



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

Date: JAN 23 2003

Contact Person:

Identification Number:

Contact Number:

Employer Identification Number:

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.

FACTS

You were incorporated on [REDACTED] to:

...educate the general public in the art and science of grain and fruit based fermentation. The means of providing such education includes, but is not limited to, maintaining a retail shop for the purpose of providing access to materials, supplies, educational information, and awarding an annual scholarship.

One of your initial directors was [REDACTED], owner of a retail store called [REDACTED] ([REDACTED]) that sold supplies for home brewing of beer and wine. At your initial meeting on [REDACTED], [REDACTED] was elected to the Board of Directors and the office of Vice President. Your Board of Directors approved transfer of [REDACTED] to you, effective [REDACTED].

On [REDACTED], [REDACTED] and his wife executed a bill of sale transferring to you all of the tangible and intangible assets of [REDACTED] in return for an agreement by you to assume its debts and obligations, and conditioned upon the recognition of your exempt status. You state that all liabilities, debts, and obligations of [REDACTED] had been paid prior to the transfer, which was therefore a gift. The "bill of sale was simply a vehicle of understanding that [REDACTED] has received the assets as a donation and exonerated the previous owners from future liabilities." An appraisal conducted by [REDACTED]

[REDACTED]

(Independent of and previously unknown to [REDACTED]) estimated the asset and current market values of the business as \$[REDACTED].

Your By-laws state that there is only one class of members who elect the directors and transact other business. Your qualifications are that the member be at least 21 years of age and have either contributed \$[REDACTED] to your initial formation or have paid an annual membership fee. However, a copy of a web page from [REDACTED] that you provided to us, distinguishes between associate and founding members. Associates, who have paid \$[REDACTED] per year, receive a [REDACTED]% discount at [REDACTED]. Founding members who paid \$[REDACTED], may make purchases at [REDACTED]% over cost, and will have "voting rights." Officers and Directors may make purchases at [REDACTED] at cost.

A "Grand Re-Opening" of the retail shop was held on [REDACTED]. The shop is open five days a week; run by [REDACTED], who receives a salary of \$[REDACTED] per year, two other part-time paid employees, and your members working as volunteers. Your board voted to "reestablish" advertising in three periodicals and the telephone yellow pages, and your budget estimates advertising expenses at \$[REDACTED] for [REDACTED]. A committee of your board has developed a business plan. Another committee has been working to improve your website, and to add the capability for on-line shopping. Your Statement of Revenue estimates revenues of around \$[REDACTED] in [REDACTED] from retail sales at the store.

In addition to retail sales of equipment and ingredients for home fermentation, you provide information to the public. According to additional information that you submitted on [REDACTED], [REDACTED] and your website, bimonthly workshops are presented on aspects of fermentation by your members. Those working in the shop also give advice and technical assistance to customers in the store, by telephone, and by e-mail. You are also assembling a library of resource materials on which you expect to spend \$[REDACTED] in [REDACTED].

You provide meeting space to local brewing clubs at no cost. The officers of at least one of the clubs were all your members and on is your treasurer and on your Board of Directors, and this club also advertises that its members receive a [REDACTED]% discount at [REDACTED].

The information submitted on [REDACTED] shows that most of your budgeted expenses for [REDACTED] are related to the retail store:

cost of goods	\$ [REDACTED]
salaries	\$ [REDACTED]
occupancy	\$ [REDACTED]
advertising	\$ [REDACTED]
postage and shipping	\$ [REDACTED]
bank fees	\$ [REDACTED]
maintenance	\$ [REDACTED]
business expenses and fees	\$ [REDACTED]

This equals \$[REDACTED] which is [REDACTED]% of your total budgeted expenses of \$[REDACTED].

The revenues that you reported in your [REDACTED] letter come almost exclusively from sales. If the donation of the business (as valued by an independent business consultant) is subtracted from the category of gifts in the year [REDACTED], it leaves:

donations	\$ [REDACTED]
membership dues	\$ [REDACTED]
receipts from sales	\$ [REDACTED]

The revenue from sales is [REDACTED] % of total revenue, before the on-line capability is added. Your Financial Data shows that you expect your operations to generate a net profit of approximately \$ [REDACTED] in [REDACTED] and approximately \$ [REDACTED] in [REDACTED].

In your letter dated [REDACTED], you state that, "...the percentage of income to be obtained from sales is expected to decrease as the other educational activities increase." However, your submitted budget and financial statement shows an increase of "gross receipts from admissions, sales" from \$ [REDACTED] in [REDACTED], to \$ [REDACTED] in [REDACTED].

You organized an exhibit about brewing and a competition of commercial beers brewed and sold in [REDACTED] for the [REDACTED] in the fall of [REDACTED]. Your directors and members contributed over two thousand hours of labor to plan, coordinate and judge the competition, build the exhibit and staff it 12 hours a day for 17 days, then break it down and clean up afterwards. The event cost approximately \$ [REDACTED] and you received revenues of nearly \$ [REDACTED]. Volunteer speakers from the brewing industry gave lectures twelve times during the weekends.

You described the revenue from the Fair as "donations" in supplemental information dated [REDACTED]. However, it is listed as "sales of merchandise" in your response to our letter of [REDACTED]. The application for the [REDACTED] states under "Entry Requirements,"

Beer not used during judging will be sold during the fair as samples to give the public an opportunity to taste a variety of beers. Proceeds from the sale of samples will go to the [REDACTED], with a portion of profits going to a brewer's scholarship fund.

Each year you intend to offer two scholarships, one to [REDACTED] and one to [REDACTED] to "professional minded brewers." Your application estimates total scholarship amounts of \$ [REDACTED] - \$ [REDACTED] per year for [REDACTED] and [REDACTED]. You also represent your intent to distribute up to [REDACTED] % of income after expenses for these scholarships. Your website announces a \$ [REDACTED] scholarship for the fall of [REDACTED]. You state that none of your voting members will be eligible. You have not submitted any rules or criteria by which they will be awarded. You expect that instructors at the local colleges will purchase supplies for their classes from you, because there is no comparable source of supply in the neighborhood.

LAW

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

Section 1.501(a)-1(c) of the Income Tax Regulations (the regulations) provides that the words "private shareholder or individual" in section 501 of the Code refers 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 provides that in order to be exempt as an organization described in section 501(c)(3), an organization must be both organized and operated exclusively for one or more of the purposes specified in the section.

Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization will not be regarded as "operated exclusively" for exempt purposes if a substantial part of its activities further some purpose other than its 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 exempt purposes unless it serves a public rather than a private interest. 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.

Section 1.501(c)(3)-1(d)(3) of the regulations provides that "educational," as used in section 501(c)(3) of the Code, refers to either the instruction or training of the individual for the purpose of improving or developing his capabilities; or the instruction of the public on subjects useful to the individual and beneficial to the community.

Section 1.501(c)(3)-1(e)(1) provides that an organization may meet the requirements of section 501(c)(3) of the Code although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of its exempt purpose and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business.

In *Better Business Bureau of Washington, D.C. v. United States*, 326 U.S. 279 (1945), the Supreme Court held that a single nonexempt purpose, if substantial, will destroy the exemption regardless of the number or importance of truly educational or other exempt purposes. If the primary purpose is conducting business of a type ordinarily carried on for profit, then the entity cannot show that it is organized for exempt purposes.

In *Scripture Press Foundation v. The United States*, 285 F. 2d 800 (1961), cert. denied, 363 U.S. 985 (1962), a publishing house, not affiliated with any specific religious denomination or church, sold a large volume of religious literature, periodicals, and Sunday school supplies at a substantial profit. The Court found that operating profits and accumulated earnings were disproportionately large and there was no clear purpose to further any particular religious beliefs. Providing instructional material does not, in itself, make a business activity exclusively educational. Thus, the Court concluded that the organization was primarily engaged in a trade or business and was not recognized as exempt under section 501(c)(3) of the Code.

In *American Institute for Economic Research v. United States*, 157 Ct. Cl. 548 (1962), the Court of Claims considered a petition to be recognized as exempt by a corporation organized to research economic and financial topics and disseminate the results to educate students and the general public through publications and through advising for a fee. The Court concluded that the taxpayer was conducting a commercial business based upon the fact that the publications earned a profit, the subscribers paid for and received investment advice, and investment counseling and services are commonly provided as a commercial enterprise.

In *Fides Publishers Association v. United States*, 263 F. Supp. 924 (1967), a publisher of religious books priced at commercial levels that showed moderate but consistent operating profits was held not exempt under section 501(c)(3) of the Code. The Court said that although the "publishing activities furthered the exempt purpose of educating the Catholic lay apostolate," nevertheless, there was a substantial nonexempt purpose: "the publication and sale of religious literature at a profit."

In *BSW Group, Inc. v. Commissioner*, 70 T.C. 352 (1978), an organization formed to consult on rural policy and program development, used independent contractors, and charged fees sufficient to cover the consultants and a small administrative fee. The Tax Court held it was conducting business with a primarily commercial purpose because its sole activity was conducting a consulting business, it competed with commercial consulting firms, was financed entirely through fees for service, the fees provided a net profit, and its clientele included for profit organizations.

In *est of Hawaii v. Commissioner*, 71 T.C. 1067 (1979), the Tax Court clarified that benefits found to be private benefits need not be unreasonable or exceed fair market value. An organization that primarily exists to funnel business to another organization provides a private benefit to it.

The Court in ***American Campaign Academy v. Commissioner*, 92 T.C. 1053 (1989)** provided a definition of private benefit. Private benefit was described as "non-incident benefits conferred on disinterested persons that serve private interests." Political training conducted by the American Campaign Academy substantially benefited the Republican Party and its candidates rather than the general public.

In *Living Faith, Inc. v. Commissioner*, 950 F. 2d 365 (7th Cir. 1991), the Circuit Court held that a restaurant run in the same manner as a normal business, in competition with other

restaurants, priced competitively, and advertising extensively is not qualified for exemption as a religious organization.

Rev. Rul. 67-139, 1967-1 C.B. 129 contrasts two mineral and gem clubs to conclude that one meets the definition of educational and the other is recreational. The Revenue Ruling holds that a club that conducts monthly meetings to discuss gem and mineral topics and sell or exchange specimens, issues a bulletin containing news of members' social activities and their collections, and an annual show for the public at which members display lapidary techniques and specimens is primarily operated for the recreation of the members. However, a club which conducts monthly lectures and demonstrations by qualified experts, sponsors field trips to collect and study rocks, issues a bulletin containing educational material, assists the local museum, and conducts an annual show including a juried competition is considered to be educational within the meaning of section 501(c)(3) of the Code.

Rev. Rul. 66-103, 1969-1 C.B. 134 provides that an organization making fellowship grants to needy individuals who otherwise would not be able to pursue their studies qualifies for exemption under section 501(c)(3) of the Code.

Rev. Rul. 69-257, 1969-1 C.B. 151 holds that an organization that awards scholarships based on scholastic ability, without regard to financial need, may qualify for exemption under section 501(c)(3) of the Code.

RATIONALE

Based upon the information contained in your application and subsequent correspondence, we have concluded that you do not qualify for exemption under section 501(c)(3) of the Code because (1) your activities do not accomplish an exempt purpose, (2) you are organized and operated for the primary purpose of carrying on an unrelated trade or business, and (3) you are operated for the benefit of private interests.

You have not established that you are organized and operated for an exempt purpose. The Code recognizes education as an exempt purpose, and section 1.501(c)(3)-1(d)(1)(ii) of the regulations defines education as the instruction or training of the individual for the purpose of improving or developing his capabilities; or the instruction of the public on subjects useful to the individual and beneficial to the community.

While you describe your purpose as educating the public, most of the activity you refer to relates directly to use of the materials and equipment sold in your store. You conduct two informal workshops each month led by members. The other activity that you describe as educational consists of answering questions from customers in person, over the telephone by e-mail, or by using the reference materials in your library. This activity appears primarily to be marketing or customer relations. Any sale of specialized equipment or materials is likely to be accompanied by such advice and instruction. Thus, providing instructional material as part of a business does not convert the business activity into an exclusively educational activity. See *Scripture Press Foundation* and *Fides Publishers Association, supra*. The fact that there is no

comparable source of supplies in the community does not make it educational, nor does that fact that instructors at the local community colleges can purchase supplies for their classes.

Donation of a small portion of your revenues to scholarships is not a significant exempt purpose. Although you estimate scholarships of about \$[REDACTED] for the next two years out of estimated revenues of approximately \$[REDACTED] per year in your application for exemption, you have announced only a \$500 scholarship on your website. You have given no indication that the scholarships will demand a significant amount of your time or finances. Furthermore, you have not provided any criteria for awarding the scholarships either on the basis of academic ability, or on the basis of financial need.

Your participation in the [REDACTED] appears to be commercial, rather than educational. During the 204 hours that your exhibit was open at the [REDACTED], you had at most 12 hours of lecture, most of them by commercial brewers. While your members and directors contributed an significant amount of volunteer time to the event, selling and promoting the commercial products of [REDACTED] breweries, even if accompanied by demonstrations is not primarily educating the public within the meaning of §1.501(c)(3)-1(d)(3) of the regulations. The distinction made between the mineral clubs in Rev. Rul. 67-139, *supra*, is applicable because the home brewing of interest to your members is analogous to a hobbyist's interest in minerals and gems. Your organization is more like the non-exempt club that conducts monthly meetings at which some mineral and gem topics are discussed and specimens are exchanged, and which holds an annual show for the public. Your activities lack the regular lectures and demonstrations by outside experts, trips devoted to study, a bulletin containing educational material, and a level of expertise sufficient to advise and assist the local museum that distinguished the other club.

In order to qualify for exempt status, an entity must be organized and operated exclusively for exempt purposes. The Service and the courts have interpreted "exclusively" to mean primarily, thus allowing some ancillary non-exempt purposes. An organization may even operate a trade or business if it is in furtherance of its exempt purpose and if its primary purpose is not carrying on an unrelated trade or business, as provided in section 1.501(c)(3)-1(e)(1) of the regulations. However, an entity that has a substantial non-exempt purpose will not qualify for exempt status as provided in section 1.501(c)(3)-1(c)(1) of the regulations and discussed in *Better Business Bureau of Washington, supra*.

The manner in which you were formed and your structure indicates substantial commercial purposes. You are the successor to a retail operation, and have not significantly changed the character of the operation. You continue in the same location with similar staffing, hours, pricing, inventory, and advertising. Your financial structure more closely resembles a commercial than a nonprofit model. You have had an infusion of cash from "founding members", who expect to recoup it through discounts at your store, and have voting privileges. In the future, you do not expect membership dues to provide a significant portion of your revenue. You do not have a fundraising program, and do not expect significant donations.

Your operations demonstrate that your primary activity is conducting a commercial operation. Your financial statement, your minutes and your website document a commercial

organization, contrary to your assertion in your application that you will spend █% of your time on educational activities. As listed in your application, █% of your expenses relate to the retail operation, and █% of your revenue was from sales. Because your activity at the █ is not considered to be educational, the sales and expenses related to it cannot be classified as educational. Furthermore, those revenues are from sales of commercially produced beer, not from your products. Even if the revenues collected at the fair were donations to you rather than sales of commercial beers, they still represent only █% of your revenues for the year to date. Sales from the retail store are approximately █%.

The operation of your business does not appear to further an educational purpose. Selling the materials used in learning or practicing a craft is not a necessary part of teaching it. Therefore, you do not meet the exception of section 1.501(c)(3)-1(e)(1) of the regulations. Your operations are almost identical to those carried out by commercial businesses. Your customers are ordinary individuals who pay for and receive goods. You expect your operations to generate a profit of \$█ in █ and \$█ in █, even after accounting for two scholarships. The courts have repeatedly upheld IRS determinations that organizations that resemble and compete with commercial entities are not qualified for exempt status because an organization that has a substantial purpose in operating a business cannot be operated "exclusively" for exempt purposes. See, e.g. *Living Faith*, *American Institute for Economic Research*, and *BSW Group, supra*.

Your organization also provides a private benefit to the officers and directors in violation of section 501(c)(3) of the Code and section 1.501(c)(3)-1(c) of the regulations which prohibit payment of net earnings to persons having private interests in the activities of the organization. The former owner of your retail store is the only one of your directors who receives a salary, which in two years will almost equal the value of the assets he donated to you. Furthermore, your officers and directors receive the private benefit of purchasing their supplies at cost, and the founding members at █% over cost. You also permit some of your directors to hold meetings of other organizations in your space at no cost, and you provide discounts to members of the other organizations. The private benefits are not inevitable results of your exempt purposes. A certain amount of private benefit is acceptable if it is "incidental" to the exempt purposes of the organization. *American Campaign Academy v. Commissioner, supra*. However, private benefit that is not incidental demonstrates that the organization is not operating for exempt purposes and is proscribed under Sec. 1.501(c)(3)-1(d)(1)(ii) of the regulations. Private benefit need not be unreasonable or excessive, if it is substantial and not incidental. See, *BSW Group, Inc. v. Commissioner, est. of Hawaii v. Commissioner, supra*. The private benefit that you confer on your officers, directors, and founding members is more than incidental.

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

[REDACTED]

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 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 section 6104(c) of the Code.

When sending additional letters to us with respect to this case, you will expedite their receipt by faxing them to 202-283-8937 or by using the following address:

Internal Revenue Service
TE/GE ([REDACTED])
[REDACTED]
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) [REDACTED]

[REDACTED]
Manager, Exempt Organizations
Technical Group 2

Originated By

Reviewed By

[REDACTED]
Jan 22, 2003

[REDACTED]
01-23-2003