disregarded (See IRC 482). This is because the subsidiary is in reality an arm, agent or integral part of the parent.

Currently, the definition of "control" in the case of exempt organizations having taxable subsidiaries, is ownership directly, indirectly, or by attribution of at least 50 percent of stock, by vote or value (rather than 80 percent of combined voting stock, under present law), and extends "control" rules where exempt organizations in the aggregate own more than 50 percent of the subsidiary's stock. Other indications of control are common corporate offices, common management, and not arms length transactions.

The 20XX 1120 tax return for CO-1's return indicates that ORG has invested a total of \$ in CO-1. This consists of \$ for common stock and \$ in additional paid in capital. Revenue for this year is stated as \$. Associated expenses are stated as \$.

If CO-1 commercial activity is attributed to the parent (ORG) for the year under audit, the percentage of the organization's exempt purpose revenue and expenses is further diminished. Total financial activity for 20XX is as follows:

**20XX**

<b>Program Revenue (990)</b>	<b>\$</b>
UBI Rental Revenue (990T)	\$
Subsidiary Revenue (1120)	\$
Total	\$
 <b>Program expense (990)</b>	 <b>\$</b>
UBI Rental expense (990T)	\$
Subsidiary Expense (1120)	\$
Total	\$

Under either scenario, ORG falls far short of the standard for exemption as found in the "operational" test of Reg. §1.501(c)(3)-1(c)

**The Law:**

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The law requires that an organization claiming exemption under Code Sec. 501(c)(3) also be operated exclusively for the prescribed exempt purposes. Under the “operational” test of Reg. §1.501(c)(3)-1(c), an organization is regarded as operated “exclusively for” exempt purposes only if it engages primarily in activities that accomplish one or more of the exempt purposes. As with the “organizational” test, an organization is not regarded as exempt “if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.”

IRC §501(a) provides tax-exempt status to organizations that are described under IRC §501(c). Among the organizations that qualify for tax-exempt status are those described under IRC §501(c)(3) as: corporations organized and **operated exclusively** for religious, charitable, scientific, etc. purposes. In order to qualify as an organization exempt from tax under IRC §501(c)(3), the organization must be both (1) organized exclusively for one or more of the exempt purposes specified in the Code section (known as the “organizational test”), and (2) **operated exclusively for this purpose (known as the “operational test”)**. In applying both of these tests, the term “exclusively” does not mean “solely” or “absolutely without exception.” Nonetheless, **the presence of a single nonexempt purpose, if substantial in nature, precludes tax-exempt status.**

IRC Code Sec. 501(c)(3) Organizations: Organized and Operated: Primary purpose doctrine  
Code Sec. 501(c)(3) requires an organization to be organized and operated **exclusively** for exempt purposes in order to qualify for tax-exempt status under that provision. In this context, the term “operated exclusively for exempt purposes” is interpreted as “engaged primarily in activities” in furtherance of one or more of the organization's exempt purposes (Reg. §1.501(c)(3)-1(c)(1)). This is known as the primary purpose doctrine.

**FINAL-REG, TAX-REGS, §1.501(c)(3)-1. Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals**

a) *Organizational and operational tests*

- (1) In order to be exempt as an organization described in section 501(c)(3), 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.

**FINAL-REG, TAX-REGS, §1.501(c)(3)-1. Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals**

(c) *Operational test*



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(1) *Primary activities.* —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.

Case law that supports these regulations is as follows:

In the *Better Business Bureau of Washington, D.C. v US*, SCt, 326 US 279, 66 SCt 112, the U.S. Supreme Court has declared that “the presence of a single (nonexempt) purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly (exempt) purposes.”

In *Living Faith, Inc.*, CA-7, 92-1 USTC ¶50,003, 950 F2d 365, A not-for-profit corporation that operated vegetarian restaurants and health food stores did not operate exclusively for exempt purposes and accordingly did not qualify as a tax-exempt organization. Although the restaurants and health food stores were operated to further the dietary goals of the Seventh Day Adventist church, the purpose of the restaurants and health food stores was substantially commercial.

In *New Faith, Inc.*, 64 TCM 1050, Dec. 48,572(M), TC Memo. 1992-601, a nonprofit public benefit corporation that obtained most of its revenues from providing food to the general public from lunch trucks in exchange for donations was not operated exclusively for a tax-exempt purpose. The commercial activity accounted for nearly all of its gross revenues and there was no evidence that any food items were offered at below-cost prices to needy persons.

In *Make a Joyful Noise, Inc.*, 56 TCM 1003, Dec. 45,405(M), TC Memo. 1989-4, an organization did not satisfy its burden of proving that the IRS' revocation of its tax-exempt status under Code Sec. 501(c)(3) was erroneous. The organization was not regarded as “operated exclusively” for one or more exempt purposes because it did not engage primarily in activities in order to accomplish its exempt purpose. Its primary activity was the management and operation of bingo games for other exempt organizations —a trade or business activity that did not qualify as an exempt activity under Code Sec. 501(c)(3).

In *Senior Citizens of Missouri, Inc.*, 56 TCM 480, Dec. 45,126(M), TC Memo. 1988-493, a taxpayer that was organized for aiding handicapped and elderly citizens was denied tax-exempt status because it did not prove that it operated exclusively for such tax-exempt purpose.

In *Housing Pioneers, Inc.*, CA-9, 95-1 USTC ¶50,126, 49 F3d 1395, a housing corporation that was organized to provide affordable housing for low-income and disabled people did not qualify for tax-exempt status as a charitable organization because it was not operated exclusively for exempt purposes. The organization became a co-general partner in two for-profit limited partnerships in order to take advantage of a state (California) property tax reduction for low-

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income rentals, by receiving a portion of the tax credits with which to pursue its charitable purposes.

In *Airlie Foundation*, DC D.C., 2003-2 USTC ¶50,719, 283 FSupp2d 58, an organization that operated its conference center in a manner consistent with that of a commercial business did not qualify for tax-exempt status. The taxpayer brought a declaratory judgment action against the IRS seeking reinstatement of its exempt status based on the argument that its conference activities were undertaken principally to advance educational and charitable purposes. However, the totality of the circumstances established that it furthered a substantial nonexempt purpose.

In *Interneighborhood Housing Corp. v. Commissioner*, T.C. Memo 1982-66, The sole issue for decision is whether INHC was organized and operated exclusively for one or more exempt purposes within the meaning of section 501(c)(3). The court stated that A major part of your activity is the management of eight multiple family dwellings for a fee. Income Tax Regulation section 1.501(c)(3)-[1](a)(1) states "In order to be exempt as an organization described in section 501(c)(3), an organization must be both organized and operated exclusively for one or more of the purposes specified in such section." The management of buildings for a fee is not an exempt activity within the scope of section 501(c)(3) \* \* \*. Accordingly, your organization does not meet the requirements for exemption under that section of the Code.

In *Federation Pharmacy Services, Inc. v. Commissioner*, 625 F.2d 804 (8th Cir. 1980), aff'g 72 T.C. 687 (1979), the appellate court held that a nonprofit pharmaceutical service was not exempt as a charitable organization because it was operated for the substantial commercial purpose of providing pharmacy services to the general public. Although it provided special discount rates for handicapped and senior citizens in its area, it was not committed to providing any drugs below cost or free to indigent persons. Therefore, although its services did improve health in the area, it was primarily a commercial venture operated in competition with other area pharmacies.

In *Senior Citizens Stores v. United States*, 602 F.2d 711 (5th Cir. 1979), an organization whose stated purpose was to provide training, jobs, and recreation for senior citizens by operating retail stores did not qualify for exemption under IRC 501(c)(3). Although it incidentally served the needs of senior citizens, the evidence indicated that the retail sales operation was an end in itself. Proceeds from the business were used almost exclusively for its perpetuation. Thus, the organization's primary activity was the operation of the retail store, which was not devoted exclusively to charitable purposes.

In *Orange County Agricultural Society and Greater United Navajo Development Enterprises Inc.*, (*Cited Below*) the activities of the subordinate organization were attributed to the parent and as a result, exemption was lost.

In *Orange County Agricultural Society, Inc.*, CA-2, 90-1 USTC ¶50,076, 893 F2d 647

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An agricultural society no longer qualified as a tax-exempt organization since it was not operated exclusively in furtherance of its stated exempt purpose of promoting the interests of agriculture and horticulture. The society's involvement in automobile racing activities that were conducted on the racetrack at the society's fairgrounds was extensive. **Although a separate corporation was formed to conduct the racetrack business, it was merely a corporate shield designed to protect the society against potential liability arising from the racing activities.**

In *Greater United Navajo Development Enterprises Inc.*, 74 TC 69, Dec. 36,890. Aff'd, CA-9, a corporation organized to assist the poor of the Navajo Nation did not qualify as an exempt organization because it was not operated exclusively for exempt purposes. Through its agent, a wholly owned subsidiary corporation, the corporation engaged in non-charitable, profit-motivated activities, leading to a finding that non-exempt business activities were more than an insubstantial part of the corporation's total activities.

**Taxpayer's Position:**

My findings were presented at the closing conference to DIR-1, CPA CPA, and DIR-2, the current Director of ORG. At that time, no one took issue with the facts as they are stated in this document. Nor did anyone dispute my interpretation of the law as it is cited in this document. However, since none of the persons present at the meeting was a lawyer, the T/P felt that it would be prudent at this point to consult a lawyer.

The T/P's lawyer would like to cure the problems with the organization by divesting of certain holdings and refocusing the organization and its assets on the exempt functions as stated in the application for exempt status.

ORG will pursue this option during the appeals process and therefore there will not be an agreed closing of this case.

**Service Position and Recommendation:**

The Service's position on the operational test and primary activities is consistent with the cited case law. The "primary activities" portion of the regulation helps to harmonize the regulation with the unrelated business income tax provisions set forth in Regs. 1.501(c)(3)-1(e)(1) which allow an exempt organization to engage in unrelated trade or business activity so long as engaging in such trade or business is not the organization's primary purpose. The not "more than an insubstantial part of its activities" standard can be understood by reference to *Better Business Bureau v. U.S.*, 326 U.S. 279 (1945), which held that an organization which engaged in some educational activity but pursued nonprofit goals outside the scope of the statute was not exempt under IRC 501(c)(3). The Court stated that an organization is not operated exclusively for charitable purposes if it has a single *noncharitable purpose* that is *substantial* in nature. This is true regardless of the number or importance of the organization's charitable purposes.



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Regarding the attribution of the commercial activities of CO-1 to that of ORG, this requires that the doctrine of corporate entity be disregarded. Legally, this is not easy (See Moline Properties, Inc vs. Commissioner of Internal Revenue). However, a parent's exempt status may be jeopardized if the commercial activities of its subsidiary can be considered to be, in fact, activities of the parent. If the parent corporation so **controls** the affairs of the subsidiary that it is merely an instrumentality of the parent, the corporate subsidiary may be disregarded (See IRC 482). This is because the subsidiary is in reality an arm, agent or integral part of the parent. As such, the activity of the CO-1, Inc. should be considered the activity of ORG

ORG does not pass the operational or primary purpose test. The majority of the financial activity of this EO is commercial in nature. The primary activity of ORG is carrying on a business with the general public in a manner similar to organizations that are operated for profit. Status as a 501(c)(3) organization should be revoked. Additionally, the activity of the wholly owned subsidiary should be considered the activity of ORG

**Conclusion**

In order to be exempt as an organization described in section 501(c)(3), an organization must be both organized and operated exclusively for one or more of the purposes specified in such section, and if an organization fails to meet either the organizational or operational test, it is not exempt for purposes of section 501(a). ORG does not meet the criteria of a 501 (c) (3) and classification as such should be discontinued as of January 1, 20XX.



TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

DEPARTMENT OF THE TREASURY  
Internal Revenue Service  
1100 Commerce Street  
Dallas, TX 75242

February 2, 2007

ORG  
ADDRESS

Taxpayer Identification Number:

Form:

Tax Year(s) Ended:

Person to Contact/ID Number:

Contact Numbers:

Telephone:

Fax:

Certified Mail - Return Receipt Requested

Dear ,

We have enclosed a copy of our report of examination explaining why we believe revocation of your exempt status under section 501(c)(3) of the Internal Revenue Code (Code) is necessary.

If you accept our findings, take no further action. We will issue a final revocation letter.

If you do not agree with our proposed revocation, you must submit to us a written request for Appeals Office consideration within 30 days from the date of this letter to protest our decision. Your protest should include a statement of the facts, the applicable law, and arguments in support of your position.

An Appeals officer will review your case. The Appeals office is independent of the Director, EO Examinations. The Appeals Office resolves most disputes informally and promptly. The enclosed Publication 3498, *The Examination Process*, and Publication 892, *Exempt Organizations Appeal Procedures for Unagreed Issues*, explain how to appeal an Internal Revenue Service (IRS) decision. Publication 3498 also includes information on your rights as a taxpayer and the IRS collection process.

You may also request that we refer this matter for technical advice as explained in Publication 892. If we issue a determination letter to you based on technical advice, no further administrative appeal is available to you within the IRS regarding the issue that was the subject of the technical advice.

If we do not hear from you within 30 days from the date of this letter, we will process your case based on the recommendations shown in the report of examination. If you do not protest this proposed determination within 30 days from the date of this letter, the IRS will consider it to be a failure to exhaust your available administrative remedies. Section 7428(b)(2) of the Code provides, in part: "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 its administrative remedies within the Internal Revenue Service." We will then issue a final revocation letter. We will also notify the appropriate state officials of the revocation in accordance with section 6104(c) of the Code.

You have the right to contact the office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. You may call toll-free 1-877-777-4778 and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate at:

If you have any questions, please call the contact person at the telephone number shown in the heading of this letter. If you write, please provide a telephone number and the most convenient time to call if we need to contact you.

Thank you for your cooperation.

Sincerely,

Marsha A. Ramirez  
Director, EO Examinations

Enclosures:  
Form 6018  
886-A  
Publication 892 & 3498