NO PROTEST RECEIVED
Release to Manager/EO Determinations [illegible]

DATE: [redacted]

SURNAME [redacted]

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

Date: JUL 11 2001

Contact Person: [redacted]
ID Number: [redacted]
Telephone: [redacted]

[redacted]

Employer Identification Number: [redacted]

Dear Applicant:

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

You were incorporated on [redacted] as a [redacted] not-for-profit corporation. Article 3 of your Certificate of Incorporation states that your activities will include grant making to enhance academic and educational opportunities for public school students; and the oversight, planning and making of grants for construction and reconstruction of public school facilities that further the charitable and educational purposes of independent charter schools and public school districts.

Article III Section 2 of your Bylaws provide that a majority of the Board of Directors must consist of individuals who are not affiliated with [redacted].

Article III section 11 states that any Director with a financial interest in a contract or transaction with you must disclose it. Such transaction must be approved by a majority of disinterested Directors.

Form 1023, Part II, Question 10(a) states that [redacted] will provide office space, supplies, accounting services, personnel services, legal services and other services, and that the applicant will compensate [redacted] based on the actual costs. The agreement between [redacted] and the Applicant must be renewed annually and will not

[redacted]

[redacted]

renew automatically.

Form 1023 Part II Question 12(b) states *"the Organization expects to conduct its charitable activities principally, but not exclusively, to benefit school districts, and/or charter school boards that have retained [redacted] to assume educational and operational responsibility for individual schools. However, the Organization will not necessarily limit its charitable activities to school districts and charter school boards that have retained [redacted]"* (Emphasis added.)

You state that you may offer some of your programs to public or charter schools that have not retained [redacted]

The Chairman of [redacted], is the Chairman of your Board of Directors. The President of [redacted] is one of your directors. A third director, [redacted], is the vice-chairman of [redacted], which owns 6% of [redacted] though its affiliates, [redacted] and [redacted]. The remaining four directors are [redacted], and [redacted].

All [redacted] holdings of [redacted] CEO and president of [redacted] and [redacted] are pledged to [redacted] as security for certain loans. In the event of a foreclosure, [redacted] affiliates would own over 16% of the voting power of [redacted], a [redacted] affiliate served as an underwriter of [redacted] two public offerings.

Section 501(c)(3) of the Internal Revenue Code provides an exemption for exemption from federal income tax for a corporation, community chest, fund, or foundation that is organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary or educational purposes.

Section 1.501(c)(3)-1(c)(1) of the Income Tax 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. 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, in part, 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. The words private shareholder or individual refers to persons having a personal and private interest in the activities of the organization.

[redacted]

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations provides, in part, that an organization is not organized or operated for one or more...[exempt] purposes...unless it serves a public rather than a private interest. Thus to meet the requirement of this subdivision, an organization must establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled directly or indirectly by such private interests.

The existence of a single nonexempt purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly exempt purposes. Better Business Bureau v. United States, 326 U.S. 279, 283 (1945). Operating for the benefit of private parties constitutes a substantial nonexempt purpose. Old Dominion Box Co. v. United States, 477 F.2d 340 (4th Cir. 1973), cert. denied 413 U.S. 910 (1973).

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

The petitioner in est of Hawaii, 71 T.C. 1067 (1979), conducted training, seminars and lectures in the area of intrapersonal awareness. Such activities were conducted under licensing arrangements with various for-profit corporations. The licensing agreements were conditioned on the petitioner maintaining tax exempt status. petitioner argued that it had no commercial purpose of its own and that its payments to the for-profits were just ordinary and necessary business expenses. The Court did not agree, and stated:

> To accede to petitioner's claim that it has no connection with International (the for-profit licensor of the educational program) is to ignore reality. While it may be true that the same individuals do not formally control them, International exerts considerable control over petitioner's activities. It sets the tuition for the standard training and requires a minimum number of such trainings. It requires petitioner to conduct regular seminars and to host special events. It controls the programs conducted by petitioner by providing trainers who are salaried by and responsible to EST, Inc., and it further controls petitioner's operations by providing management personnel who are paid by and responsible to EST, Inc. In short, petitioner's only function is to present to the public for a fee ideas that are owned by International with materials and trainers that are supplied and controlled by EST, Inc. Moreover, we note that petitioner's rights vis-à-vis EST, Inc., International,

and PSMA are dependent on the existence of its tax-exempt status--an element that indicates the possibility, if not the likelihood that the for-profit corporations were trading on such status...

Regardless of whether the payments made by petitioner to International were excessive, International and EST, Inc., benefited substantially from the operation of petitioner, (Emphasis added).

In P.L.L. Scholarship v. Commissioner, 82 T.C. 196 (1984), an organization operated bingo at a bar for the avowed purpose of raising money for scholarships. The board included the bar owners, the bar's accountant, also a director of the bar, as well as two players. The board was self-perpetuating. The Court reasoned that since the bar owners controlled the organization and appointed the organization's directors, the organization's activities could be used to the advantage of the bar owners. The organization claimed that it was independent because the bar received no payments and there was separate accounting. The Court was not persuaded:

A realistic look at the operation of these two entities, however, shows that the activities of the taxpayer and the Pastime Lounge were so interrelated as to be functionally inseparable. Separate accountings of receipts and disbursements do not change that fact.

The Court concluded that the organization had a substantial nonexempt purpose.

In KJ's Fund Raisers, Inc. v. Commissioner, T.C. Memo 1997-424 (1997), affirmed 82 AFTR 2d 7092 (1998), the Tax Court found that another gaming organization was not exempt. Although the organization raised money for charitable purposes, it also operated for the substantial benefit of private interests. The organization's founders were the sole owners of a bar, KJ's Place. The organization, through the owners and employees of KJ's Place, sold lottery tickets exclusively at KJ's Place during regular business hours. While in KJ's Place, the lottery ticket purchasers were sold beverages from the bar. The Court concluded that KJ's Fund Raisers, Inc. was operated for substantial private benefit and did not qualify for exemption. The Court of Appeals affirmed the decision and found that the organization had served the private interests of its founders.

In Church by Mail, Inc. v. Commissioner, 48 T.C.M. 471 (1984), aff'd 765 F.2d 1387 (9th Cir. 1985), the Court affirmed a Tax Court decision. Church by Mail sent out sermons in numerous mailings, which necessitated a significant amount of printing services. Twentieth Century Advertising Agency, which was controlled by the two

[redacted]

ministers who controlled Church by Mail, provided the printing and the mailing. The same ministers controlled Twentieth Century. Church by Mail business comprised two-thirds of the business of Twentieth Century. In deciding for the government, the Court makes the following statement:

> There is ample evidence in the record to support the Tax court's finding that the Church was operated for the substantial non-exempt purpose of providing a market for Twentieth's services. The employees of Twentieth spend two-thirds of their time working on the services provided to the church. The majority of the Church's income is paid to Twentieth to cover repayments on loan principal, interest, and commissions. Finally, the potential for abuse created by the ministers' control of the Church requires open and candid disclosure of facts bearing upon the exemption application. Moreover, the ministers' dual control of both the Church and Twentieth enables them to profit from the affiliation of the two entities through increased compensation.

The Church argued that the compensation to Twentieth was reasonable. The Court's statement on the subject is very significant:

> The Church exaggerates the importance of the contracts. The critical inquiry is not whether particular contractual payments to a related for-profit organization are reasonable or excessive, but instead *whether the entire enterprise is carried on in such a manner that the for-profit benefit substantially from the operation.(Emphasis added).*

In Wendy L. Parker Rehabilitation Foundation v. C.I.R., T.C. Memo 1986-348, the court denied exemption to an organization created to aid the victims of comas because thirty percent of the organization's income was expended to benefit Wendy Parker, a coma victim whose family controlled the organization.

In American Campaign Academy v. Commissioner, 92 T.C.1053 (1989), the Tax Court concluded that an organization which ran a school to train campaign professionals was not described in section 501(c)(3) because it benefited a private group rather than the general public. The organization trained campaign professionals who served exclusively on the campaigns of Republican candidates. Two of the three directors of the organization had substantial ties to the Republican Party. The National Republican Congressional Trust funded the organization and the National Republican Congressional Committee contributed some physical assets to the organization. The Court determined the private benefit to Republican candidates to be more than incidental, and concluded that the organization could not confer substantial benefits on disinterested persons and still serve public purposes within the meaning of section 1.501(c)(3)-1(d)(1)(ii) of the regulations.

In International Postgraduate Medical Foundation v. Commissioner, TCM 1989-36 (1989), the Tax Court considered the qualification for exemption under section 501(c)(3) of the Code of a non-profit corporation that conducted continuing medical education tours. The petitioner had three trustees: Mr. Helin, who was a shareholder and the president of H & C Tours, a for-profit travel agency. Mr. Regan, an attorney, and a third director who was ill and did not participate. Mr. Helin served as executive director. The petitioner shared offices with H & C Tours. The petitioner used H & C Tours exclusively for all travel arrangements. The petitioner's contract with H & C Tours permitted it to acquire competitive bids, but provided that H & C Tours would always get the bid if it was within 2.5%. There is no evidence that the petitioner ever sought a competitive bid. The Court found that a substantial purpose of the petitioner was benefiting the for-profit travel agency. It concluded that:

> When a for-profit organization benefits substantially from the manner in which the activities of a related organization are carried on, the latter organization is not operated exclusively for exempt purposes within the meaning of section 501(c)(3) even if it furthers other exempt purposes.
>
> We find that a substantial purpose of petitioner's operations was to increase the income of H & C Tours. H & C Tours benefits from the distribution and production of brochures which solicit customers for tours arranged by H & C Tours. Approximately 90 percent of petitioner's total revenue for 1977 were expended on production and distribution of brochures. The terms of the Travel Service and Administrative Support Agreement further insured that H & C Tours would substantially benefit from petitioner's operations. Petitioner did not solicit competitive bids from any travel agency other than H & C Tours.

Section 4945 of the Code provides that a grant by a private foundation to an individual for educational purposes is a taxable expenditure by the private foundation unless it satisfies certain requirements. Generally, when an employer makes educational grants available to its employees or their family members on a preferential basis, the employer-employee relationship indicates that the purpose is to compensate or otherwise provide an employment incentive to the employee,, rather than a scholarship or grant.

Rev. Proc 76-47, 1976 C.B. 670 provides guidelines to be used where grants are made by a private foundation under an employer related grant program. Sections 4.01 through 4.07 set forth seven conditions that must be satisfied in order for the Service to determine that grants from a private foundation under an employer-related grant program will qualify as scholarships:

[redacted]

1) The programs may not be used to recruit new employees or induce employees to stay;

2. The selection committee must be totally independent from the private foundation its organizer and the employer concerned.

3. Minimum eligibility standards must be imposed that in general do not refer to employment related factors.

4. Selection of grant recipients must be based solely upon substantial objective standards that are completely unrelated to the employment of the recipients or their parents and to the employer's line of business;

5. The grant may not be terminated because the recipient or parent of the recipient terminates employment with the employer subsequent to the awarding of the grant.

6. The course of study for which grants are available must not be limited to those that would be of particular benefit to the employer or to the foundation

7. The terms of the grant must meet be consistent with a disinterested purpose of enabling the recipients to obtain an education in their individual capacities solely for their own benefit and not for the benefit of the employer.

Rev. Proc . 80-39, 1980-2 C.B. 772 applies these conditions to the determining whether educational loans made by a private foundation under an employer-related loan program are taxable expenditures under section 4945, and whether such a loan program serves charitable purposes described in section 501(c)(3).

Section 501(c)(3) of the Code sets forth two tests for qualification for exempt status. An organization must be both organized and operated exclusively for purposes described in section 501(c)(3). If applicant fails either the organizational or operational test, it will not be recognized as exempt from taxation as a 501(c)(3) organization. Applicant satisfies the organizational test. The issue is whether you are operated so that no more than an insubstantial part of your activities further a non-exempt purpose. Better Business Bureau, supra.

Your bylaws provide that a majority of your directors are not related to [redacted] or its major shareholders. Although the majority of the Board of Directors is not related to [redacted] or its major shareholders, there is a significant connection. Two of your seven directors are officers in [redacted]. A third is an officer of an entity that owns 6% of [redacted] through its affiliates, and has underwritten [redacted]'s two public offerings. The

[redacted]

CEO of [redacted] has pledged his ownership interest in [redacted] to this entity as security for certain loans. In the event of foreclosure, it would have a 16% interest in [redacted]

You have entered into a management agreement with [redacted] the terms of which provide in essence that [redacted] will provide administrative and personnel services, as well as office space to you at cost. Approval to renew the agreement must be obtained from the Board of Directors on an annual basis. The facts that a for-profit lacks structural control over an organization, and that amounts paid by it to the for-profit under contracts are reasonable does not preclude a finding that the for-profit entity is using the non-profit as an instrument to further its for-profit purposes. In Church by Mail and est of Hawaii, the Courts looked to the business relationship between the exempt entity and the related for-profit entity. The Courts viewed these relationships as ones in which the exempt organization was merely the instrument of the for profit corporation to further its business operations. You state, at Form 1023 Part II question 12, that you expect to conduct your activities primarily to benefit school districts and/or charter school boards that have retained [redacted]. Your stated purpose is to primarily fund organizations that have contracted with [redacted], a for-profit company. Your program can be used by [redacted] to induce potential customers to contract with it, in that your funds will be primarily available to those who contract with [redacted]. In this regard, you are similar to the organization described in Rev. Proc. 76-47 because in both cases charitable funds are being used as an inducement by private companies. Your funds are not restricted to 501(c)(3) activities because your eligible grantees need not be tax exempt under section 501(c)(3) or governmental agencies so long as they have contracted with [redacted]. Your purpose is so intertwined with the interests of [redacted] as to make you an instrumentality of [redacted]. Based on the above, you serve the private interests of [redacted] in a manner that is inconsistent with section 1.501(c)(3)-1(d)(1)(ii) of the regulations.

Accordingly, you do not qualify for exemption as an organization described in section 501(c)(3) of the Code and you must file federal income tax returns.

Contributions to you are not deductible under section 170 of the Code.

You have the right to protest this ruling if you believe it is incorrect. To protest, you should submit a statement of your views, with a full explanation of your reasoning. This statement, signed by one of your officers, must be submitted within 30 days from the date of this letter. You also have a right to a conference in this office after your statement is submitted. You must request the conference, if you want one, when you file your protest statement. If you are to be represented by someone who is not one of your officers, that person will need to file a proper power of attorney and otherwise qualify under our Conference and Practices Requirements.

[redacted]

If you do not protest this ruling in a timely manner, it will be considered by the Internal Revenue Service as a failure to exhaust available administrative remedies. Section 7428(b)(2) of the Code provides, in part, that a declaratory judgment or decree under this section shall not be issued in any proceeding unless the Tax Court, the 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 administrative remedies available to it within the Internal Revenue Service.

If we do not hear from you within 30 days, this ruling will become final and a copy will be forwarded to the Ohio Tax-Exempt and Government Entities (TE/GE) office. Thereafter, any questions about your federal income tax status should be directed to that office, either by calling 877-829-5500 (a toll free number) or sending correspondence to: Internal Revenue Service, TE/GE Customer Service, P.O. Box 2508, Cincinnati, OH 45201. The appropriate State Officials will be notified of this action in accordance with Code section 6104(c).

When sending additional letters to us with respect to this case, you will expedite their receipt by using the following address:

Internal Revenue Service
Attn: T: EO: RA: T: 4
1111 Constitution Ave., N.W.
Washington, D.C. 20224

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

Sincerely,

(signed) Gerald V. Sack

Gerald V. Sack
Manager, Exempt Organizations
Technical Group 4

cc: [redacted]