



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Release Number: **201041047**

Release Date: 10/15/10

Date: July 20, 2010

Uniform Issue List:

501.00-00

501.03-00

501.03-08

501.33-00

Contact Person:

Identification Number:

Contact Number:

Employer Identification Number:

Form Required To Be Filed:

Tax Years:

Dear

This is our final determination that you do not qualify for exemption from Federal income tax as an organization described in Internal Revenue Code section 501(c)(3). Recently, we sent you a letter in response to your application that proposed an adverse determination. The letter explained the facts, law and rationale, and gave you 30 days to file a protest. Since we did not receive a protest within the requisite 30 days, the proposed adverse determination is now final.

Because you do not qualify for exemption as an organization described in Code section 501(c)(3), donors may not deduct contributions to you under Code section 170. You must file Federal income tax returns on the form and for the years listed above within 30 days of this letter, unless you request an extension of time to file. File the returns in accordance with their instructions, and do not send them to this office. Failure to file the returns timely may result in a penalty.

We will make this letter and our proposed adverse determination letter available for public inspection under Code section 6110, after deleting certain identifying information. Please read the enclosed Notice 437, *Notice of Intention to Disclose*, and review the two attached letters that show our proposed deletions. If you disagree with our proposed deletions, follow the instructions in Notice 437. If you agree with our deletions, you do not need to take any further action.

In accordance with Code section 6104(c), we will notify the appropriate State officials of our determination by sending them a copy of this final letter and the proposed adverse letter. You should contact your State officials if you have any questions about how this determination may affect your State responsibilities and requirements.

If you have any questions about this letter, please contact the person whose name and telephone number are shown in the heading of this letter. If you have any questions about your Federal income tax status and responsibilities, please contact IRS Customer Service at 1-800-829-1040 or the IRS Customer Service number for businesses, 1-800-829-4933. The IRS Customer Service number for people with hearing impairments is 1-800-829-4059.

Sincerely,

Robert Choi
Director, Exempt Organizations
Rulings & Agreements

Enclosure
Notice 437
Redacted Proposed Adverse Determination Letter
Redacted Final Adverse Determination Letter



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Date: May 12, 2010

Contact Person:

Uniform Issue List:

- 501.00-00
- 501.03-00
- 501.03-08
- 501.33-00

Identification Number:

Contact Number:

FAX Number:

Employer Identification Number:

Legend:

| | |
|------------------------|---|
| <u>Taxpayer</u> | = |
| <u>State</u> | = |
| <u>Director 1</u> | = |
| <u>Director 2</u> | = |
| <u>Day Care Center</u> | = |
| <u>Karate School</u> | = |
| <u>x</u> | = |
| <u>x2</u> | = |

Dear

We have considered your application for recognition of exemption from Federal income tax under Internal Revenue Code section 501(a) ("Code"). Based on the information provided, we have concluded that you do not qualify for exemption under Code section 501(c)(3). The basis for our conclusion is set forth below.

FACTS

You were incorporated under the State Nonprofit Public Benefit Corporation Law for the specific purpose of operating for charitable purposes within the meaning of section 501(c)(3) of the Internal Revenue Code. Specifically you state that you intend to provide "educational services to disenfranchised groups and low income families" Your application and supporting documents reflect the intention to engage in the following activities:

- provide financial assistance to low-income families in the form of child-care scholarships,
- provide after-school tutoring to the open community, specializing in students with learning disabilities, and
- prevent crime by providing recreational classes to the open community during after-school hours.

You state that your primary activity is to provide financial assistance to low-income families in the form of child-care scholarships. You plan on providing these scholarships exclusively to the students of Day Care Center, a day care center owned and operated by Director 1 and Director 2. You state that your goal is to provide 15 scholarships to students already attending Day Care Center. This scholarship would specifically cover the cost of an increase in tuition charged by Day Care Center. The program imposes a monthly income limit based on family size in order to qualify for the scholarships. You state that without this assistance it is likely that one-third of the low and low-moderate income students will be unable to continue to attend the day care center.

In addition to the scholarship program, you plan to tutor children with learning disabilities. You state that students will be "academically assessed" by you and "grouped by ability." You would tutor children "twice a week." You did not provide any other information relating to your tutoring program. You also plan on offering an after-school recreational program that offers instruction in karate. You state that you formed a partnership with karate school, Karate School. This program would require a monthly tuition fee of \$x1. Later, you informed us that you are no longer planning on partnering with Karate School. You state that you still intend to provide this program, however you did not provide any additional information regarding this program.

You expect to seek funding primarily from institutional sources such as the government, foundations, and corporations. You have applied for one government block grant. According to your revised statement of revenues and expenses, you plan to spend \$x2 on your scholarship program. You have not allocated any funding for your tutoring program or after-school recreational program.

Your Board of Directors is made up of three individuals. Two of your Directors, Director 1 and Director 2 are family members and are the owners of Day Care Center. In addition, you state that Director 1 is also your Chief Executive Officer, and Director 2 is your Chief Financial Officer.

Your administrative offices are located on the grounds of Day Care Center. You propose to lease space from Day Care Center for \$ per month. You do not have a lease agreement in place with Day Care Center. You state that other locations have agreed to lease space to you if necessary, but did not provide additional information regarding those potential leases.

LAW

Section 501(a) of the Internal Revenue Code ("Code") provides that an organization described in sections 501(c) or (d) or section 401(a) shall be exempt from taxation under this subtitle unless such exemption is denied under sections 502 or 503.

Section 501(c)(3) of the Code exempts from federal income tax corporations organized and operated exclusively for charitable, educational and other purposes, provided that no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(a)(1) of the Income Tax Regulations ("Regulations") provides that in order to qualify for exemption, an organization must be both organized and operated exclusively for one or more exempt purposes. If an organization fails to meet either of the above tests, the organization will not qualify for exemption.

Section 1.501(c)(3)-1(c)(1) of the Regulations states 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) of the Code. 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 provides 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)(ii) of the Regulations provides that an organization is not organized or operated exclusively for one or more of the purposes specified in subdivision (i) of this subparagraph unless it serves a public rather than a private interest. Thus, to meet the requirement of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

In Rev. Rul. 70-533, 1970-2 CB 112, the organization was formed to operate a work related child care and development center. The center operates in conjunction with an industrial company to provide preschool school age children of factory workers with an educational program and care during the work day. The center enrolls pre-school age children of employees of the company, children of parents employed in nearby factories, and children of parents recommended through contacts with antipoverty and welfare agencies. Employment with the company does not give any employee the right to have his child enrolled at the center. Children are selected on the basis of the financial need of the family and the need of a child for the care and development program. It was held that this organization was exempt from federal income tax under section 501(c)(3) of the Code.

Rev. Proc. 2010-9, 2010-2 I.R.B. 258 provides in part that exempt status will be recognized in advance of operations if 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 statement 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, and the nature of the 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 required before a ruling or determination letter will be issued.

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." Better Business Bureau of Washington, D.C., Inc. v. United States, 326 U.S. 279, 283 (1945).

In United Cancer Council, Inc. v. Commissioner of Internal Revenue, 165 F.3d 1173, 1176 (1999), the court provided that the term any private shareholder or individual in the inurement clause of section 501(c)(3) of the Code has been interpreted to mean an insider of the charity. Additionally the court stated that a "charity is not to siphon its earnings to its founder, or the

members of its board, or their families, or anyone else fairly to be described as an insider, that is, as the equivalent of an owner or manager.”

In est of Hawaii v. Commissioner, 71 T.C. 1067 (1979), several for-profit est organizations exerted significant indirect control over est of Hawaii, a non-profit entity, through contractual arrangements. The Tax Court concluded that the for-profits were able to use the non-profit as an “instrument” to subsidize their for-profit purposes. The fact that amounts paid to the for-profit organizations under the contracts were reasonable did not affect the court’s conclusion. Consequently, est of Hawaii did not qualify as an organization described in section 501(c)(3).

In American Campaign Academy v. Commissioner, 92 T.C. 1053 (1989), the court stated that when an organization operates for the benefit of private interest, the organization by definition does not operate exclusively for exempt purposes. Prohibited private benefits may include an advantage; profit; fruit; privilege; gain; or interest. Occasional economic benefits flowing to persons as an incidental consequence of an organization pursuing exempt charitable purposes will not generally constitute prohibited private benefits. Thus, should the organization be shown to benefit private interests, it will be deemed to further a nonexempt purpose under section 1.501(c)(3)-1(d)(1)(ii) and will prevent an organization from operating primarily for exempt purposes absent showing that no more than an insubstantial part of its activities further private interests or any other nonexempt purposes.

In Church By Mail, Inc. v. Commissioner, 765 F.2d 1387, 1392 (9th Cir. 1985), the court in determining that a non-profit was operated for substantial non-exempt purposes and that income inured to the benefit of private persons stated that “[t]he critical inquiry is not whether particular . . . payments to a related for-profit organization are reasonable or excessive, but whether the entire enterprise is carried on in such a manner that the for-profit organization benefits substantially from the operation of the [non-profit].” The court additionally upheld the Tax Court’s determination that church was operated for substantial nonexempt purpose of providing a market for services of advertising agency, a for-profit organization owned and controlled by ministers of church.

In Wendy Parker Rehabilitation Foundation Inc. v. Commissioner, 52 T.C.M. (CCH) 51 (1986), the Tax Court upheld the Service’s position that a foundation formed to aid coma victims, including a family member of the founders, was not entitled to recognition of exemption due to inurement. The organization received voluntary contributions, a portion of which were expended for the benefit of a named beneficiary, Wendy Parker. The officers and directors of the organization were all relatives of Wendy Parker. The Court also noted that such distributions relieved the family from the economic burden of providing medical care and rehabilitation care for their family member and, therefore, constituted inurement to the benefit of private individuals.

ANALYSIS

Based on the facts presented in your application, we conclude that you are not operated for exempt purposes. Accordingly, you do not qualify for exemption as an organization described in section 501(c)(3) of the Code.

Your application and supporting documentation must demonstrate that your organization meets the operational test under section 1.501(c)(3)-1(a)(1) of the Regulations. Exempt organizations must operate exclusively for exempt purposes. I.R.C. § 501(c)(3). The term exclusively has been interpreted to mean primarily. Treas. Reg. § 1.501(c)(3)-1(c)(1). A single substantial non-exempt purpose is sufficient to prevent exemption. Better Business Bureau, 326 U.S. at 283. If an organization fails the operational test, it cannot qualify as an exempt organization under section 501(c)(3) of the Code.

A taxpayer has the burden of proof to show that they serve the public rather than the private interests of designated individuals, the creator, or person controlled, directly or indirectly by private interests. Treas. Reg. § 1.501(c)(3)-(d)(1)(ii). If an organization's net earnings inure in whole or in part to the benefit of a private individual, then that organization is not operated exclusively for exempt purposes. Treas. Reg. § 1.501(c)(3)-1(c)(2). A private shareholder or individual is defined as person or persons having a personal and private interest in the activities of the organization. Treas. Reg. § 1.501(a)-1(c). You have not demonstrated that you are not operated for private interests.

You are directly controlled by Director 1 and Director 2, who also own and operate for-profit Day Care Center. Director 1 and Director 2 are also your officers. Your activities are carried on in such a manner that the for-profit organization benefits substantially. Your purpose is to provide scholarships to the children attending Day Care Center so that they can afford an increase in tuition. You do not provide scholarships that pay for child-care costs at any other facility. These scholarships promote the business of Director 1, Director 2, and Day Care Center. As such you are operated for the private interests of Director 1, Director 2, and Day Care Center.

Additionally, operating for the purpose of providing a market for a for-profit corporation is not an exempt purpose and provides a private benefit to the for-profit. In Church By Mail, 765 F.2d at 1392, the court upheld the Tax Court's determination that the non-profit was operated for substantial nonexempt purpose of providing a market for services of a for-profit advertising agency that was owned and controlled by insiders of the church. Similar to the organization in Church by Mail, you are operated for the benefit of a for-profit organization. You were created to prevent Day Care Center from losing "one-third" of its students due to a tuition increase. You are also similar to the organization in est of Hawaii, 71 T.C. at 1082, where several for-profit est organizations exerted significant indirect control over est of Hawaii, a non-profit entity, through contractual arrangements. The Tax Court concluded that the for-profits were able to use the non-profit as an "instrument" to further their for-profit purposes. Day Care Center is furthering its for-profit business by ensuring that students do not withdraw from the center due to an increase in tuition.

You are distinguishable from the organization described in Rev. Rul. 70-533. While the organization in this revenue ruling provided benefits to any child, including pre-school age children of employees of the company, children of parents employed in nearby factories, and children of parents recommended through contacts with antipoverty and welfare agencies, your scholarships are limited to children who are enrolled at Day Care Center. Your operation is designed to directly promote and benefit the business of Day Care Center, thereby serving the private interest of the Day Care Center, Director 1, and Director 2. Since net earnings of your organization inure to the benefit of persons having a personal interest in your activities, you are not operated exclusively for exempt purposes. Treas. Reg. § 1.501(c)(3)-1(c)(2).

You are also providing a private benefit to the children of Day Care Center. Like the organization in Wendy Parker Rehabilitation Foundation, 52 T.C.M. (CCH) 51, you have formed an organization solely to aid the students who attend Day Care Center by providing partial scholarships to specific students to cover the cost of an increase in their tuition. While your scholarship program may benefit persons who may be within certain income limitations, this program serves already identified children of Day Care Center. In this respect, your scholarship program accomplishes activities that are not exclusively in furtherance of one or more exempt purposes because they further the private purposes of Day Care Center's students and not the general public as required under Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii).

By serving primarily private interests, you are not operated exclusively for an exempt purpose. See Treas. Reg. §§ 1.501(c)(3)-1(c)(1) 1.501(c)(3)-1(d)(1)(ii). However, even if you were not operated for the private interests of Director 1, Director 2, and Day Care Center, you have not provided sufficient detail to conclude that you are operated for an exempt purpose. Under Rev. Proc. 2010-9, 2010-2 I.R.B. 258 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. An organization must fully describe the activities in which it expects to engage, including the standards, criteria, procedures, or other means adopted or planned, and the nature of the contemplated expenditures.

You refer to both an after-school tutoring program for students with learning disabilities and a program to provide recreational classes such as karate, but have not described those programs in any detail. When asked to provide additional information on those programs, you did not describe the standards, criteria, or procedures for these programs. For example, you did not provide information regarding the number of students you expect to attend, how you will recruit those students, the curriculum you will teach, etc. Additionally, your statement of revenues and expenditures does not show any financial allocations for these programs. As such, you have not met your burden of disclosing all the facts bearing on your organization, operations and finances that would allow us to make a decision about your activities. Rev. Proc. 2010-9, *supra*.

CONCLUSION

Based on the information provided, we are not able to conclude that you are operated exclusively for public rather than private purposes. Despite any charitable purposes your activities may achieve, you cannot qualify for tax exemption because more than an insubstantial part of your activities are not in furtherance of exempt purposes.

You have the right to file a protest if you believe this determination is incorrect. To protest, you must submit a statement of your views and fully explain your reasoning. You must submit the statement, signed by one of your officers, within 30 days from the date of this letter. We will consider your statement and decide if the information affects our determination.

Your protest statement should be accompanied by the following declaration:

Under penalties of perjury, I declare that I have examined this protest statement, including accompanying documents, and, to the best of my knowledge and belief, the statement contains all the relevant facts, and such facts are true, correct, and complete.

You also have a right to request a conference to discuss your protest. This request should be made when you file your protest statement. An attorney, certified public accountant, or an individual enrolled to practice before the Internal Revenue Service may represent you. If you want representation during the conference procedures, you must file a proper power of attorney, Form 2848, *Power of Attorney and Declaration of Representative*, if you have not already done so. For more information about representation, see Publication 947, *Practice before the IRS and Power of Attorney*. All forms and publications mentioned in this letter can be found at www.irs.gov, Forms and Publications.

If you do not file a protest within 30 days, you will not be able to file a suit for declaratory judgment in court because the Internal Revenue Service (IRS) will consider the failure to protest as a failure to exhaust available administrative remedies. Code section 7428(b)(2) provides, in part, that a declaratory judgment or decree shall not be issued in any proceeding unless the Tax Court, the United States Court of Federal Claims, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted all of the administrative remedies available to it within the IRS.

If you do not intend to protest this determination, you do not need to take any further action. If we do not hear from you within 30 days, we will issue a final adverse determination letter. That letter will provide information about filing tax returns and other matters.

Please send your protest statement, Form 2848 and any supporting documents to this address:

Internal Revenue Service
1111 Constitution Ave, N.W.
Washington, DC 20224

You may also fax your statement using the fax number shown in the heading of this letter. If you fax your statement, please call the person identified in the heading of this letter to confirm that he or she received your fax.

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

Sincerely,

Robert Choi
Director, Exempt Organizations
Rulings & Agreements