



TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

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

**Release Number: 200822044**

Release Date: 5/16/08

Date: February 19, 2008

UIL Code: 501.03-05

501.03-30

501.30-02

501.32.00

Contact Person:

Identification Number:

Contact Number:

Employer Identification Number:

Form Required To Be Filled:  
1120

Tax Years:  
All 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.

Since 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.

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, you should 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.

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Catalog Number 47632S

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 S. Choi  
Director, Exempt Organizations  
Rulings & Agreements

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



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INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

Date:

Contact Person:

Identification Number:

Contact Number:

FAX Number:

Employer Identification Number:

LEGEND

A = Name of Applicant  
B = State  
C = Name of LLC  
D = Name of Supported Organization  
E = Name of Organization  
F = Name of Director  
G = Name of Director  
H = Name of Director  
I = Name of Director  
J = Name of Director  
K = State  
L = Name of Project I  
M = Name of Project II  
N = Name of Consulting Organization  
O = Name of Organization  
P = Name of Organization  
Z = Date

UIL. Nos.

501.03-05  
501.03.30  
501.30-02  
501.32.00

Dear :

We have considered your application for recognition of exemption from Federal income tax under Internal Revenue Code section 501(a). 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.

ISSUES

1. Does A, who conducts housing activities in the State of B and has entered into a contract with C and other related parties, qualify for exemption under section 501(c)(3) of the Code?

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2. If A is exempt, is it a supporting organization as described in section 509(a)(3) of the Code?

**FACTS**

Form 1023, Application for recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code, was submitted June 1, 2006. Information submitted with the application indicates that A was incorporated in the State of B on Z. A is located in K.

A is requesting exemption as a public charity under section 509(a)(3) of the Code. Schedule D of Form 1023 states A will be "supervised, operated, and controlled by" one or more publicly supported organizations described in section 509(a)(1) or 509(a)(2). The supported organization is D.

The Articles of Corporation states A is organized to:

- Develop and implement housing solutions for people with developmental disabilities that improve their quality of life and to provide support and assistance as needed to oversee and manage such housing solutions;
- Support the housing activities of its sole member, E, an K nonprofit corporation, in the State of B;
- Operate exclusively for charitable purposes within the meaning of section 501(c)(3) of the Internal Revenue Code of 1986, as amended (or corresponding provisions of any future United States internal revenue law)("Code"); and
- Engage in any lawful act, activity or business not contrary to and for which a nonprofit corporation may be formed under Chapter 24.03 of the Revised Code of B and to have and exercise all powers, rights and privileges conferred by the laws of B on nonprofit corporations as its Board may, any time and from time to time deem advisable.

The Articles of Incorporation list F, G, H, I, and J as the initial directors.

A filed Articles of Amendment with the State of B changing the sole member to D. The amendment was the result of the fact that E did not receive exemption as an organization described under section 501(c)(3). E did merge with D. The Articles of Merger list D as the surviving entity. No documentation was submitted to the Internal Revenue Service showing that the merger was approved by the Internal Revenue Service.

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Section 1.3 of the bylaws states the sole member shall be D. Section 3.1 of the bylaws states that the Directors shall be elected at the annual meeting of the member.

Section 9.3 of the bylaws states that the corporation intends to qualify for federal tax exemption as a section 501(c)(3) organization through a group exemption letter issued to the member. A submitted a letter dated September 29, 2006 that states they planned to be part of a group ruling along with the other subsidiaries but withdrew their request once they were informed that the Internal Revenue Service does not issue group rulings for organizations that conduct housing activities.

F is the President and H is the Secretary and Treasurer. H does serve in a part-time role as Director of Finance of D. At the end of 2005 G and I were not eligible to serve on the board since they were no longer board members of D. On December 5, 2006 they were replaced by two individuals that have no business interest in C.

D was formed on \_\_\_\_\_, 2002 in the State of K and was granted exemption under section 501(c)(3) of the Code as an organization described in section 509(a)(1) and 170(b)(1)(A)(vi). Presently, D is operating in 10 states to provide affordable, community housing solutions for individuals with developmental disabilities. A is the first nonprofit "subsidiary" that D is activating in a state. D expects to activate additional state-specific nonprofit "subsidiaries" as the success of its business strategy continues to grow.

D created this organization to enhance its ability to obtain additional affordable housing grants in B. While being a B nonprofit corporation is not mandatory for receiving affordable housing grants, the state agencies prefer to contract with a locally formed nonprofit corporation. Thus far D has received all the grant funding and performed all of the housing activities.

In making affordable, community-based housing available to individuals with developmental disabilities there are two support services that are needed which are (i) housing services that provide access to, and management of, homes; and (ii) supporting living services that provide the support and resources to enable individuals with disabilities to live in the residential communities.

A is to provide the necessary housing services needed to locate, renovate and manage homes in neighborhoods selected by individuals with developmental disabilities in the State of B. A will also work closely with the providers offering supportive living services to individuals. The providers are most often state and local agencies such as the Division of Developmental Disabilities.

The housing activities will be conducted by D until A receives tax exempt status. The housing activities conducted by D are separated into two projects, L (Project I) and M (Project II). In 2005, D received two grants from governmental agencies for \$ \_\_\_\_\_ and \$ \_\_\_\_\_ fund Project I. The grants will be used for the purchase and renovation of two homes to serve seven individuals with developmental disabilities. In 2006, D received two \$ \_\_\_\_\_ grants from

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government agencies to fund Project II. The grants will be used to purchase and renovate four homes to serve 12 individuals with developmental disabilities. D holds title to six properties in the State of B and will transfer the titles to A after they receive tax exemption. A plans to apply for more grants to purchase additional homes.

In addition, D was awarded operations and maintenance ("O & M") funding from the state of B for both projects. The "O & M" funds are available to supplement the rent revenue to cover reimbursement for operation and maintenance expenses incurred by D to manage and maintain the homes acquired through the grants. From the 3<sup>rd</sup> quarter of 2005 through the 1<sup>st</sup> quarter of 2007 D received \$ "O & M" funds. Funds from the "O & M" vouchers were used for off-site management repairs and maintenance, accounting, insurance, and utilities. Some funds were allocated for reserves.

Once A is exempt they anticipate applying for HUD funded HOME Investment Partnership program grants, which are administrated by the State of B and other participating cities and counties. The HOME program grants are limited to a fixed dollar amount per house (about \$ in 2006).

After A has secured funding to acquire single-family residential homes within an appropriate price range, the potential houses are selected from the general housing market by individuals with developmental disabilities. Once the home is selected it will be acquired by A. A will then work with the case manager and the service provider to renovate and modify the home to meet the needs of the individuals. This may include widening doorways or creating an accessible bathroom. Once the home is ready for occupancy, A enters into a lease agreement with the individuals with developmental disabilities.

The financial data on page 9 of the Form 1023 application shows \$ in grants in 2007 and 2008. Projected rental income for 2007 and 2008 is \$ and \$ respectively. Total expenses for 2007 and 2008 are \$ . In a reply to our letter dated September 15, 2006, A stated that the excess revenue will be used to purchase and renovate homes. This would include (i) sellers of the homes being purchased; (ii) title company and other parties needed for closing on the purchase of the homes; (iii) architect developing and renovation plans; (iv) contractor doing the renovation, as selected through an open bid process, (v) for an administration fee in awarding its grants, and (vi) D as the developer of the project.

D serves as the sponsor and developer of both projects. This means that D receives a payment from governmental agencies for its services as the developer of the project. The budgets for Project I and Project II include developers' fees for \$ and \$ , respectively. The developer fees are payment for the services needed to design, develop and implement the specific project approved under an awarded affordable grant. This would include activities needed to submit an application, negotiate the terms of the grant contracts, coordinate the services of the architect and contractor needed to renovate a home once it is acquired, coordinate with the providers that will be supporting the individuals with developmental disabilities to ensure the homes meets their needs and comply with the terms of the grants by

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submitting the needed reports to the grant funders. These activities will be conducted by D.

In our letter dated September 15, 2006 we asked who will manage the homes and if any of the board members or their related entities will provide goods or services to A. A stated that D will manage the homes even though A & D are located in K, they have the resources to manage properties in B. I, who is the Vice President/Housing and Development, is responsible for overseeing the activities and does travel to B and other states where D owns property. I is a paid employee of D. They did retain a local property manager to provide support for after hours and emergency issues arising in the homes. They also stated that none of the board members or their related organizations provides any services to A.

I formed N to provide legal and business support services to social enterprises. N entered into a contract with D to serve as Vice President/Housing Development and received a monthly stipend of \$ . The contract was to run until December 31, 2007. However, it was terminated on December 31, 2006. The services provided by N, through I, was development of the affordable housing grant activities needed to support the housing social venture for individuals undertaken by D. I is also responsible for performing or overseeing the legal work needed by D in pursuing its tax exempt activities.

On January 1, 2006, C entered into a management contract with D to provide management support services for all of the properties owned by D, including the six located in B. The services provided to D are separated into two categories: (1) housing services and (2) accounting services. The housing services involves property acquisition services needed to purchase, renovate, reconstruct or construct the homes and property management support services needed to lease and manage the homes. Accounting services will include bookkeeping services, bank account and fund management services and affordable housing grant and other financing reporting services needed to support the operations of the homes. During the term of the Agreement, D will pay C \$ per home per month for housing services, and \$ per month per home for accounting services. D did not consider any other organizations to provide housing services to their properties. C provided these services to D during 2005 but did not charge any fees.

F, the President and Director of A, is the owner of O. O provides sales and marketing support to C. In their letter dated February 26, 2007, A stated that under such an arrangement F serves as the Vice-President, Business Development for C. The compensation paid by C to O is commission based. F is responsible for representing C with service providers that provide residential support services to individuals with developmental disabilities and with state agencies that fund such services. In their letter dated April 30, 2007, A stated F is compensated by D through O.

F served as President of P, a 501(c)(3) organization since 2005. P owned and operated a number of group homes that were intermediate care facilities for individuals with mental retardation that were licensed by K. In 2001, P sold its group homes to an unrelated publicly traded company. The funds received in the sale were transferred to D. P is still in existence as

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a subsidiary of D and F still serves as its President.

C was formed by G and is located in the same office as A. G was the President of E which was formed in 2004 as a subsidiary of D. E was formed to protect D from business risk arising from owning real estate that is leased to individuals with developmental disabilities. As stated earlier, E merged into D on \_\_\_\_\_, 2006.

G has served on the board of D and has been involved in the activities of D since 2002. This includes the transition period from a residential service provider to a support organization for individuals with developmental disabilities.

Prior to being on the board of D, G was an advisor to P which operated group homes for the mentally retarded and/or developmentally disabled in central K since the mid-1980's. During this time G was also an executive of a large residential service provider that often leased homes for serving the individuals with mental retardation and/or developmental disabilities that it serves. Because of his experience G was a well-qualified person to advise D on its activities supporting individuals with developmental disabilities. Therefore, D appointed him to the board in 2002. Subsequently, as D worked to develop its own programs it decided that housing for individuals with developmental disabilities was a key component to engaging such individuals in their community. Because of the expertise of G, as co owner of C, in providing housing services to individuals with disabilities, D approached C to assist in the development of its housing activities. The development of the housing activity arrangement between C and D was accomplished on an arm's length transaction through negotiation of independent legal counsel for each party.

The file contains monthly financial reports submitted by C to D that include; a quarterly housing report submitted by C to D; a copy of the 2005 annual report submitted by D to the governmental agencies; a copy of the quarterly "O & M" reports for both projects submitted by D to the governmental agencies; and a copy of the approved reimbursement requests submitted to the governmental agencies to obtain funding for the capital expenditures for both projects.

The reimbursement requests that were filed on the Voucher Distributions contain numerous invoices all addressed to C and some included G as the care of person. In some instances it was addressed to C and listed D as the dba. Developers Fees for L in 2005 was \$ \_\_\_\_\_. The developer fees for M in 2006 were \$ \_\_\_\_\_. When we tried to get a breakdown of the fees they simply said that it was paid to D. They also stated that there is no supporting documentation in any of the reports submitted for the developers fees earned. Also the address for C is the same as A. C allows D to use one of their suites at no charge since the office space they use is minimal.

The "O & M" voucher shows that L received \$ \_\_\_\_\_ and M received \$ \_\_\_\_\_ 2006. Payments include insurance, real estate taxes, maintenance, and offsite management.

The financial data for E shows that they paid C \$ \_\_\_\_\_ in 2006. This is not broken down into

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the different subsidiaries. It also shows \$            in other payables to C for accounting and management fees and \$            deferred developers' fees for M.

### ISSUE 1 – IRC 501(c)(3)

#### Law

**Section 501(c)(3) of the Code** provides, in part, for the exemption from Federal income tax organizations organized and operated exclusively for charitable, religious or educational purposes, 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 Regulations** states in order to qualify under section 501(c)(3) of the Code, an organization must be both organized and operated exclusively for one or more exempt purposes. If an organization fails to meet either the organizational or operational test, it is not exempt.

**Section 1.501(c)(3)-1(a)(2) of the Regulations** states the term "exempt purpose or purposes", means any purpose or purposes specified in section 501(c)(3) of the Code.

**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(d)(1)(ii) of the Regulations** states that an organization is not operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. It must not be operated for the benefit of designated individuals or the persons who created it.

In **Better Business Bureau of Washington, DC Inc. v. United States, 326 U.S. 279 (1945)**, the Supreme Court held that the presence of a single non-exempt purpose, if substantial in nature, will destroy a claim for exemption regardless of the number of importance of truly exempt purposes.

In **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.

In **Church By Mail, Inc. Petitioner, v. Commissioner of Internal Revenue Services Respondent, 765F2nd 1387 (9<sup>th</sup> Cir. 1985)** the petitioner was denied exemption because the principal activity consists of mailing its literature, which focuses on the ministry James E Ewing,

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to individuals throughout the United States. The petitioner has sent out over 3,000,000 pieces of mail. The literature petitioner mails is procured through Twentieth Century Advertising Agency, Inc. (Advertising). Rev. Ewing and Rev. McElrath are the sole shareholders of Advertising. Advertising does not print the material itself. Instead, it subcontracts the work out and bill petitioner the subcontractor's price plus 15% commission. It was determined that the organization was formed to benefit the officer of the organization and their exemption was revoked.

In Salvation Navy v. Commissioner, T.C.M. 2002-275(2002), the court found that one of reasons why the organization did not qualify for exemption from federal income tax was because it could not prove that its net earnings would not inure to the benefit of a private individual, its founder.

In Bubbling Well Church of Universal Love, Inc. v. Commissioner, 670 F.2d 104 (9<sup>th</sup> Cir. 1981), the court affirmed the tax court's decision that held that the organization supplied no evidence showing that the payments to its controlling members were reasonable and the court also found that the potential for abuse created by the family's control of the organization required open candid disclosure of facts.

In The Schoger Foundation v. Commissioner of Internal Revenue Service, 76 T.C. 380 (1981) the court held if one of the purpose of an organization's activities is substantial and non-exempt (e.g. commercial), the organization will be denied exempt status under section 501(c)(3), even if its activity also furthers an exempt purpose.

In P.P.L. Scholarship v. Commissioner, 82 T.C. (1984), an organization operated bingo at a bar for the avowed purposes of raising money for scholarships. The board included the bar owners, the bar accountant, also the 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.

In International Postgraduate Medical Foundation v. Commissioner, TCM 1989-36 the tax court considered the qualification for exemption under section 501(c)(3) of the Code of a nonprofit corporation that conducted continuing medical education tours. Michael Heilin, trustee and executive director of the nonprofit corporation, was also a shareholder and president of H & C Tour, a travel agency. The foundation used H & C Tours exclusively for all travel arrangements. The Foundation did not solicit competitive bids from any entity other than H & C Tours. In holding, the Foundation not to be exempt, the court stated:

When a for profit organization benefits substantially from the manner in which the activities for a related organization are carried on, the latter organization is not operated exclusively for exempt purposes within the meaning of 501(c)(3), even if it furthers other exempt purposes.

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In est of Hawaii v. Commissioner, 71 T.C. 1067 (1979), several for profits est. corporations exerted significant indirect control over est. of Hawaii, a non profit entity, through contractual arrangements. The Tax Court concluded that the for-profit entities were able to use the nonprofit as an "instrument" to further their for-profit purposes. Neither the fact that the for-profit lacked structural control over the organization nor the fact that the amounts paid to the for-profit organization under the contracts were reasonable affected the court's conclusion that est. of Hawaii did not qualify as an organization described in section 501(c)(3) of the Code.

**Rev. Rul. 67-5, 1967-1 C.B. 123**, holds that a foundation controlled by the creator's family was operated to enable the creator and his family to engage in financial activities that were beneficial to them, but detrimental to the foundation. This resulted in the foundation's ownership of common stock that paid no dividends of a corporation controlled by the foundation's creator and his family, which prevented it from carrying on a charitable program commensurate in scope with its financial resources. This ruling concluded that the foundation was operated for a substantial non-exempt purpose and served the private interest of the creator and therefore, was not entitled to exemption under section 501(c)(3) of the Code.

**Rev. Rul. 70-186, 1970-1 C.B. 128**, it was found that it would be impossible to accomplish the organization's charitable purposes of cleaning and maintaining a lake without providing benefits to certain private property owners. In the quantitative sense, to be incidental, the benefit to private interest must not be substantial in the context of the overall public benefit conferred by the activity.

### Application of Law

Section 501(c) of the Code and Section 1.501(c)(3)-1(a) of the Regulations sets forth two requirements for qualification for exempt status. An organization must be organized and operated exclusively for purposes described in section 501(c)(3) of the Code. Because A's Articles of Incorporation state purposes described in section 501(c)(3) of the Code and upon dissolution all assets will go to organizations that are exempt under section 501(c)(3) of the Code, you pass the organizational test.

You must however satisfy the operational test. The key requirement is that an organization be operated exclusively for one or more purposes describe in section 501(c)(3) of the Code.

Reg. 1.501(c)(3)-1(c) (2) clarifies that an organization is not operated exclusively for exempt purposes if its net earnings inure to the benefit of private individuals. Based on the information submitted your organization inures to the private benefit of C, F, and G and is not operating exclusively for purposes described in section 501(c)(3) of the Code.

There are a number of various entities that are related to the applicant that have some influence in our decision. D, is the supported organization and was formed in 2002 and given tax exemption under section 501(c)(3) of the Code in 2004. They are conducting all of the

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activities and receiving the grants until A qualifies for tax exemption. C is the for profit entity that has entered into a management service contract with D to provide a number of housing services for the properties owned by D. E was formed in 2004 and requested exemption as a supporting organization to D. They later withdrew their application and merged into D. Even though they were the merged organization they continue to conduct a number of housing services. P is a tax exempt entity that initially funded D. Since 1986 P owned and operated a number of group homes that were intermediate care facilities for individuals' with developmental disabilities in K. They sold the homes to an unrelated party and donated the funds to D.

The purposes of C are to provide various housing and accounting services to organizations that provide housing to individuals who have developmental disabilities. They provide this service to over 70 properties located in 10 states that are owned by D including A. A is often referred to as "subsidiary" of D who is conducting all of the activities until A receives tax exemption. A review of the facts shows that there is a close relationship between C and D and the activities of A & C substantially benefit C, F, and G. The owner of C is G and was one of the original board members of D until 2005, and is the President of E. G was also one of the initial board members of A and they allow D free space in their offices. In addition, F is compensated by C on a commission basis. A has a non-charitable purpose that is substantial in nature. See **Better Business Bureau v. United States, supra**.

In your letter dated September 29, 2006 you stated that none of the board members or their related for profit entities provides any services to A except for F who is the Executive Director of D and will also serve as a board member of its "subsidiaries" including this organization. However, during the development of the application we found this not to be the case.

F, G, and I have all taken an active role in the development of the supporting organization and the supported organization and have a financial interest in a number of related for profit entities. G is the founder of C and was an original director of A. In 2004 G became President of E, a "subsidiary" of D. E was formed as a separate corporation to protect D from the business risk arising from owning real estate that is leased to individuals with developmental disabilities. In 2005 E applied for tax exemption as a supporting organization and subsequently withdrew their application when we proposed to deny them exemption. E then merged with D. D was the surviving entity. The Internal Revenue Service was never officially notified of the merger. He was no longer eligible to serve on the board at the end of 2005 because he was no longer on the board of D. It is not clear the role that he has in E. However, A & D share the same offices as C. G left after he had established a long-term relationship with D. Since A & D share office space with C and there are common board members between C & D it appears that D & A were both formed to service the purposes of C and its' owner.

F serves as a board member and President of A. F also serves as President and Executive director of D. In her role as executive director, she spends about 25 hours a week overseeing its grant funding and other charitable activities. She is not compensated by A, but does receive an annual salary of \$: from D. The balance of her time is spent as a business consultant for O, which she is the owner. O provides sales and marketing support to C. Under such an

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arrangement, F serves as Vice-President of Business and Development for C on a part-time basis. The compensation paid by C to O is commissioned based. The commissions are based on her efforts in acquiring new homes for housing individuals. She works at least 20 hours per week for C and is active in promoting the business of C. She is responsible for representing C with service providers that provide residential support services to individuals with developmental disabilities and with state agencies that fund such services. She is also the President of the other subsidiaries. Hence, the more homes the D acquires the more homes C will manage the higher her commission will be.

I is the Vice President of A and also serves as the Vice President/Housing & Development for D. I is not compensated by A, but does earn a salary from D for overseeing the day-to-day operation of the community housing business. The balance of his time is spent through his company N. I formed N to provide legal and business support services to social enterprises. N entered into a contract with D to serve as Vice-President/Housing Development and received compensation of \$\_\_\_\_\_ for 2006. The contract was signed on January 1, 2006 and was to continue until December 31, 2007. The arrangement was terminated at the end of 2006 to allow I to serve directly as Vice President/Housing & Development overseeing the same activities that were previously provided through N. Similar to Church by Mail v. Commissioner, supra, your organization was formed for the benefit C, N, & O and their respective owners.

Control is an important factor in determining whether an organization operates for the benefit of private interests. Similar to the organizations in P.L.L. Scholarship v. Commissioner, supra and Rev. Rul. 67-5 evidence shows that A is controlled and influenced by F, G, and I. A was formed by D and appoints its board members. F, G, and I were all initial board members of D and A. At the present time only F is on the board of D. She is also the President of A and provides services for C and is compensated on a commission from C. Even though G is no longer on the board he provides free space to D and all of their subsidiaries including A. He is also the President of E which merged into D. It should be noted that all of the board members reside in K. There is no evidence in the file that they attempted or considered having board members that reside in B.

Even though A is conducting a charitable activity the private benefit to the related parties is substantial. A is similar to Leon A. Beeghly v. Commissioner, supra, 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.

Like the organization in International Postgraduate Medical Foundation v. Commissioner, supra, you have contracted for services with individuals who directly control your organization. You are similar to International Postgraduate Medical Foundation v. Commissioner, supra because F, G, and I could benefit substantially from the manner in which your activities are carried on.

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In order for private benefit to be present, it is not required that payment for services to C be reasonable or exceed fair market value. In est of Hawaii, supra, the Tax Court stated:

"nor can we agree with the petitioner that the critical inquiry is whether the payments made to International were reasonable or excessive. Regardless of whether payments made by petitioner to International were excessive, International and Est, Inc. benefited substantially from the operation of petitioner."

In est of Hawaii, supra, and Church by Mail, supra, the organization procured service from for-profits entities. Although there was no structural relationship between the entities, the Court inferred from the totality of benefits flowing from the exempt organization to the for-profit organizations that they had substantial influence over the nonprofit organizations operations. Your situation is more egregious in that there is a direct relationship between you and F & G can benefit substantially from your operations.

Private benefit has both qualitative and quantitative connotations. In the qualitative sense, to be incidental, the private benefit must be a necessary concomitant of the activity that benefits the activity at large, i.e., the benefit to the public cannot be achieved without necessarily benefiting private individuals. In Rev. Rul. 70-186 it was found that it would be impossible to accomplish the organization's charitable purposes of cleaning and maintaining a lake without providing benefit to certain private property owners. In quantitative sense, to be incidental, the private interests must not be substantial in the context of the overall public benefit conferred by the activity. C receives a substantial amount in developers' fees and the President's salary from her related for profit company is based on the success of D. In addition, they also control how the funds are being spent.

Per the management contract between C & D, C will receive a monthly fee of \$        for each home for its housing services and \$        per month per home for its accounting services. A owns 6 homes which amounts to an annual income of \$        (        ) to C. The budgets for Project I and Project II include developers' fees totaling \$        . The developers' fees are payments for services needed to design, develop and implement the specific project approved under the affordable grant. These are the same services that are described in the management contract.

Since all of the activities that A will be conducting are now being conducted by D we are required to look at the activities that are now being conducted by D even though they have been exempt since February 2002. A portion of the developers' fees went to C. We do know that the developers' fees and all the grant funding is controlled by D, and individuals that have a financial interest in related for profit entities have a major influence in the operations of D. Both F & I are paid employees of D and are on the board or have been on the board of A & D. In addition, they both own related for profit entities that have provided services to C, D, & their related subsidiaries. Similar to Bubbling Well Church of Universal Love, Inc. v. Commissioner, supra your organization did not demonstrate that the net earning would not inure to the benefit of private individuals and the potential for abuse created because A & D are

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controlled and influenced by individuals that have a financial interest in C, N, and O.

Even though G is not on the board of A and has been removed from the D's board of directors he has been involved in the activities of D since its formation in 2002 and has had a long term working relationship with F. This includes the transition from a residential service provider to a support organization for individuals with developmental disabilities. C, the company that he owns, provides free space to D and all of their subsidiaries. From 1986 to 2001, F served as President of P, the predecessor organization to D and a 501(c)(3) organization. P operated 20 residential homes for individuals with developmental disabilities in the central K area. In 2001 P sold the homes to an unrelated entity. The profits from this sale went to the start up cost for D. During this time G was an advisor to P and an executive of a large residential service provider that often leased homes for serving individuals with mental retardation and/or developmental disabilities.

The comprehensive management plan of Project I is undertaken on behalf of D by C. C is the project manager and is responsible for property acquisition and development support. This support includes overseeing the selection of the homes, inspection of the homes to ensure both suitability for meeting the needs of the residents and being in good condition; and the selection of the contractors and other vendors needed to under take necessary and appropriate renovations. C's other responsibilities will include developing and implementing a regular on-going repair and maintenance program for each home; working with the Project architect and contractor to make major repairs and renovation, as needed, for the homes; monitoring and paying on a timely basis all bills and expenses related to the upkeep of the homes; and obtaining adequate insurance coverage on the homes. One of the staff members of C supporting D is G. Furthermore, C will assist D in completing the annual reports required under the terms of the grants.

The Housing Finance Program for Project II states D shall acquire, improve or construct, maintain and operate housing on real property located at four separate locations to be determined within the County. The County shall reimburse D for satisfactory completion of requirements specified in the Contract and this Exhibit, payable in the following manner: The sum, not to exceed \$ , shall be paid upon submission of invoices and supporting documentation by D.

We expressed our concerns regarding how an organization that is located in K can effectively manage homes that are located in B. A stated that D has the resources and support to effectively manage homes located in B and will be undertaken by I. A did retain a local property manager to provide support for after hours and emergency issues arising in the homes. Based on facts submitted your organization contracts out this services to C. Therefore, your organization does not manage and maintain the homes.

The file contains a Supportive Property Management Agreement with the local Property Manager (Manager) in which they will be responsible for managing and maintaining the condition of the homes. You state that the purpose is to provide local, on-site support in

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managing and maintaining the homes. The Manager agrees to provide property management support services to the Foundation, including:

- a. Regularly inspecting each home, no less than 2 times each year and as requested by Foundation, for purposes of determining its current condition and the need for maintenance and repairs.
- b. Receiving calls from, responding to, Service Provider regarding maintenance and repairs for a home on a 24hour/7day a week basis. The Foundation acknowledges that Manager serves primarily in a supportive role by providing after hour and local, on-site services needed to maintain each home.
- c. Undertaking and overseeing maintenance and repairs as outlined in this agreement.
- d. Cooperating and coordinating its activities with the real estate coordinator designated by the Foundation when undertaking appropriate maintenances and repairs at home.
- e. Keeping the Foundation fully informed of its activities with respect to the homes, including regular reports to the designated real estate coordinator, to ensure that each home is in good repair as required by the B Residential Landlord Tenant Act.

The Foundation will pay a monthly management fee to Manager of \$ per home for which the Manager is responsible for providing services during such month. In addition the Foundation will agree to pay a service fee to Manager of \$ per hour for on-site maintenance and repairs services undertaken at home by the manager.

The agreement states the Foundation's obligation is to maintain adequate property insurance, timely pay all mortgages, encumbrances; homeowner association fees, taxes and other assessments on the homes; coordinate with the service provider to ensure manager has reasonable access to each home for making inspections, undertaking maintenance or making repairs, alterations, or improvements to the home; and pay, upon the request of manager, for any maintenance and repairs incurred at a home under the terms of this agreement.

Reviewing the two contracts between D & C and D & the local property manager there appears to be a number of duplicated services that are provided by the management companies. This raises the question, why does D have to pay C for services that the local management company can provide? Would it not be more efficient to have a local management company provide these services? Part of the housing services provided by C includes management and maintenance of the properties. The contract will provide support to manage the homes in a manner that enables the homes to be maintained as housing for the residents. They will also provide support to maintain the homes in good condition and repair and they have the right to retain a local property manager.

Other housing activities conducted by C are searching for homes to be acquired by D; provide support needed to close on the purchase of the home or the construction of the home; provide support needed to prepare, negotiate, and execute the lease needed for the home and to monitor compliance of the tenant under the lease during its term, and providing reports to D.

It appears that A & D are merely conduit organizations so they can obtain grants.

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After reviewing the contract and other information it appears that the only activity to be conducted by A is to hold title to the homes and apply for grants. The two support services needed to provide housing to individuals with developmental disabilities are housing services and support living services and they are both being contracted to third parties. In addition to the housing services mentioned above C will also provide A with a number of accounting services that include billing and collection, depositing all rents and revenues, maintaining adequate books and records, preparing monthly financial reports, and distributing access funds in the operating account to D. The contract also states that D will provide to C a copy of terms contained in the housing grant documents.

The financial data on page 9 of the application shows excess revenue of: \_\_\_\_\_ for tax years 2007 and 2008. We requested an explanation on how these funds will be spent in our letter dated September 15, 2006. In your reply you stated that they will be used to purchase and renovate homes. When we requested an itemized list of a breakdown of this expense you stated recipients would include sellers of the homes; title company and other parties needed for closing on the home; architect and contractor developers completing the renovation; C for an administration fee; and D as the developer of the project. Your organization did submit approved capitol budgets for L & M. However, no actual expenses were submitted. The budgets did include developers' fees. We requested a breakdown of the actual developers' fee and copies of all cancelled checks. You stated that the developers' fees were paid to D and therefore there were no cancelled checks. However, D entered into a management contract with C to be the project manager of L & M.

Similar to the organizations described in Salvation Navy v. Commissioner, supra, you have not supplied enough evidence to show that the net earnings would not inure to the benefit of C, N, and O.

After E merged into D, E continued to operate as if the merger never occurred. We received financial reports for 2006 for E showing net real estate investments of \$ \_\_\_\_\_ for tax period ending \_\_\_\_\_, 2006. In the meantime D is continuing to acquire homes that will be managed by C.

A review of the facts makes it difficult to distinguish the difference A, C, D & E. They all share the same office space. C does not charge A or D for rent because the space they occupy is minimal even though they have over \$ \_\_\_\_\_ is real estate assets and own over 70 properties. Some of the invoices from contractors are addressed to C and others are addressed to D. In some instances they are addressed to C and D. A key employee of C is also the President of D and is paid on a commission. Since the affairs of A, C, and D are irretrievably intertwined that the benefits A hopes to obtain by tax exemption would obviously benefit C, F, G, and I.

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### DETERMINATION - ISSUE 1

Based on the information provided in your Form 1023 and supporting documentation, we conclude that you are not operated exclusively for purposes described in section 501(c)(3) of the Code. You have not shown that your assets do not inure to private individuals. In fact, your application demonstrates you operate for the benefit of C, F, and G. Therefore, your organization does not qualify for exemption under section 501(c)(3) of the Code because you are not operated exclusively for 501(c)(3) purposes. Based on the above facts your organization was formed and operated primarily for the benefit of private individuals.

### ISSUE 2 - IRC 509(a)(3)

#### Introduction

We have also considered your application for supporting organization status (non-private foundation status) under section 509(a)(3) of the Code in the event that you would qualify for exemption under section 501(c)(3). Our conclusion regarding your private foundation classification under section 509(a)(3) of the Code is based on a number of factors discussed in the following material.

**Section 509(a)(3) of the Code** provides that the term "private foundation" does not include an organization which:

- (A) is organized, and at all times thereafter is operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified organizations described in section 509(a)(1) or (2),
- (B) is operated, supervised, or controlled by or in connection with one or more organizations described in section 509(a)(1) or (2), and
- (C) is not controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more organizations described in section 509(a)(1) or (2).

**Section 509(a)(3)(A)**, in effect, describes as a public charity, an organization which is organized and at all times thereafter is operated, exclusively for the benefit of, to perform the functions of, or carry out the purposes of one or more specified organizations described in sections 509(a)(1) or 509(a)(2). In our discussion of these issues, we are cognizant of the fact that at all times you are asserting qualification under section 509(a)(3) under the "operated, supervised, or controlled by" relationship provided in section 1.509(a)-4(i)(1) of the Income Tax Regulations.

For an organization to qualify as a supporting organization it must pass the organizational and

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operational test (509(a)(3)(A)), relationship test (509(a)(3)(B)) and a control test (509(a)(3)(C)).  
Your organization does not pass the operational test.

### Operational Test

**Section 509(a)(3)(A) of the Code** provides that, in order to qualify under section 509(a)(3) an organization at all times thereafter is operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified organizations described in section 509(a)(1) or (2).

**Reg. 1.509(a)-4(b)(1)** provides that in order to qualify as a supporting organization, an organization must be both organized and operated exclusively "for the benefit of, to perform the functions of, or to carry out the purposes of" one or more specified publicly supported organizations. If it fails to meet either the organizational test or operational test, it cannot qualify as a supporting organization.

**Reg. 1.509(a)-4(e)(1)** provides that a supported organization will be regarded as "operated exclusively" to support one or more specified publicly supported organization only if it engages solely in activities which support or benefit the specified publicly supported organizations.

### Application of Operational Test

You are not operated exclusively for the benefit of specified publicly supported organizations as required by section 509(a)(3)(A). As describe above your organization was formed to benefit C and the financial interest of F & G. Under the totality of facts and circumstances, A failed to meet the operational test of Section 509(a)(3)(A) of the Code.

### DETERMINATION - ISSUE 2

Based on our analysis of your activities and, in light of the applicable law, we have determined you do not qualify for tax exclusion from private foundation status under section 509(a)(3) of the Code. A did not pass the operational test.

### SUMMARY

In conclusion, you do not qualify for tax exemption as an organization described in section 501(c)(3) of the Code. Even if we determined that you were described in section 501(c)(3) of the Code, you would not qualify as a supporting organization described in section 509(a)(3) of the Code.

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. If your

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statement does not provide a basis to reconsider our determination, we will forward your case to our Appeals Office. You can find more information about the role of the Appeals Office in Publication 892, *Exempt Organization Appeal Procedures for Unagreed Issues*.

*Types of information that should be included in your appeal can be found on page 2 of Publication 892, under the heading "Regional Office Appeal". The statement of facts (item 4) must be declared true under penalties of perjury. This may be done by adding to the appeal the following signed declaration:*

*"Under penalties of perjury, I declare that I have examined the statement of facts presented in this appeal and in any accompanying schedules and statements and, to the best of my knowledge and belief, they are true, correct, and complete."*

*Your appeal will be considered incomplete without this statement.*

*If an organization's representative submits the appeal, a substitute declaration must be included stating that the representative prepared the appeal and accompanying documents; and whether the representative knows personally that the statements of facts contained in the appeal and accompanying documents are true and correct.*

An attorney, certified public accountant, or an individual enrolled to practice before the Internal Revenue Service may represent you during the appeal process. If you want representation during the appeal process, you must file a proper power of attorney, Form 2848, *Power of Attorney and Declaration of Representative*, if you have not already done so. You can find more information about representation in 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](http://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 appeal 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.

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

Mail to:

Internal Revenue Service  
EO Determinations Quality Assurance  
Room 7-008  
P.O. Box 2508  
Cincinnati, OH 45201

Deliver to:

Internal Revenue Service  
EO Determinations Quality Assurance  
550 Main Street, Room 7-008  
Cincinnati, OH 45202

You may 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