



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

EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

SEP 25 2003

Date:

[REDACTED]

Contact Person:

[REDACTED]

ID Number:

[REDACTED]

Telephone Number:

[REDACTED]

Employer Identification Number:

[REDACTED]

NO PROTEST RECEIVED  
Release to Manager, EO Determinations - Cincinnati

DATE:

[REDACTED]

SURNAME

[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 conclude that you have not established that you are organized or operated exclusively for the exempt purposes described in section 501(c)(3) of the Code. The basis for our conclusion is set forth below.

[REDACTED] was incorporated under [REDACTED] law on [REDACTED]. [REDACTED] was formed in [REDACTED] for the purpose of acquiring from the general public donations of products and services and trade credits in order to benefit the [REDACTED] chapters. [REDACTED] is applying as a public charity under section 509(a)(1) and 170(b)(1)(A)(vi) of the Code.

[REDACTED] obtains trade credits from the general public and, through a third person, redeems these trade credits for items that [REDACTED] needs. According to the development letter dated [REDACTED], response # [REDACTED] the trade credit is described as follows:

"Trade-credits are non-monetary credits which are used in barter exchange programs between individuals and businesses to exchange goods and services.... While the trade-credits are not exchangeable directly for cash and are, therefore, non-negotiable, they can be traded or exchanged for things of value. In and of themselves, trade credits donated to or for the benefit of [REDACTED] Chapters are useless to [REDACTED] Chapters. They must first be redeemed for items of value, which the [REDACTED] Chapters can readily use for their charitable purposes."

use of trade credits can be summarized as follows:

An individual or organization renders a service. Rather than getting paid for services rendered, they are issued a trade credit. This trade credit has value and can be redeemed, if the individual or organization redeems the trade credit. Just like someone being compensated for services rendered, someone being issued trade credits will be required to report the trade credits as income. (See Rev. Rul 80-52, 1980-1 CB 100). Because there are many individuals and organizations that do not redeem these credits, [redacted] solicits donations of these unused trade credits for the [redacted] chapters. [redacted] receives trade credit donations for the [redacted] and exchanges the credits for items which [redacted] needs, such as restaurant certificates, hotel certificates and pre-paid long distance cards. Since an individual who receives a trade credit will have to report the credits as income when a donation of the trade credit is deductible. Therefore, an organization that solicits trade credits for the benefit of the [redacted] can qualify for tax exempt status.

However, [redacted] uses an agency to effectuate the actual exchange of the trade credits. Because participating in the actual exchange process can be a very complicated process, an organization that is experienced in handling extensive dealing and negotiating trade credits is needed to convert the trade credits into property or services needed by the [redacted]. The agency responsible for redeeming and exchanging trade credits is named [redacted] ([redacted]). [redacted] will be compensated at [redacted] % of the donated trade credits. [redacted] is not controlled by [redacted] but is controlled by [redacted], subject to the agency agreement that both parties have prepared. [redacted] and [redacted] have directors in common. [redacted]'s by-laws also specify in Article VII that additional Board members may be added by nomination and acceptance of the Board. In fact, all of [redacted]'s directors own all of the stock in [redacted], a for-profit corporation.

[redacted] and [redacted] will not be maintaining any inventory, only trade credits. [redacted] will only need some office space to maintain records and make phone calls. However, it will not need a facility to store products since it will only be acquiring trade credits. [redacted] will not incur any expenses for fundraising or advertising. [redacted] will not solicit individuals and businesses to exchange their trade credits. In [redacted] development letter dated October 16, 2002, response 19, [redacted] responded: "[redacted] is different from for-profit trade credit organizations because [redacted] does not solicit individuals and businesses to exchange their products, to conduct business through trade credits and to join their local trade credit exchange.... In contrast [redacted] solicits donations of trade credits from participants of trade exchanges for the benefit of [redacted] local chapters and utilizes the donated trade credits to obtain products and services that the [redacted] need which offset their operating costs." [redacted] serves only the [redacted]

### APPLICABLE LAW

Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations organized and operated exclusively for charitable purposes, no part of the net earnings of which inures to the benefit of any private individual.

Section 1.501(a)-1(c) of the Income Tax Regulations states that the words "private shareholder or individual" in section 501 refer to persons having a personal and private interest in the activities of the organization.

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

Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Section 1.501(c)(3)-1(c)(2) of the regulations 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. The section cross references the definition of private shareholder which is contained in section 1.501(a)-1(c). That section provides that the words private shareholder or individual in section 501 refers to person having a personal and private interest in the activities of the organization.

Section 1.501(c)(3)-1(d)(1) of the regulations states that an organization is not organized or operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. Thus, to meet the requirements 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 determining whether an organization is operated for a public benefit rather than a private benefit, a court may consider the size of the board of directors and their control of the organization. Western Catholic Church v. Comm., 73 T.C. 196 (1979).

In Better Business Bureau of Washington, D.C., Inc. v. United States, 326 U.S. 279

(1945), the requirement in section 501(c)(3) that an organization be organized and operated "exclusively" for exempt purposes is construed as meaning that the organization have its "primary" activity the performance of exempt functions. The Court further held that the presence of a single non-exempt purpose, if substantial in nature, will destroy a claim for exemption regardless of the number or importance of truly exempt purposes.

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. 10 (1973).

In Bubbling Well Church of Universal Love, Inc. v. Commissioner, 74 T.C. 531 (1980), aff'd, 670 F.2d 104 (9th Cir. 1980) the Tax Court considered the qualification for exemption of an organization purporting to be a church. The applicant was controlled by three family members. The court stated:

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

Thus, close control of an applicant, because of the potential for abuse, requires a clear demonstration that private interests will not be served.

In P.L.L. Scholarship v. Commissioner, 82 T.C. 196 (1984), an organization operated a lounge at a bar for the avowed purpose of raising money for scholarships. The board included the bar owners, the bar's accountant, 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 activities of the organization could be used to the advantage of the bar owners. The organization claimed that it was independent because there was separate accounting and no payments were going to the bar. The Court was not persuaded.

"A realistic look at the operations 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 International Postgraduate Medical Foundation v. Commissioner, T.C. Memo. 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 was 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."

#### ANALYSIS

Section 501(c)(3) of the Code sets forth two main tests for qualification for exempt status. An organization must be both organized and operated exclusively for purposes described in section 501(c)(3).

is not operated exclusively for exempt purposes within the meaning of section 501(c)(3) of the Code. The regulations under section 501(c)(3) expand on the requirements for satisfaction of the operational test. The key requirement is that an organization must be operated exclusively for one or more exempt purposes. Section 501(c)(3)-1(d)(1)(ii) of the regulations expands on the operated exclusively concept by providing that an organization is not operated exclusively to further exempt purposes

unless it serves a public rather than private interest. Based on the facts that [redacted] provided in its application for recognition of exemption, even though it is operating for exempt purposes, CCC does not operate exclusively for exempt purposes as it has a substantial nonexempt purpose.

Similar to Bubbling Well Church of Universal Love, supra, [redacted]'s Board Members own all of the stock of [redacted], a for-profit entity. Because the for-profit members also control the non-profit board, then any decision making could be made for [redacted] business interest rather than [redacted]. [redacted]'s by-laws also specify in Article VII that additional Board members may be added by nomination and acceptance of the Board. These factors lead to the high probability that the organization could be used to the advantage of the Board members. Close control of [redacted]'s Board, because of the potential for abuse, requires a clear demonstration that private interests will not be served. Based on the information provided, [redacted] has failed to overcome this presumption. Accordingly, [redacted] is operating in large part for the private benefit of [redacted] and [redacted]'s net earnings inure to the benefit of private shareholders or individuals. See Section 1.501(a)-1(e) of the regulations and Letter Business Bureau, supra.

[redacted] situation is similar to that of the organization described in International, supra. [redacted] exclusively uses [redacted] to secure trade credits. Even if the [redacted] commission is reasonable, [redacted] benefits from having an assured source of business without having to compete with other providers of similar services. Therefore, [redacted] is not operating exclusively for charitable purposes.

The non-exempt purposes served by [redacted] activities are substantial in nature. As the Supreme Court stated in Letter Business Bureau, supra, the presence of a single non-exempt purpose, if substantial in nature, will destroy a claim for exemption regardless of the number or importance of truly exempt purposes. Further, because [redacted]'s directors own stock in [redacted], their provision of benefits to their own controlled enterprise violates the statutory prohibition against private inurement.

### CONCLUSION

[redacted] does not operate exclusively for one or more exempt purposes. [redacted] operates for the benefit of private interests. [redacted] is operated for private rather than public purposes within the meaning of section 1.501(c)(3) and (d)(1)(i) of the regulations. [redacted]'s operations violate the statutory prohibition against private inurement.

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 to this office, 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.

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 Exemption 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

1111 Constitution Avenue, N.W.  
Washington, D.C. 20224

[Redacted]

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

Sincerely,

[Redacted]  
[Redacted]  
Manager, Exempt Organizations  
[Redacted]