



## DEPARTMENT OF THE TREASURY

Internal Revenue Service  
TE/GE EO Examinations  
1100 Commerce Street  
Dallas, TX 75424

### TAX EXEMPT AND GOVERNMENT ENTITIES DIVISION

Release Number: **200842053**

Release Date: 10/17/08

UIL Code: 501.03-01

Legend

ORG = Organization name

ORG

ADDRESS

July 10, 2008

Address = address      XX = Date

Person to Contact

Identification Number:

Contact Telephone Number:

In Reply Refer to: TE/GE Review Staff

EIN:

### Certified Mail – Returned Receipt

LAST DATE FOR FILING A PETITION  
WITH THE TAX COURT: October 8, 20XX

Dear

This is a Final Adverse Determination Letter as to your exempt status under section 501(c) (3) of the Internal Revenue Code. Your exemption from Federal income tax under section 501(c) (3) of the code is hereby revoked effective January 1, 20XX. You agreed to the change per your signature on the Form 6018, Consent to Proposed Action, on December 21, 20XX.

Our adverse determination was made for the following reasons:

A substantial part of your activities consists of providing down payment assistance to home buyers. To finance the assistance you rely on home sellers and other real-estate related businesses that stand to benefit from these down payment assistance transactions. Your receipt of a payment from the home seller corresponds to the amount of the down payment assistance provided in substantially all of your down payment assistance transactions. The manner in which you operate demonstrates you are operated primarily to further your insiders' business interests. Therefore, you are operated for a substantial nonexempt purpose. In addition, you operations further the private interests of the persons that finance your activities. Accordingly, you are not operated exclusively for exempt purposes described in section 501(c) (3).

You failed to meet the requirements of IRC section 501(c) (3) and Treas. Reg. section 1.501(c) (3) -1(d) in that you failed to establish that you were operated exclusively for an exempt purpose.

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 the year ending December 31, 20XX, and for all years thereafter. You have properly prepared returns for the years December 31, 20XX, 20XX, 20XX, and 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 initiate a suit for declaratory judgment in the United States Tax Court, the United States Claim Court or the District Court of the United States for the District of Columbia before the 91<sup>st</sup> day after the date this determination was mailed to you. Contact the clerk of the appropriate court for the rules for initiating suits for declaratory judgment.

You also have the right to contact the office of the Taxpayer Advocate. However, you should first contact the person whose name and telephone number are shown above since this person can access your tax information and can help you get answers.

You can call and ask for Taxpayer Advocate assistance. Or you can contact the Taxpayer Advocate from the site where the tax deficiency was determined by calling, or writing to: Internal Revenue Service, Taxpayer Advocates Office.

Taxpayer Advocate assistance cannot be used as a substitute for established IRS procedures, formal appeals processes, etc. The Taxpayer Advocate is not able to reverse legal or technically correct tax determinations, nor extend the time fixed by law that you have to file a petition in the United States Tax 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.

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

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> <b>ORG</b>		<b>Year/Period Ended</b> <b>12/31/20XX,</b> <b>20XX &amp; 20XX</b>

**LEGEND**

ORG = Organization name      XX = Date      EMP-1, EMP-2 = 1<sup>st</sup> & 2<sup>nd</sup> employees  
 motto = motto      website = website      Bank = bank      Co-1 = 1<sup>st</sup> company  
 DIR -1, DIR-2 & DIR-3 = 1<sup>st</sup>, 2<sup>nd</sup> & 3<sup>rd</sup> directors

**ISSUE**

Whether ORG operated exclusively for exempt purposes within the meaning of I.R.C. § 501(c)(3)?

**FACTS**

ORG is currently recognized as an I.R.C. § 501(c)(3) organization. It filed Forms 990 for the calendar years ended December 31, 20XX, 20XX and 20XX with the Internal Revenue Service. ORG filed no Forms 990-T, 941, 945, W-2, 1099-MISC, and/or 1099-INT for these years. ORG has a related for-profit entity, CO-1 (CO-1). CO-1 filed Forms 1120 for 20XX, 20XX and 20XX. ORG currently has one employee (EMP-1) but the Forms W-2 and 941 are filed thru the related company, CO-1. A Form 1099 for commissions paid to EMP-2 in the amount of \$ was not issued.

ORG’s activity, as stated in its Form 990 for 20XX, was as follows: “The organization provides assistance to low-income first- time home buyers to be used by the recipients to cover down payment and closing costs in order to provide the ability to realize the American dream of home ownership.”

**History of ORG**

ORG, was established in the State of      in August 31, 20XX as a non-profit entity. It filed Forms 990 in 20XX, 20XX, 20XX, & 20XX.

ORG filed the original Form 1023 with the Internal Revenue Service on November 12, 20XX. The directors, as stated on the application, were DIR-1, DIR-2, and DIR-3.

The Form 1023 stated that: ORG will provide grants primarily to low-income, first-time homebuyers who meet certain criteria. These grants can be used for their down payments and/or closing costs to help them purchase their first home. They must qualify for a first mortgage loan from a lender. The grant will be a gift from the organization and does not have to be paid back by the buyer. At least 75% of the families will qualify as low-income units; and either at least 20 percent of the units are occupied by residents that also meet the very low income limit for the area or 40 percent of the units are occupied by residents that also do not exceed 120 percent of the area’s very low-income limit. The income limits for low-income

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families are in accordance with standards established by HUD, (attached hereto). This will be the only activity of the organization at this time. 95% of our time will be used to locate qualified recipients of these grants. Minimal contact, if any will be made with the sellers or with brokers to assist them in the sale of residential units. Our organization plans to begin issuing grants in December of 20XX. The grant applications will be reviewed by our grant screening committee, which at this time will include DIR-1 and DIR-2. We will assist as many qualified members of the community as we can in purchasing the first homes. We will target those members of the community at the lower end of the income scale because they are typically the ones that need the most help. Our ability to provide grants will be predicated on contributions received by the organization from community businesses, private individual or government entities. Hopefully we can help many worthy families and individuals.

### **ORG's Operations**

Starting in late 20XX, ORG has operated its motto (motto) program under the leadership of DIR-1 for both ORG and CO-1, ORG's related for-profit entity. ORG's primary activities in 20XX, 20XX, 20XX, 20XX, & 20XX related to its motto program. ORG does not engage in the business of selling homes or in financing the purchase of homes. If potential home buyers call, ORG will provide consulting to them.

From 20XX through 20XX, ORG provided motto grants to any home buyer using a mortgage company that would accept a "gift" from a section 501(c)(3) organization as the down payment for the purchase of a house, as allowed by regulations issued by HUD and administered by the Fair Housing Administration (FHA). As a result, ORG claims that 99.99 percent of its down payment grants were made in conjunction with FHA loans. FHA has loan limits and median income guidelines based on economic standards of living for each specific zip code which determine who will receive a loan. The FHA is the only entity that will accept a gift from a section 501(c)(3) organization for a down payment for the purchase of a house. FHA underwrites the loan and requires a so-called "gift letter" from the donor for the down payment.

ORG follows these steps for its motto program:

1. A real estate contract prepared by the realtor is negotiated between a buyer and seller, where the seller agrees to pay a so-called "seller service fee" to ORG. The seller service fee is ORG's only source of income. In most cases, the realtor knows about ORG's motto program through the mortgage broker or a builder. The seller service fee paid by the seller is a stated fee as determined by the selling agent and the seller in coordination with the buyer of the house plus a ORG's service fee. The real estate contract might state that, "Seller agrees to pay a Seller Service Fee to ORG in the amount of \$ at closing." The amount to be paid was the sum of amount of the down payment provided by ORG plus ORG's service fee. The

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seller had to agree to participate in the motto program. The real estate contract evidenced the seller's acknowledgement of the agreement to pay the seller service fee. The amount of service fee per the example contract provided was a \$ fee but the records provided show that the difference between the amount sent and the amount received can vary from \$ to \$. Most are in that \$ to \$ range.

2. For FHA loans, the buyer or buyer's lender completes and submits a grant application form requesting motto from ORG. The buyer could submit the form to ORG by fax, postal service, or e-mail to its website at website.
3. ORG prepares the gift letter for the buyer, and faxes it to the lender. The gift letter shows ORG's name, address, and phone number and is identified as non-profit 501(c)(3) .
4. ORG contacts the designated title officer to coordinate wiring instructions and closing times. ORG faxes closing instructions directly to the title company or closing agent. The title company or closing agent then confirms to ORG that the transaction is scheduled, and confirms the grant amount needed by the buyer. The closing agent also signs closing instructions stating it will return the grant amount if the loan does not close, and agrees to collect ORG's seller service fee from the seller. ORG then wires the down payment grant directly to the title or escrow office by the requested closing date. If the loan does not close within five business days of requested closing date, the title or escrow officer will return the grant money directly back to ORG.

During 20XX through 20XX, ORG completed approximately 1,000 to 1,500 transactions per year. At no time did ORG review or receive copies of the files of the mortgage broker, the title company, or realtor involved with the individual home sales. ORG has no verification of income limits of the individuals who received the down payment grants. ORG relied on FHA maximum loan limits to qualify the borrowers.

### **Financial Information**

This examination was performed by correspondence and most of the information as stated came from the information provided on the Forms 990 and written or verbal communication from the organization or its representative.

DIR-1 maintained the bank accounts and checkbooks for ORG and CO-1. Each entity had its own separate bank account. ORG's only source of revenue is the seller service fees; its total revenue is the gross amount of the seller service fees. As expenses, ORG pays out the down payment grants to the home buyers. ORG keeps the difference between the seller service fees

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and the down payment grants as its fee. During 20XX thru 20XX, ORG made no solicitation for charitable contributions. ORG's Forms 990 shows the following:

ORG	20XX	20XX	20XX
Total Revenue, Line 12 of 990			
Total Expenses, Line 17 of 990			
Net Income, Line 18 of 990			

ORG 990 shows its financial status:

ORG 501(c)(3)	20XX	20XX	20XX
Total Assets, line 59 of 990			
Total Liabilities, line 66 of 990			
Total Equity, line 72 of 990			
Total Liabilities & Equity, line 74 of 990			

ORG's trial balance included a balance sheet account (account #) identified as "Loan-Shareholder". As disclosed on the 20XX Form 990 this was a loan from an officer where the balance at the beginning of 20XX was \$. During the year the organization paid off this loan in full. The loan was fully disclosed on the 20XX F990 return and did not bear any interest due to the relatively small amount of the loan and the length of the loan. ORG did not make any other loans to anyone. This note was paid off by the end of the year and the Forms 990 properly shows no loan from shareholders receivable/payable.

There is a Note Payable to Bank on a line of credit. Balance at the end of 20XX was \$. The interest rate is 4.5% with monthly payments of interest only and principal repayments as cash flow permits. There were no principal repayments made during the 20XX year. The loan is secured by personal guarantees of its officers. The purpose of the loan is to fund short term timing difference between revenue coming in and payments being made.

ORG's Forms 990 and its books and records show the following expenses:

ORG - Expenses	20XX	20XX	20XX
Contributions Paid			
Accounting fees			
Legal Fees			
Interest Expense			
Depreciation			
Charitable contributions			

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License and permits  
Amortization  
Bank fees  
Miscellaneous expense  
Marketing cost  
Total Expenses per Trial Balance and 990  
Return

**Marketing Expense:** During 20XX through 20XX, ORG claimed it incurred marketing expenses for amounts paid to CO-1. An agreement negotiated between ORG and CO-1 (the related for profit company) determined the marketing expenses. DIR-1 is the president of both entities. ORG agreed to pay to CO-1 the amount CO-1 charged ORG as marketing expenses as long as ORG did not realize a net loss in its operations. ORG's Forms 990 showed it paid CO-1 \$, \$ and \$ in 20XX, 20XX and 20XX, respectively.

#### **Internal controls**

Because this was a correspondence audit, the internal controls were not examined in depth.

#### **LAW AND ARGUMENT**

Section 501 of the Internal Revenue Code of 1986 provides for the exemption from federal income tax of corporations organized and operated exclusively for charitable or educational purposes, provided that no part of the net earnings of such corporations inures to the benefit of any private shareholder or individual. See section 501(c)(3). An organization seeking exempt status must establish that it was organized and is operated exclusively for charitable or educational purposes.

Section 1.501(c)(3)-1(c)(1) of the Income Tax Regulations provides that an organization operates exclusively for exempt purposes only if it engages primarily in activities that accomplish exempt purposes specified in section 501(c)(3). An organization must not engage in substantial activities that fail to further an exempt purpose. In Better Business Bureau of Washington, D.C. v. U.S., 326 U.S. 279, 283 (1945), the Supreme Court held 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." See also, Old Dominion Box Co., Inc. v. United States, 477 F.2d 340 (4<sup>th</sup> Cir. 1973), cert. denied, 413 U.S. 910 (1973) ("operating for the benefit of private parties who are not members of a charitable class constitutes a substantial nonexempt purpose").

Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) provides that an organization is not organized or operated exclusively for exempt purposes unless it serves a public rather than a private interest. To meet

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the requirements of section 501(c)(3), the organization must establish that it is not organized or operated for the benefit of private interests. When an organization operates for the benefit of private interests, such as designated individuals, its founder or his family, or persons directly or indirectly controlled by such private interests, the organization by definition does not operate exclusively for exempt purposes. American Campaign Academy v. Commissioner, 92 T.C. 1053, 1065-1066 (1989).

Treas. Reg. § 1.501(c)(3)-1(d)(2) defines “charitable” for section 501(c)(3) purposes as including the relief of the poor and distressed or of the underprivileged, and the promotion of social welfare by organizations designed to lessen neighborhood tensions, to eliminate prejudice and discrimination, or to combat community deterioration. The term “charitable” also includes the advancement of education. Id.

Treas. Reg. § 1.501(c)(3)-1(d)(3)(i) provides, in part, that the term “educational” for section 501(c)(3) purposes relates to the instruction of the public on subjects useful to the individual and beneficial to the community.

Treas. Reg. § 1.501(c)(3)-1(e) provides that an organization that operates a trade or business as a substantial part of its activities may meet the requirements of section 501(c)(3) if the trade or business furthers an exempt purpose, and if the organization’s primary purpose does not consist of carrying on an unrelated trade or business.

In Easter House v. U.S., 12 Cl. Ct. 476, 486 (1987), aff’d, 846 F. 2d 78 (Fed. Cir.), the U.S. Court of Federal Claims considered whether an organization that provided prenatal care and other health-related services to pregnant women, including delivery room assistance, and placed children with adoptive parents qualified for exemption under section 501(c)(3). The court concluded that the organization did not qualify for the tax exemption because its primary activity was placing children for adoption in a manner indistinguishable from that of a commercial adoption agency. The court rejected the organization’s argument that the adoption services merely complemented the health-related services to unwed mothers and their children. Instead, the court found that the health-related services were merely incidental to the organization’s operation of an adoption service, which, in and of itself, did not serve an exempt purpose. The organization’s sole source of support was the fees it charged adoptive parents, rather than contributions from the public. The court also found that the organization competed with for-profit adoption agencies; it engaged in substantial advertising; and it accumulated substantial profits. Moreover, although the organization provided health care to indigent pregnant women, it did so only when a family willing to adopt an indigent woman’s child had paid for the mother’s health care. Accordingly, the court found that the “business purpose, and not the advancement of educational and charitable activities purpose, of plaintiff’s adoption service is its primary goal”



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and held that the organization was not operated exclusively for purposes described in section 501(c)(3). Easter House, 12 Cl. Ct. at 485-486.

In American Campaign Academy v. Commissioner, 92 T.C. 1053 (1989), the Tax Court held that an organization that operated a school to train individuals for careers as political campaign professionals, but could not establish that it operated on a nonpartisan basis, did not exclusively serve the purposes described in section 501(c)(3) because it also served private interests more than incidentally. The court found that the organization was created and funded by persons affiliated with entities of a particular political party and that most of its graduates worked in campaigns for the party's candidates. Consequently, the court concluded that the organization conducted its educational activities with the objective of benefiting the party's candidates and entities. Although the candidates and entities benefiting from the organization's activities were not organization "insiders," the court stated that the conferral of benefits on disinterested persons who are not members of a charitable class may cause an organization to serve a private interest within the meaning of Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii). The court found that even if the political party's candidates and entities comprised "a charitable class, [the organization] would bear the burden of proving that its activities benefited members of the class in a non-select manner." American Campaign Academy, 92 T.C. at 1077.

In Aid to Artisans, Inc. v. Commissioner, 71 T.C. 202 (1978), the Tax Court held that an organization that marketed handicrafts made by disadvantaged artisans through museums and other non-profit organizations and shops operated exclusively for charitable purposes within the meaning of section 501(c)(3). The organization, in cooperation with national craft agencies, selected the handicrafts it would market from craft cooperatives in communities identified as disadvantaged based on objective evidence collected by the Bureau of Indian Affairs or other government agencies. The organization marketed only handicrafts it purchased in bulk from these communities of craftsmen. The organization did not market products produced by studio craftsmen, nor did it select individual craftsmen based on the needs of the purchasers. The court concluded that the overall purpose of the organization's activity was to benefit disadvantaged communities. The organization's commercial activity was not an end in itself but the means through which the organization pursued its charitable goals. The method the organization used to achieve its purpose did not cause it to serve primarily private interests because disadvantaged artisans who directly benefited by the activity constituted a charitable class and the organization showed no selectivity with regard to benefiting specific artisans. Therefore, the court held that the organization operated exclusively for exempt purposes described in section 501(c)(3).

In Airlie Foundation v. Commissioner, 283 F. Supp. 2d 58 (D.D.C., 2003), the court relied on the commerciality doctrine in applying the operational test to an organization that operated a conference center as its primary activity and derived most of its income from user fees. Because of the commercial manner in which the organization conducted its activities, the court found that

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it was operated for a non-exempt commercial purpose, rather than for a tax-exempt purpose. In reaching this conclusion, the court stated:

Among the major factors courts have considered in assessing commerciality are competition with for-profit commercial entities; extent and degree of below cost services provided; pricing policies; and reasonableness of financial reserves. Additional factors include, inter alia, whether the organization uses commercial promotional methods (e.g. advertising) and the extent to which the organization receives charitable donations.

See also, Living Faith Inc. v. Commissioner, 950 F.2d 365 (7th Cir. 1991) (holding that a religious organization which ran restaurants and health food stores in furtherance of its health ministry did not qualify for tax-exempt status because it was operated for substantial commercial purposes and not for exclusively exempt purposes).

In Rev. Rul. 67-138, 1967-1 C.B. 129, the IRS held that helping low-income persons obtain adequate and affordable housing is a "charitable" activity because it relieves the poor and distressed or underprivileged. There, the organization carried on several activities directed to assisting low-income families obtain improved housing, including (1) conducting a training course on various aspects of homebuilding and homeownership; (2) coordinating and supervising joint construction projects; (3) purchasing building sites for resale at cost; and (4) lending aid in obtaining home construction loans.

In Rev. Rul. 70-585, 1970-2 C.B. 115, the IRS described four situations where organizations provided housing and discussed whether each qualified as a charitable organization within the meaning of section 501(c)(3). Situation 1 involved an organization formed to construct new homes and to renovate existing homes for sale to low-income families who could not obtain financing through conventional channels. The organization also provided financial aid to low-income families who were eligible for loans under a Federal housing program but did not have the necessary down payment. The organization made rehabilitated homes available to families who could not qualify for any type of mortgage. When possible, the organization recovered the cost of the homes through very small periodic payments, but its operating funds came from federal loans and contributions from the general public. The revenue ruling held that by providing homes for low-income families who otherwise could not afford them, the organization relieved the poor and distressed.

Situation 2 involved an organization formed to ameliorate the housing needs of minority groups by building housing units for sale to persons of low and moderate income on an open-occupancy basis. The housing was made available to members of minority groups who were unable to obtain adequate housing because of local discrimination. The housing units were located to help reduce racial and ethnic imbalances in the community. Because the activities were designed to eliminate

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prejudice and discrimination and to lessen neighborhood tensions, the revenue ruling held that the organization was engaged in charitable activities within the meaning of section 501(c)(3).

Situation 3 related to an organization established to formulate plans for the renewal and rehabilitation of a particular area in a city as a residential community. The median income level in the area was lower than in other sections of the city and the housing in the area generally was old and badly deteriorated. The organization developed an overall plan for the rehabilitation of the area, sponsored a renewal project, and involved residents in the area renewal plan. It also bought an apartment building that it rehabilitated and rented at cost to low- and moderate-income families with a preference given to residents of the area. The revenue ruling held that the organization was described in section 501(c)(3) because its purposes and activities combated community deterioration.

Situation 4 described an organization formed to alleviate a shortage of housing for moderate-income families in a particular community. The organization planned to build housing to be rented at cost to moderate-income families. The revenue ruling held that the organization failed to qualify for exemption under section 501(c)(3) because the organization's program was not designed to provide relief to the poor or to further any other charitable purpose within the meaning of section 501(c)(3) and applicable Treasury Regulations.

In early 2006 the IRS issued Revenue Ruling 2006-27, 2006-21 I.R.B. 915, which describes three organizations involved in providing down payment assistance and determines whether each qualifies for exempt status under § 501(c)(3). The organization described in Situation 1 makes assistance available to low-income families to purchase decent and safe homes throughout the metropolitan area in which it is located. Individuals are eligible to participate if they are low-income and have the employment history and financial history to qualify for a mortgage with the exception that they do not have the funds necessary for down payments.

The organization in Situation 1 offers financial seminars, conducts educational activities to prepare the individuals for home ownership, and requires a home inspection report before providing funds for down payment assistance. To fund the program, the organization conducts broad based fundraising that attracts gifts, grants, and contributions from the general public. Further, the organization has policies in place to ensure that the grant making staff does not know the identity or contributor status of the home seller or other parties who may benefit from the sale and does not accept contributions contingent on the sale of particular properties.

Because the organization described in Situation 1 relieves the poor and distressed, requires a home inspection to insure that the house is habitable, conducts educational seminars, has a broad based funding program, and has policies to ensure that the organization is not beholden to particular donors, the Service held that the organization is operated exclusively for charitable purposes and qualifies for exemption from federal taxation as an organization described in section 501(c)(3).

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The organization described in Situation 2 of Revenue Ruling 2006-27 is like that described in Situation 1 except that (1) its staff knows the identity of the party selling the home and may know the identity of other parties involved in the sale; (2) the organization receives a payment from the seller (the amount of which bears a direct correlation to the amount of down payment assistance provided) in substantially all the cases in which the organization provides assistance to the home buyers; and (3) most of its financial support comes from home sellers and related businesses that may benefit from the sale of homes to buyers who receive assistance from the organization.

Because the organization described in Situation 2 provides down payment assistance amounts that directly correlate to the amounts provided by home sellers and relies primarily on payments from home sellers and real-estate related businesses that stand to benefit from the transactions to finance its program, the Service held that the organization described in Situation 2 is not operated exclusively for exempt purposes and does not qualify for exemption from federal income tax as an organization described in section 501(c)(3).

### **Benefiting Private Interests**

Even if an organization's activities serve a charitable class or are otherwise charitable within the meaning of section 501(c)(3), the organization must show that its activities serve a public rather than a private interest within the meaning of Treas. Reg. § 1.501(c)(3)-1(d)(1).

In Rev. Rul. 72-147, 1972-1 C.B. 147, the IRS held that an organization that provided housing to low-income families did not qualify for exemption under section 501(c)(3) because it gave preference to employees of a business operated by the individual who also controlled the organization. The ruling concluded that, although providing housing for low-income families may further charitable purposes, doing so in a manner that gives preference to employees of the business of the organization's founder primarily serves the private interest of the founder rather than a public interest.

In Church by Mail, Inc. v. Commissioner, 765 F.2d 1387 (9<sup>th</sup> Cir. 1985), the Ninth Circuit held that a church that conducted its activities by mail did not qualify for exemption under section 501(c)(3) because a substantial purpose of its activities was to benefit a for-profit corporation controlled by the church's insiders. The church employed an advertising agency controlled by its insiders to provide all of the printing and mailing services for the church's mass mailings. The advertising agency devoted approximately two-thirds of its time to the work for the church. The majority of the church's income was paid to the advertising agency. Although the advertising agency claimed to have clients unrelated to the church, it did not advertise its services and refused to identify its other clients. The Ninth Circuit held that the church was operated for the substantial non-exempt purpose of "providing a market for [the advertising agency's] services"

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and, thus, primarily served the private interests of the advertising agency and its owners rather than a public interest. *Id.* at 1391.

In *KJ's Fund Raisers v. Commissioner*, T.C. Memo 1997-424 (1997), *aff'd*, 1998 U.S. App. LEXIS 27982 (2d Cir. 1998), the Tax Court held that an organization formed to raise funds for distribution to charitable causes did not qualify for exemption under section 501(c)(3) because the primary purpose of its activities was to attract customers to its founders' private business. The founders of the organization were the sole owners of KJ's Place, a lounge at which alcoholic beverages were served. The founders served as officers of the organization and, at times, also controlled the organization's board. The Tax Court found that the founders exercised substantial influence over the affairs of the organization.

KJ's Fund Raisers' business consisted of selling "Lucky 7" or similar instant win lottery tickets exclusively to patrons of KJ's Place. The lottery tickets were sold during regular business hours by the owners of the lounge and their employees. The organization derived most of its funds from its lottery ticket sales. The organization solicited no public donations. From the proceeds of the sales of the lottery tickets, the organization made grants to a variety of charitable organizations. Although supporting charitable organizations may be a charitable activity, the Tax Court nevertheless upheld the Commissioner's denial of exemption to the organization on the ground that the organization's operation resulted in more than incidental private benefit to KJ's Place and, indirectly, its owners. The Second Circuit affirmed.

### **Private Inurement**

An organization serves a private rather than a public interest within the meaning of Treas. Reg. § 1.501(c)(3)-1(d)(1) if any of its assets or earnings inure to the benefit of any insiders or other disqualified persons. *See* Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii). Although stated in terms of the "net earnings" of an organization, the inurement doctrine applies to any transfer of an organization's charitable assets. *See People of God Community v. Commissioner*, 75 T.C. 127, 133 (1980).

Excessive compensation for services is a form of inurement. For example, in *Mabee Petroleum Corp. v. U.S.*, 203 F.2d 872, 875 (5<sup>th</sup> Cir. 1953), the court held that payment of a full-time salary for part-time work constitutes inurement. Furthermore, payment to one person for services performed by another (or for services presumed to be performed, without any proof of performance) is a form of inurement. In *Church of Scientology v. Commissioner*, 823 F.2d 1310, 1314, 1317-18 (9<sup>th</sup> Cir. 1987), the court ruled that royalties received by the organization's founder on the sale of publications written by others were among the improper benefits received by the founder from the organization. In *The Founding Church of Scientology v. U.S.*, 412 F.2d 1197, 1202 (Ct.Cl. 1969), the court held that the organization's payment of salary to the

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founder's daughter constituted inurement without any proof that she actually performed any services for the organization.

The provision of inurement can be direct or indirect. In Church of Scientology v. Commissioner, *supra*, 823 F.2d at 1315, the organization transferred in excess of \$3.5 million to a for-profit corporation incorporated by the organization's founder and his wife. The directors of the corporation were high-ranking members of the Church of Scientology. The directors approved the founder's decision to transfer \$2 million from the corporation's account to the ship *Apollo*, aboard which the founder and his family lived. The Ninth Circuit held that the funds funneled through the for-profit corporation constituted inurement to the founder and his family. *Id.* at 1318.

In Anclote Psychiatric Ctr. v. Commissioner, T.C. Memo 1998-273 (1998), an organization's board of directors caused the organization to sell its largest asset – a hospital – to a for-profit entity formed by the directors. The Tax Court determined that the purchase price received by the organization on the sale of the hospital was below market. Accordingly, the Tax Court held that the sale transaction resulted in inurement within the meaning of section 501(c)(3). Although the for-profit corporation was the direct beneficiary of the below-market sale transaction, the Tax Court held that the transaction resulted in “an advantage” to the shareholders of the for-profit corporation and that this “advantage” constituted inurement of the organization's charitable assets to the shareholders.

The prohibition on inurement in section 501(c)(3) is absolute. The IRS has the authority to revoke an organization's exempt status for inurement regardless of the amount of inurement. See Spokane Motorcycle Club v. U.S., 222 F. Supp. 151 (E.D. Wash. 1963); The Founding Church of Scientology v. U.S., *supra*, 412 F.2d at 1202.

### **The Effective Date of Revocation**

As a general rule, an organization may rely on a favorable determination letter received from the Internal Revenue Service. See Treas. Reg. § 1.501(a)-1(a)(2); Rev. Proc. 2003-4, § 14.01 (cross-referencing § 13.01 *et seq.*), 2003-1 C.B. 123. An organization may not rely on a favorable determination letter, however, if it omitted or misstated a material fact in its application for exemption or in supporting documents. Furthermore, an organization may not rely on a favorable determination if there is a material change, inconsistent with exemption, in the organization's character, purposes, or methods of operation after the IRS has issued the determination letter. See Treas. Reg. § 601.201(n)(3)(ii); Rev. Proc. 90-27, § 13.02, 1990-1 C.B. 514.

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The Commissioner may revoke a favorable determination letter for good cause. See Treas. Reg. § 1.501(a)-1(a)(2). Revocation of a determination letter may be retroactive if the organization omitted or misstated a material fact or operated in a manner materially different from that originally represented. See Treas. Reg. § 601.201(n)(6)(i); Rev. Proc. 2003-4, § 14.01 (cross-referencing § 13.01 et seq.).

### THE INTERNAL REVENUE SERVICE'S POSITION

ORG does not qualify as an organization described in I.R.C. § 501(c)(3). ORG operates a program that does not serve exclusively an exempt purpose described in section 501(c)(3); it provides substantial private benefit to persons who do not belong to a charitable class, including its president; and its program results in inurement of a substantial portion of ORG's net earnings to the benefit of the organization's insiders, including its president.

Charitable purposes include relief of the poor and distressed. See Treas. Reg. § 1.501(c)(3)-1(d)(2). ORG's motto program does not operate for a primary purpose of addressing the housing needs of low-income people. See Rev. Rul. 70-585, Situation 1. At no time did its motto program serve exclusively low-income persons. ORG has offered no evidence to show it has income limitations for participation in its motto program. ORG does not screen applicants for its motto program based on their income. Its records do not include data on the buyers' incomes, instead, ORG's program is open to anyone, without income limitations, who otherwise qualified for a mortgage loan. ORG does not limit its program to first-time homebuyers.

ORG does not limit its motto program to certain geographic areas, and it does not target areas experiencing deterioration or neighborhood tensions. See Rev. Rul. 70-585, Situation 4. Motto is available for any residence where the buyer otherwise qualifies for a mortgage. Arranging or facilitating the purchase of homes in a broadly-defined geographic area does not combat community deterioration or serve other social welfare objectives within the meaning of section 501(c)(3).

Only an insubstantial portion of the activity of an exempt organization may further a non-exempt purpose. As the Supreme Court held in Better Business Bureau of Washington D.C., Inc. v. United States, supra, 326 U.S. at 283, the presence of a single non-exempt purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly exempt purposes. Even if ORG directed its program exclusively to low-income individuals or disadvantaged communities, its total reliance on sellers for financing its motto program demonstrates that ORG operates its motto program for the substantial purpose of benefiting private parties.

Like the organization considered in American Campaign Academy v. Commissioner, supra, 92 T.C. at 1053, ORG structured and operated its motto program to help the private parties who

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fund it and give it business. A seller who participates in ORG motto program benefits from access to a wider pool of potential buyers, thereby decreasing risk and the length of time the home is on the market. The seller also benefits by selling the home at its full listed price or by reducing the negotiated discount on the home. The various real estate professionals who participate in ORG 's motto program, from real estate brokers to escrow companies, benefit from increased sales volume and the attendant increase in their compensation. It is obvious that ORG's motto program provides ample private benefit to the various parties in each home sale.

The manner in which ORG operated its motto program shows that the private benefit to the various participants in ORG's activities, especially DIR-1, was the intended outcome of its operations rather than a mere incident of its operations. ORG designed its motto program to channel funds in a circular manner from the sellers to the buyers and back to the sellers in the form of proceeds from the sale of their homes that may have been sold at artificially inflated prices.

To finance its motto activities, ORG relies exclusively on sellers and other real-estate related businesses that will benefit from the transactions ORG facilitates. ORG neither solicits nor receives funds from sources other than the sellers of homes. Before providing a motto grant, ORG takes into account whether the home seller will make a payment to it to cover the motto grant the applicant has requested, as well as ORG's own fee. ORG requires the seller to reimburse it, dollar-for-dollar, for the amount of the motto grant given to the buyer of the home, plus an administrative fee of several hundred dollars per home sale. ORG secures an agreement from the seller stipulating to this arrangement prior to the closing. No motto transactions take place unless and until ORG has the seller's assurance that the seller will pay the amount of the motto grant plus ORG's fee. Its instructions to the title and escrow companies provide that at the close of escrow the seller's contribution, along with ORG's fees, must be sent to ORG within five days. ORG will not do business with escrow companies that do not disburse funds to it timely and appropriately. ORG's receipt of a payment from the home seller corresponding to the amount of the motto grant to be given to the buyer in virtually every transaction indicates that the benefit to the home seller (and others involved in the transaction) is not incidental to ORG's operations, but rather the intended outcome. In this respect, ORG is like the organization considered in Easter House v. U.S., *supra*, 12 Cl. Ct. at 476, which provided health care to indigent pregnant women, but only when a family willing to adopt a woman's child agreed to pay for the health care.

ORG's promotional materials, including its website and its marketing activities show that it operated in a manner consistent with a commercial firm seeking to maximize sales or services, rather than in a manner that is consistent with a charitable or educational organization seeking to serve one or more of the charitable purposes enumerated in section 501(c)(3). The manner in which ORG operated its motto program shows that it was in the business of facilitating the sales of homes in a manner indistinguishable from an ordinary trade or business. Thus, ORG's



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operations were similar to an organization which was denied exemption because it operated a conference center for commercial purposes. See Airlie Foundation v. Commissioner, *supra*, 283 F.Supp. 2d at 58.

Operating a trade or business of facilitating home sales is not an inherently charitable activity. Unlike the trade or business in Aid to Artisans, Inc. v. Commissioner, *supra*, 71 T.C. at 202, ORG did not use its motto program as a mere instrument of furthering charitable purposes but as an end in itself. ORG provided services to home sellers for which it charged a market rate fee. ORG did not market its services primarily to persons within a charitable class. Its primary goal was maximizing the fees it derived from facilitating the sales of real property. ORG did not solicit or receive any contributions from parties that did not have an interest in the motto program. Like the organizations considered in American Campaign Academy v. Commissioner, *supra*, 92 T.C. at 1077, and Easter House v. U.S., *supra*, 12 Cl. Ct. at 486, a substantial part of ORG's activities furthered commercial rather than exempt purposes.

Furthermore, ORG structured its motto program to provide a substantial private benefit to its insiders. ORG and CO-1, a for-profit corporation wholly-owned by DIR-1, had an exclusive marketing agreement whereby ORG carried out its motto program through CO-1. For 20XX, 20XX and 20XX, the years at issue, ORG was the source of substantially all, if not in fact all, of CO-1's gross revenues. Like the organizations described in Church by Mail Inc., v. Commissioner, *supra*, 765 F.2d at 1387, and KJ's Fund Raisers v. Commissioner, *supra*, T.C. Memo 1997-424, at least since the end of 20XX, ORG existed for the substantial nonexempt purpose of creating business for CO-1. Thus, like the organizations in Church by Mail and KJ's Fund Raisers, ORG's operations resulted in a substantial private benefit to ORG's insiders, CO-1 and CO-1's owner, DIR-1.

ORG's operations also resulted in inurement of its charitable assets to its insiders. Pursuant to its agreement with CO-1, ORG agreed that every grant made by ORG is attributable to marketing services performed by CO-1. As a result, ORG paid CO-1 the fee from every motto transaction without regard to whether there was proof of actual services performed by CO-1. Payment to one person for services performed by another (or for services presumed to be performed, without any proof of performance) constitutes inurement. See, e.g., Church of Scientology v. Commissioner, *supra*, 823 F.2d at 1317-18. Furthermore, where a party to a transaction giving rise to inurement is a for-profit corporation in which the organization's insiders are shareholders, the advantage accruing from the transaction to the shareholders who are insiders constitutes inurement. See Anclote Psychiatric Center v. Commissioner, T.C. Memo 1998-273. In the absence of proof that every motto transaction engaged in by ORG was actually attributable to CO-1's services, ORG's marketing arrangement with CO-1 will be treated as resulting in inurement of ORG's net earnings to CO-1, and indirectly, to its sole shareholder, DIR-1.

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ORG is very similar to Situation 2 of Rev. Rul. 2006-27, where to finance its motto activities, ORG relies on sellers and other real-estate related businesses that stand to benefit from the transactions ORG facilitates. Further more, in deciding whether to provide assistance to a low-income applicant, ORG's grant making staff know the identity of the home seller and may also know the identities of other interested parties and is able to take into account whether the home seller or another interested party is willing to make a payment to ORG. ORG's receipt of a payment from the home seller corresponding to the amount of the motto is substantially all of the transactions, and ORG's reliance on these contributions for most of its funding indicate that the benefit to the home seller is a critical aspect of ORG's operations. In this respect, ORG is like the organization considered in Easter House, which received all of its support from fees charged to adoptive parents, so that the business purpose of the adoption service because its primary goal and overshadowed any educational or charitable purposes. Like the organization considered in American Campaign Academy, ORG is structured and operated to assist private parties who are affiliated with its funders. Like the organization considered in American Campaign Academy, Easter House, and Columbia Park Recreation Associations, ORG does not operate exclusively for exempt purposes.

Based on the foregoing, ORG does not operate exclusively for exempt purposes, and, accordingly, is not entitled to exemption under section 501(c)(3). The IRS proposes revocation of ORG's exemption back to January 1, 20XX. Since then, the organization has operated in a manner materially different from that represented in its Form 1023 and upon which the IRS granted ORG its tax exemption.

#### **THE TAXPAYER'S POSITION**

ORG has indicated its agreement to the government's position of revocation of exemption effective January 1, 20XX, by signing Form 6018 Consent to Proposed Action Section 7428.

#### **CONCLUSION**

ORG does not operate exclusively for exempt purposes, and, accordingly, is not entitled to exemption under section 501(c)(3). The IRS proposes revocation of ORG's exemption back to January 1, 20XX (the earliest year under examination). Since then, the organization has operated in a manner materially different from that represented in its Form 1023 and upon which the IRS granted ORG its tax exemption.



TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

DEPARTMENT OF THE TREASURY

Internal Revenue Service  
Attention: Terri Anderson, Stop 4925STP  
30 East 7th Street, Suite 1130B  
St. Paul, MN 55101

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:  
Publication 892  
Publication 3498  
Report of Examination