



DEPARTMENT OF THE TREASURY

Internal Revenue Service
TE/GE EO Examinations
1100 Commerce Street
Dallas, TX 75424

**TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION**

April 17, 2008

Number: **200829046**
Release Date: 7/18/2008

UIL: 501.03-01

LEGEND

ORG = Organization name XX = Date Address = Address

ORG
ADDRESS

Person to Contact:
Identification Number:
Contact Telephone Number:
In Reply Refer to: TE/GE Review Staff
EIN:

CERTIFIED MAIL – RETURN RECEIPT

LAST DATE FOR FILING A PETITION
WITH THE TAX COURT: July 16, 20XX

Dear :

This is a Final Adverse Determination Letter as to your exempt status under section 501(c)(3) of the Internal Revenue Code. Your exemption from Federal income tax under section 501(c)(3) of the code is hereby revoked effective July 1, 20XX. You agreed to this adverse determination per signed Form 6018, on February 14, 20XX.

Our adverse determination was made for the following reasons:

Your primary activity and purpose since your inception has consisted of the selling of member artwork, to private individuals, for pecuniary gain. I.R.C. section 501(c)(3) requires organizations to operate exclusively for an exempt purpose. See Treas. Reg. Section 1.501(c)(3)-1(a). You failed to meet the requirements of IRC section 501(c)(3) and Treas. Reg. section 1.501 (c)(3) -1(d) in that you failed to establish that you were operated exclusively for an exempt purpose. Rather, you were operated for a substantial non-exempt purpose by displaying and selling artwork exclusively for those who were active members in your gallery shows.

Contributions to your organization are no longer deductible under section 170 of the Internal Revenue Code. You are required to file Federal income tax returns on Form 1120. You have provided those returns for periods ended June 30, 20XX through June 30, 20XX. We will submit the return to the appropriate Service Center.

Processing of income tax returns and assessment of any taxes due will not be delayed should a petition for declaratory judgment be filed under section 7428 of the Internal Revenue Code.

If you decide to contest this determination in court, you must initiate a suit for declaratory judgment in the United States Tax Court, the United States Claim Court or the District Court of the United States for the District of Columbia before the 91st day after the date this determination was mailed to you. Contact the clerk of the appropriate court for the rules for initiating suits for declaratory judgment.

You also have the right to contact the office of the Taxpayer Advocate. However, you should first contact the person whose name and telephone number are shown above since this person can access your tax information and can help you get answers.

You can call and ask for Taxpayer Advocate assistance. Or you can contact the Taxpayer Advocate from the site where the tax deficiency was determined by mailing:

Taxpayer Advocate assistance cannot be used as a substitute for established IRS procedures, formal appeals processes, etc. The Taxpayer Advocate is not able to reverse legal or technically correct tax determinations, nor extend the time fixed by law that you have to file a petition in the United States Tax Court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling.

We will notify the appropriate State Officials of this action, as required by section 6104(c) of the Internal Revenue Code.

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

Sincerely yours,

Marsha A. Ramirez
Director, EO Examinations

Internal Revenue Service

Department of the Treasury
TE/GE EO Examinations Division
915 2nd Avenue, M/S W 540-DW
Seattle, WA 98174

Date: January 23, 2008

ORG
ADDRESS

Taxpayer Identification Number:

Form:

Tax Year(s) Ended:

Person to Contact/ID Number:

Contact Numbers:

Telephone:

Fax:

CERTIFIED MAIL - RETURN RECEIPT REQUESTED

Dear ,

We have enclosed a copy of our report of examination explaining why we believe revocation of your organization's exempt status is necessary.

If you do not agree with our position you may appeal your case. The enclosed Publication 3498, *The Examination Process*, explains how to appeal an Internal Revenue Service (IRS) decision. Publication 3498 also includes information on your rights as a taxpayer and the IRS collection process.

If you request a conference, we will forward your written statement of protest to the Appeals Office and they will contact you. For your convenience, an envelope is enclosed.

If you and Appeals do not agree on some or all of the issues after your Appeals conference, or if you do not request an Appeals conference, you may file suit in United States Tax Court, the United States Court of Federal Claims, or United States District Court, after satisfying procedural and jurisdictional requirements as described in Publication 3498.

You may also request that we refer this matter for technical advice as explained in Publication 892, *Exempt Organization Appeal Procedures for Unagreed Issues*. If a determination letter is issued to you based on technical advice, no further administrative appeal is available to you within the IRS on the issue that was the subject of the technical advice.

If you accept our findings, please sign and return the enclosed Form 6018, *Consent to Proposed Adverse Action*. We will then send you a final letter revoking your exempt status. If we do not hear from you within 30 days from the date of this letter, we will process your case on the basis of the recommendations shown in the report of examination and this letter will become final. In that event, you will be required to file Federal income tax returns for the tax period(s) shown above. File these returns with the Ogden Service Center within 60 days from the date of this letter, unless a request for an extension of time is granted. File returns for later tax years with the appropriate service center indicated in the instructions for those returns.

You have the right to contact the office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. You may call toll-free 1-877-777-4778 and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate at:

If you have any questions, please call the contact person at the telephone number shown in the heading of this letter. If you write, please provide a telephone number and the most convenient time to call if we need to contact you.

Thank you for your cooperation.

Sincerely,

David Weaver
Internal Revenue Agent

Enclosures:
Publication 892
Publication 3498
Form 6018
Report of Examination
Envelope

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
Name of taxpayer ORG	Tax Identification Number	Year/Period ended June 30, 20XX - June 30, 20XX

LEGEND

ORG = Organization name XX = Date Motto = motto XYZ = State City = city
CO-1 thru CO-20 = 1st, 2nd, 3rd, 4th, 5th, 6th, 7th, 8th, 9th, 10th, 11th, 12th, 13th, 14th,
15th, 16th, 17th, 18th, 19th, 20th, 21st, and 22nd companies Director = director
CPA = CPA

ISSUES

- 1) Is the primary activity of ORG ("ORG") the selling of motto on behalf of its members?
- 2) If the primary activity of ORG is the selling of motto on behalf of its members, should ORG continue to be recognized as tax exempt under §501(a) of the Internal Revenue Code ("Code") as an organization described in Code §501(c)(3)?

FACTS

ORG, was incorporated under the laws of the State of XYZ as a non-stock, nonprofit corporation on November 13, 19XX.

The ORG purpose as stated in its articles of incorporation is fourfold as follows:

- I. The collection and preservation of objects and materials of Hawaiian arts and crafts, to perpetuate Hawaiian culture, and to encourage and inspire artistic expressions of native Hawaiian skills and creativity.
- II. To foster and encourage art appreciation and expression, the development of artistic ability and other skills, particularly through the medium of classes or other guidance and instruction in all forms of art, including oil painting, water color, drawing, sketching, ceramics, sculpture, lei making, oriental flower arrangement, interpretive dancing, little theatre groups, and generally to cultivate and promote community interest in every form of artistic activity.
- III. To acquire and maintain buildings, halls, rooms or other places where works of art may be exhibited, studied, crated or preserved, and a center where persons having artistic interests may meet for mutual discussion and exchange of ideas.
- IV. To accept and receive gifts and grants of money, paintings and objects of art of every kind and nature, and to administer the same for civic and community betterment in the promotion of the objectives of this ORG.

The ORG original application for exemption, Form 1023, was received by the IRS Exempt Organizations Los Angeles office on March 28, 19XX. The ORG purpose as stated in the original exemption application was "for the purpose of educating people as to what is good art in the County of City. Classes are held where art teachers teach interested students how to paint." In addition, the ORG stated in response to question 10(g) that it "plans to engage in fund-raising activities by selling the paintings of its members or paintings contributed by recognized painters in the State of XYZ."

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On May 21, 19XX, the ORG application for exemption was denied by the Internal Revenue Service ("IRS"). The examining agent cited private interests being served as the reason for denial.

On October 30, 19XX, a second application for exemption was received by the IRS. The ORG purpose as stated in the second application was threefold as follows:

- I. To educate the public to appreciate the aesthetic values of native Hawaiian art, crafts, and culture by establishing a free public art museum and gallery on City where art objects may be collected, preserved, and displayed.
- II. To promote the arts by sponsoring regular art classes, lectures, demonstrations, and exhibits for the public. For instance, regularly scheduled 2 and 4 hour classes are conducted several mornings and evenings during the week by recognized art instructors,
- III. To assist in the renovation of the Court House, a National Monument, as the site of the public art museum and gallery.

In response to question 10(g) concerning fundraising activities, the ORG presented an analysis of its gross receipts for the year of 1969 to demonstrate its various fund raising activities. The analysis is summarized below:

- The Beaux Art Ball produced 22% of the ORG gross receipts. This was an annual event in which the proceeds were earmarked for the restoration of the Court House into an art museum for the public and for the improvement of workshop areas where art classes were held.
- Membership registration produced 30% of the ORG gross receipts. This was essentially member dues revenue.
- Commissions produced 14% of ORG gross receipts. The ORG allowed local artists to display and sell their art work on the Court House grounds during the weekends. The requested commission ranged between 10-15% of the sale price.
- Maintenance fees produced 30% of the ORG gross receipts. The maintenance fees were fees charged to the students of classes sponsored by the ORG to cover supplies and janitorial expenses related to the classes.

In response to question 10(j) the ORG disclosed that it had discontinued the activity of collecting tuition from its students to reimburse its instructors and charging artists a rent fee for displaying motto on Courthouse grounds.

In a letter dated January 14, 19XX, the President of the ORG clarified at the request of the Power of Attorney, the "correction" of two procedures formally used by the ORG. In the letter the President stated

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that the ORG would no longer allow purchasers of motto to make checks payable to the ORG. Instead, the purchasers will be required to make the check payable to the artist and the artist would then pay the ORG the commission. Secondly, the collection of the teachers fees will be the responsibility of the teachers with the ORG supplying the workroom as a free service to the artists as part of its community service.

In a letter dated February 1, 19XX, the President of the ORG clarified the structure of the Beaux Art Ball at the request of the then Power of Attorney. The President describes the Beaux Art Ball as an annual event in which art work that was donated to the ORG would be displayed in the prior week and then auctioned at the event itself. This event was described as "the main source of funds to carry on the work of providing these varied facilities."

The letters from the ORG President and a letter from the Power of Attorney dated February 8, 19XX, were part of correspondence to the IRS office that was considering granting the ORG exemption from Federal income tax.

On February 25, 19XX, a letter was issued approving the ORG exemption from Federal income tax. The letter cites the following reasons for granting the ORG exemption (summarized):

- No profit motive was evident for showing art work at the ORG galleries. The artists could likely receive more commission from other galleries.
- Several artists are benefiting from the showings not just a few.
- Checks are now being made payable to the artists and not the ORG.
- Most of the receipts were from the Beaux Ball in which artists donated work to be auctioned to promote charitable purpose. In contrast, commissions received from artists came in only slightly more than 10% of gross receipts. Thus this activity was deemed to be incidental to overall operation which is for public purpose not private.

In a subsequent determination letter dated December 2, 19XX, the ORG was held to be exempt from Federal income tax as an organization described in Code §501(c)(3) and classified as a public charity described in Code §509(a)(2).

According to the most recent version of the by-laws, the ORG is controlled by the Board of Trustees that consists of not less than eight and not more than twenty five members. The trustees must be voting members of the ORG for at least three months.

On June 5, 20XX, the Internal Revenue Service ("IRS") initiated an examination of the books and records of ORG.

On July 12, 20XX, the assigned agent interviewed officers of the organization along with the Power of Attorney. Below is a transcript of that interview:

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The questions asked are listed below, with responses immediately following the numbered question.

1. Did you receive Publication 1, have you read it, and do you have any questions concerning your rights?

Yes. No questions.

2. To get a full understanding of your organization, please describe the history of your organization and all of its activities.

The organization's main focus is to promote art by means of education. The organization ("EO") sponsors free art classes to local schools and work shops. There is no charge for the classes and supplies are often paid for by the organization. Secondly, the EO is involved with historic restoration and preservation of a historical site. The EO is allowed to use the "old courthouse" in downtown as an art gallery. Rent payment to the County is used by the County for historical preservation initiatives as a certain percentage is funneled into an organization known as Restoration Foundation.

The EO attempts to pay an annual scholarship to an Art student. The normal amount of the scholarship is around \$.

Art instructors are hired by the organization and are employees and not independent contractors. During the year under examination, the EO had 8-9 teachers, a full time office manager and a full time bookkeeper on the payroll.

The EO supports itself by three different activities. They are as follows:

- **Art Gallery:** The EO rents a commercial space from the county. It is commonly referred to because it is a historical landmark in the community. The gallery is open from 9:00 AM to 5:00 PM every day with an exception of a few annual holidays. Members' motto is displayed and sold at the gallery. When a piece of motto is sold, the member receives 60% of the sales price as a "commission". The EO receives 40% of the sales price. The EO categorized this revenue as "contributions, gifts, and grants" on the Form 990. The EO commits two full time employees to the gallery (The Gallery Manager and Assistant) and the bookkeeper who is part time devotes a majority of their time to the gallery and its functions.
- **Art Shows:** The EO will sponsor art shows every other weekend. The most typical art show is that of the show. The format is the same as the gallery with the exception that most of these events are held outdoors. art shows are also held on county property. The property is park like immediately outside the where the gallery is housed. The EO gets 40% of the sales price and the artists gets 60% of the sales price. The EO categorized this revenue as "contributions, gifts, and grants" on its Form 990 for the year under examination. The County of City requires a non-profit organization to operate on its facility and pandering of motto by individuals on its property is prohibited by local ordinances. Therefore, the EO allows the transactions to flow through its books in order for the member sales to be lawful.

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- **Member Dues/Assessments:** The EO is a membership organization. Typically, the membership requirements are that the prospective member has an interest in art and is a resident of City County. Individual memberships are annual \$ assessments and Family Memberships are \$ assessments. In addition, a member assessment of \$ is made when \$ or more of a members' motto is sold at an art show.
- **Grants:** The EO applies for various grants from city, county and state government.
- **Public Donations:** Public donations are accepted on a limited basis.

3. Does the organization have an art gallery(s)? Who is entitled to use it? What items are sold there? Whose motto is sold? Consignment Basis? Was the commission paid to artist reported on Form 990 (Show 1099 amounts)? Why not? Who are the payees? Members?

All members can use the galleries. Residents of City County can become members. 99% of the people who apply are accepted as members. The application criteria are that the prospective members provide original works of art to a jury of current members. The presented work must not be imported motto.

4. How is it determined what works are selected for presentation (modern trends or salability)? Who sets the price?

The organization verifies that the artists' does their own work. No imported motto may be presented. Committees are formed to insure this requirement is strictly adhered to.

5. How much time and effort is devoted to the art gallery and selling local artist's motto?

The gallery is open seven days a week 9-5. It has two full time employees. The Gallery Manager is full time. The Bookkeeper is part time.

6. Is the art gallery advertised to the public?

The EO typically will on occasion advertise in a couple of local art magazines such as Art guide to City.

7. Are you aware of any other commercial art galleries in the area?

It could be that there are 50 art galleries in the local area. The area is known for its artistic culture.

8. Is the organization involved in souvenir sales?

No.

9. Gross Rents of \$ was reported on the Form 990 as revenue? What is it?

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This revenue is generated from members. During art fairs, the members are allowed to rent booth space from the EO. If an artist generates \$ or more in sales, then a \$ assessment is generated against the member. The assessment is payable to the EO. These assessments are made against the members to assist in paying for the \$ permit fees paid to the county for the art fairs.

10. Indirect Public Support of \$ was reported on the Form 990 as revenue. What is this revenue source?

This revenue represents the commissions generated from member art sales at both the gallery and art fairs.

11. Other Salaries and Wages \$ reported on Form 990 for fiscal year end 20XX06. However, \$ was reported on Forms 941 for calendar year ending December 31, 20XX. The Form 990 does not report any of the \$ reported on Forms 1099-MISC to various individuals. Why was these commissions paid to artists not reported on the Form 990?

The EO takes the position that the artists' sell their own work. The EO is simply the selling agent.

12. The Form 990 reports Other Employee benefits of \$. What is the benefit?

The other benefits are mainly medical insurance. Any employee that works 20 hours or more per week receives medical benefits.

13. The Form 990 reports Credit Card Fees of \$. What is it?

The credit card company that the EO uses charges a transaction fee. This amount is the total amount paid to the credit card company for said fees.

14. Is this a membership organization?

Yes. The EO had about 200 members during the year under examination.

15. What classes of members are there and are there any differences in voting rights?

There are two classes of members as follows:

- Personal Membership requires a \$ per year dues assessment; and
- Family Membership which requires a \$ per year dues assessment.

16. Are there associate member classes? If yes, do they have voting rights?

No.

17. Are there any employees of the organization? State the number and type of positions. Have all federal and state employment tax returns been timely filed?

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The EO has the following employees:

- 8-9 Art Instructors;
- A full time Office Manager;
- A part time Bookkeeper; and
- A part time Gallery Assistant.

A reconciliation of books and records was performed by the assigned agent. The following is the result of said reconciliation:

EXPENSES

	Per 990	Per Audit	Differences
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Grants and allocations:

Salaries and Wages

Salaries and Wages

Commissions

Benefits paid to or for members:

Employee Benefits (Health Insurance)

Insurance

Payroll Expense – Other

Commission Paid to Member Artists:

Consignment Sales Commission

Shipped Sales

Payroll taxes:

Accounting fees:

Accounting

Bookkeeping

Outside Service – Other

Supplies:

Telephone:

Postage and shipping:

Labor

Postage

Supplies

Shipping – Other

Poster Postage

Occupancy:

Rent

Repairs and Maintenance

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Utilities
Equipment rental and maintenance:
Travel:
Interest:
Depreciation, depletion, etc:
Other Expenses:
 Historic Preservation
 Credit Card Fees
 XYZ General Excise Tax
 Poster Expense
 Other Expense

EXPENSES

	<u>Per 990</u>	<u>Per Audit</u>	<u>Differences</u>
Professional Fees			
Advertising & Promotion			
Insurance			
Penalties			
Awards			
Consultant			
Fundraising Total			
News Letter			
TOTAL EXPENSES			

REVENUES

	<u>Per 990</u>	<u>Per Audit</u>	<u>Difference</u>
Contributions, gifts, grants:			
Donated Art			
Public Donations			
Grants			
Program service revenue:			
Gallery Sales			
Art Fair			
Consignment Sales - Other			
Galleries - Shipped Sales			
Art Fair - Shipped Sales			
Poster Sales – Shipped			
Poster Sales – Gallery			
Shipping Charges			
Referral Fee			
Show Fees			
Supplies Sold			
Membership dues/assessments:			

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Interest on saving/investments:

Fundraising Income

Gross rents:

Less rental expenses:

Other revenue

TOTAL REVENUE

_____	_____	_____
=====	=====	=====

On July 13, 20XX, the assigned agent perused the local phone book (City) under the sub-heading Art Galleries-Dealers & Consultants. A list of local galleries was compiled from the phone book. A partial list of local art galleries is illustrated below as it stood at that time:

1. CO-1
2. CO-2
3. CO-3
4. CO-4
5. CO-5
6. CO-6
7. CO-7
8. CO-8
9. CO-9
10. CO-10
11. CO-11
12. CO-12
13. CO-13
14. CO-14
15. CO-15
16. CO-16
17. CO-17
18. CO-18
19. CO-19
20. CO-20

On the same page of the phone book that the 20 names above were acquired, there were 74 other galleries listed including ORG. Subsequent pages of the phone book were not reviewed.

In the March of 20XX Board Meeting Minutes, Director (Executive Director) reported to the Board that artists' income was \$ in the year 20XX. From that level, it had increased to \$ in 20XX (51% increase), \$ in 20XX (5% increase), \$ in 20XX (3% increase). He stated that artists' income had increased 64% since he started and that the artists' income had increased again in 20XX despite the increase in the gallery share of the sales.

According to the July of 20XX Board Meeting Minutes, the aforementioned Director proposed the creation of a new "taxable non-profit" organization and that it be incorporated. The new non-profit organization would be owned by ORG and carry on the art selling activity as taxable activity. The profits would then be

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passed on to ORG. Director stated the reason for his proposal was because the art selling activity jeopardized the federal charitable status of ORG. The proposal by Director was never acted upon by ORG and Director is no longer with ORG as an employee.

On February 22, 20XX, through use of an information document request, the assigned agent requested information concerning the activities of the organization during the year under examination. The information document request asked for the documents to be received no later than March 22, 20XX. Below is a partial transcript of the information document request that is relevant to this report:

Concerning the Membership:

- Are members given the opportunity to display and sell motto in the ORG (“ORG”) art gallery and/or sponsored art shows? If so, what is the criteria for the art to be shown other than verifying that the motto is the original work of a ORG member?
- Do the ORG members have a volunteer time requirement? If so, how is the volunteer time requirement fulfilled? Is the volunteer time requirement fulfilled by working in the gallery or community classes?

Concerning the ORG Facility:

- The approximate square footage of the art gallery (both upstairs and downstairs) and indicate approximately how many square feet is allocated to (1) motto sales, (2) storage, (3) office space, and (4) motto display.
- The hours of operation of the art gallery for the year under examination.
- The total number of hours the gallery was open during the year of examination.
- The total number of hours of sponsored outdoor art shows during the year of examination.

Concerning Employee and Volunteer Staff Time:

- Please determine how many hours of paid and volunteer labor for each of the following activities accrued during the course of the year under examination. Please provide me with your determination along with any documentation that supports your calculation. Please indicate how each of the following activities was arranged. The calculation should included administrative hours and method of allocation:
 - a) Both free and fee based art classes for the general public
 - b) Community art education activities such as workshops, demonstrations, lectures and tours

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- c) School programs such as free and fee based art classes for youth, demonstrations, and lectures
- d) Art gallery operation
- e) Outdoor art shows and fairs. Please indicate whether motto is sold at these events and how.
- f) Any other activities not mentioned above.

Concerning ORG Community Education Activities:

- A list of classes sponsored by ORG. For each class please determine and provide the number of class hours and how the instructor is selected. Class hours should include prep time.
- A list of other community education activities such as workshops, demonstrations, lectures and tours. Please indicate the nature and purpose of the activity.

Concerning School Programs:

- A list of classes sponsored by ORG. For each class please determine and provide the number of class hours and how the instructor is selected. Total class hours should include prep time.

Concerning the Art Gallery and Art Shows:

- The date the ORG gallery was first opened.
- Whether or not non art related souvenirs are sold in the gallery.
- Hours of operation for the gallery.
- The method of determination for which art work is displayed in the gallery and for how long.
- Who is responsible for making the decision on what art is displayed and when to remove it?
- What happens to the art work if it is not sold?
- For the year of examination, how many active members work was displayed and sold?
- Was any non-member art work sold during the year of examination?
- With respect to the contract between members and ORG, please describe the terms of sales, including the percentage that is given to artist and the percentage retained by ORG from sale of motto.

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Concerning the Salary Expenses of ORG:

- The ORG Profit & Loss Statement for the tax period ending June 30, 20XX, reports Salaries and Wages in the amount of \$. Please determine the amount of the aforementioned salary expense that was allocated to the art gallery and art shows for the year under examination. Please provide me with your determination along with any supporting documentation that supports your calculation.

Concerning the Form 8374, Support Schedule for Advance Ruling Period, for the tax period ending June 30, 20XX, received from CPA, CPA (Power of Attorney) on August 10, 20XX:

- Copies of Profit and Loss Statements for the tax periods 20XX-20XX to reconcile the figures on aforementioned schedule.
- Accountant's work papers concerning said schedule (if available).

On March 15, 20XX, the IRS received a written request for an extension of time to provide documentation requested in the aforementioned information document request. The request was for an additional 30 days. The request was granted by the assigned agent.

As of April 30, 20XX, no response to the aforementioned information document request had been received by the IRS. A second information document request was issued requesting the same information. The information document request advised ORG that it was the "second request" for the aforementioned documentation and information.

On July 16, 20XX, the IRS received a response to the aforementioned information document request. For informational purposes, the narrative is attached as exhibit 1 to this report. Below is a summarized account of the provided information:

- ORG gallery space includes both the CO-21 and CO-22. CO-22 is a two story facility that contains about 1,928 square feet. Approximately 10 square feet are allocated to cash drawer, packaging table, computer and invoice area. Approximately 50 square feet are allocated to storage. Approximately 416 square feet are allocated to office space. The remainder of the facility is allocated to motto display.
- Both of the galleries are open from 9:00 AM until 5:00 PM throughout the year, excluding Christmas Day. The galleries were open a total of hours during the year under examination.
- Outdoor art shows totaled 384 hours.
- A total of 1,774.25 hours of paid teaching hours and 812 volunteer teaching hours were accrued during the year under examination for free art classes to the public.

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- A total of 1040 hours was allocated to the Art Outreach Coordinator who works 20 hours a week.
- Administrative time allocated to education activities was 350 hours.
- Labor for the galleries was paid through the commission, hourly rates, and salaried positions. There was at least one paid person working each day, and sometimes administrative paid labor occurred during the same day. Total paid labor equals 5,000 hours for the year under examination. Total volunteer labor for the galleries equaled 5,824 hours for the year under examination.
- Outdoor art show labor totaled 864 hours (administrative 480 + 384 hours of art shows).
- City County regulations do not allow any money to be exchanged at the out door art shows because it is held on county property. When a customer wants to purchase a piece of art from an artist, the artist writes up an invoice. The customer then brings the invoice into the gallery. The ORG gallery worker completes the financial transaction and stamps "paid" on the invoice. The customer then provides the invoice to the artist who gives the art to the customer or makes shipping arrangements.
- 137 active members sold motto during the year under examination.
- According to the ORG payroll records, a total of \$ was expended for gallery payroll and \$ for art show payroll during the year under examination.
- According to the ORG payroll records, a total of \$ was expended on youth programs payroll during the year under examination.
- According to Profit and Loss Statement for the year under examination, ORG incurred a total salary expense of \$.

LAW

Code §501(c)(3) exempts from Federal income tax organizations organized and operated exclusively for charitable, educational, and other exempt purposes, provided that no part of the organization's net earnings inures to the benefit of any private shareholder or individual.

Code §7805(b) provides that the Secretary may prescribe the extent, if any, to which any ruling (including any judicial decision or any administrative determination other than by regulation) relating to the internal revenue laws shall be applied without retroactive effect.

Federal Tax Regulations ("Regulations") §1.501(c)(3)-1(a) provides that in order to be exempt as an organization described in Code §501(c)(3), 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.

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Regulations §1.501(c)(3)-1(c)(1) 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 Code §501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities in not in furtherance of an exempt purpose.

Regulations §1.501(c)(3)-1(c)(2) provides that the operational test is not satisfied where any part of the organization’s earnings inure to the benefit of private shareholders or individuals, and where the organization serves a private benefit rather than public interests.

Regulations §1.501(c)(3)-1(d)(ii) provides that an organization is not organized or operated exclusively for one or more exempt purposes unless it serves a public rather than private interest. Thus, it is necessary for an organization to establish that 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.

Proposed Tax Regulations §1.501(c)(3)-1(d)(1)(iii) provides examples to illustrate the restriction on private benefit as stated in Regulations §1.501(c)(3)-1(d)(ii). Example number 2 reads as follows:

“(i) O is an art museum. O’s sole activity is exhibiting art created by a group of unknown but promising local artists. O is governed by a board of trustees unrelated to the artists whose work O exhibits. All of the art exhibited is offered for sale at prices set by the artist. Each artist whose work is exhibited has a consignment arrangement with O. Under this arrangement, when art is sold, the museum retains 10 percent of the selling price to cover the costs of operating the museum and gives the artist 90 percent.

(ii) The artists in this situation directly benefit from the exhibition and sale of their art. As a result, the sole activity of O serves the private interests of these artists. Because O gives 90 percent of the proceeds from its sole activity to the individual artists, the direct benefits to the artists are substantial and O’s provision of these benefits to the artists is more than incidental to its other purposes and activities. This arrangement causes O to be operated for the benefit of private interests in violation of the restriction on private benefit in §1.501(c)(3)-1(d)(1)(ii). Based on these facts and circumstances, O is not operated exclusively for exempt purposes and, therefore, is not described in Code §501(c)(3).”

Regulations §1.501(c)(3)-1(d)(2) provides that the term “charitable” is used in Code §501(c)(3) in its generally accepted legal sense, and includes the promotion of education.

In Revenue Ruling 66-178, 1966-1 C.B. 178, the Service recognized an organization that sponsored an annual public art exhibit that displayed the works of unknown and promising artists to be exempt from Federal income tax under Code §501(c)(3). Although the organization charged a nominal admission fee to the exhibit and sold a catalogue describing the exhibit, the organization did not sell or offer the displayed works for sale.

In Revenue Ruling 71-395, 19XX-2 C.B. 228, a cooperative art gallery was formed by a group of artists to exhibit and sell their works. Additional artists were admitted to membership only on approval of existing members. All works displayed at the gallery could be purchased by the public and many could also be

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rented. The gallery retained a commission from the sales and rentals to cover its costs of operation. In concluding that the art gallery was not entitled to recognition of exempt status, the ruling emphasized that the gallery was a vehicle for advancing the careers of its members and for promoting the sale of their work. As such, it "serves the private purposes of its members, even though the exhibition and sale of paintings may be an educational activity in other respects."

In Revenue Ruling 76-152, 1976-1 C.B. 151, a group of art patrons formed an organization to promote community understanding of modern art trends. Its sole activity was the selection of modern art works of local artists for exhibition and for possible sale at its gallery, which was open to the public. A modern art work of any local artists was eligible for consideration for exhibition and, if selected, the artist's work was displayed on a consignment basis with the artist setting the selling price. The artist had no control over the organization or its selection process. The organization kept a ten percent commission on sales. On these facts, the Service ruled, as in Revenue Ruling 71-395, that the artists were being directly benefited by the exhibition and sale of their works with the result that a major activity of the organization was serving the private interests of those artists whose works were displayed.

The presence of a single substantial nonexempt purpose can destroy the exemption regardless of the number or importance of exempt purposes. Better Bus. Bureau v. United States, 326 U.S. 279, 238, 90 L. Ed. 67, 66 S. Ct. 112 (1945); Am. Campaign Acad. V. Commissioner, 92 T.C. 1053, 1065 (1989); see also Old Dominion Box Co., Inc. v. United States, 477 F.2d. 340 (4th Cir. 1973), cert. denied, 413 US 910 (1973) ("operating for the benefit of private parties who are not members of a charitable class constitutes a substantial nonexempt purpose".) When an organization operates for the benefit of private interests, such as designated individuals, the creator or his family, or persons directly or indirectly controlled by such private interests, the organization by definition does not operate exclusively for exempt purposes. Am. Campaign Acad. V. Commissioner, supra at 1065-1066.

In Goldsboro Art League, Inc. v. Commissioner, 75 T.C. 337 (1980), a Code §501(c)(3) organization operated two commercial-type art galleries in connection with an art center which furnished various educational and charitable services to the community. The art galleries sold works of art created by various artists on a consignment basis. The organization would set the sales price of each work of art and advertise the sale of art works to the general public. Under the informal arrangement with the artists, the organization would turn over approximately 80 percent of the proceeds to the artists while retaining the remainder to cover expenses. The Tax Court held that the organization qualified for exemption under Code §501(c)(3) because the primary purpose of the two galleries was to foster community awareness and appreciation of contemporary artists and to provide a constant flow of visual art for students to study techniques.

In making its decision, the Tax Court considered the following factors to be critical to its determination: (1) there were no other museums or galleries in the area, thus, the exhibition of art works showed a purpose primarily to educate rather than to sell and the selling activity served merely as an incentive to attract artists to exhibit their work; (2) works were selected for their representation of modern trends rather than salability; (3) the organization's convincing record of dedication to teach the public, through a variety of means, to appreciate art indicated that its sales activities were "secondary and incidental" to furthering its exempt purposes; and (4) of more than 100 works of arts exhibited in the two galleries, only the _____ of 2 members of the organization were exhibited in the galleries.

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GOVERNMENT'S POSITION

Issue 1 – Is the primary activity of ORG the selling motto on behalf of its members?

As can be seen in the facts section of this report, ORG was originally denied exemption under Code §501(c)(3) on May 21, 19XX. The reason cited for denial was “private interest being served” due to the organization’s planned fund raising activities. The organization stated in its original application that it “plans on fund-raising activities by selling the paintings of its members or paintings contributed by recognized painters in the State of XYZ.” It was not until more than two years later when the organization submitted a second application that exemption was granted by the IRS. However, on the second application for exemption there was no mention of selling “member” motto as an activity. In fact, the representative stated on the application that checks would no longer be made payable to ORG but directly to the artist and that this activity would be no more than an insubstantial activity of the organization.

As will be shown in the following paragraphs, the very same activity that ORG was originally denied exemption for has become the primary activity of the organization today. The primary activity of ORG is selling the motto of its members and retaining a commission for said activity.

The organization has testified both orally and in writing that members are allowed to display motto in the ORG gallery. ORG has a full time paid and volunteer staff working in the gallery. If a piece of art is sold, the transaction flows through the ORG books. The organization retains a 25% commission and the artist is paid the balance. The art show transactions are similar but with a different commission schedule. The volume of sales, \$ (Galleries \$ + Art Fair \$ + Galleries Shipped Sales \$ + Art Fair Shipped Sales \$ + Poster Shipped Sales \$) and the amounts remitted to members \$ (Regular Artists% \$ + Tax Exempt Artists% \$), are substantial.

Furthermore, selling member motto has been an ongoing activity. As explained by the ORG Executive Director in the March of 20XX Board Meeting Minutes, said activity has been ongoing and on the rise since the year 20XX. The gross receipts from sale of member motto represents 92.8% of gross receipts (\$/\$). In addition, 67% of the total gross receipts are paid to members in form of commissions (\$/\$).

Using the information provided by ORG on July 16, 20XX, it can be clearly seen by analyzing the amount of paid and volunteer hours expended by ORG that the primary activity of this organization is sales of member motto. An analysis of hours expended by ORG below illustrates that the organization spends about 75% of its paid and volunteer staff hours on said activity:

Staff Hours – Specific Categories

<u>Category</u>	<u>Volunteer Hours</u>	<u>Paid Hours</u>	<u>Total Combined</u>	<u>Percent of Total</u>
Education (Art Classes/Staff Hours)				
Education (Administrative)				
Gallery Staff Hours				
Art Show Staff Hours				

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Art Show (Administrative)

Totals

Staff Hours – Broad Categories

<u>Category</u>	<u>Hours</u>	<u>Hours</u>	<u>Combined</u>	<u>of Total</u>
Education				
Gallery & Art Shows				
Totals				

The organization expended approximately _____ in funds during the year of examination. Of this amount, 88% was expended for gallery and art show related activities. This fact is illustrated in the following analysis:

	EXPENSES¹		
	<u>Gallery & Art Shows</u>	<u>Education</u>	<u>Total</u>
Grants & Scholarships			
Salary Expenses:			
Salaries and Wages			
Employee Benefits			
Payroll taxes			
Artists (Members) Commission			
General Operational Expenses:			
Accounting fees			
Supplies			
Telephone			
Postage and shipping:			
Occupancy			
Equipment rental and maintenance			
Travel			
Interest:			
Miscellaneous Expenses:			
Historic Preservation			
Credit Card Fees			
XYZ General Excise Tax			
Poster Expense			
Other Expense			
Professional Fees			
Advertising & Promotion			
Insurance			

¹ Payroll taxes and employee benefits were allocated using percentage of total salary factor (Gallery 62% and Education 38%). All other expenses were allocated using percentage of time factor. Since the organization spent 75% of its staff hours on gallery related activities general expenses were allocated using a factor of (Gallery 75% Education 25%).

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Penalties

Awards

Consultant

News Letter

TOTAL EXPENSES

In summary, it is clear that the primary activity of this organization is the selling of its members' motto and retaining a commission for doing so as illustrated by the following facts:

- ✓ Over 90% of the organization's gross receipts are generated from member motto sales;
- ✓ Nearly 75% of paid and volunteer staff hours were devoted to said activity;
- ✓ Nearly 90% of the organization's expenditures were devoted to said activity;
- ✓ This activity has been ongoing and on the rise since at least the year 20XX.

Issue 2 - If the primary activity of ORG is the selling of motto on behalf of its members, should ORG continue to be recognized as tax exempt under §501(a) of the Internal Revenue Code ("Code") as an organization described in Code §501(c)(3)?

ORG does not qualify for exemption as an organization described in Code §501(c)(3) because it does not meet the operational test under Code §501(c)(3) and Regulations §1.501(c)(3)-1(a)(1). ORG fails the operational test because it is not operated exclusively for a Code §501(c)(3) purpose. The organization serves the private interests of its members rather than public purpose contrary to the requirements of Regulations §1.501(c)(3)-1(d)(1)(ii).

The government concedes that fact that ORG is involved in substantial educational activities such as sponsoring free art classes for children. However, the fact remains that the primary activity of the organization is the selling of member motto. As shown in the Better Business Bureau case, a substantial non-exempt purpose will disqualify an organization from exemption despite the number or importance of its other exempt activities. In the case of ORG, the non-exempt activity is not only substantial but primary.

ORG is not similar to the organization described in Revenue Ruling 66-178. The organization described in that ruling charged a nominal admittance fee but did offer motto for sale. In contrast, ORG allows free public admittance to its gallery but sells member motto exclusively. Furthermore, the organization described in this ruling displayed motto from promising artists who were non-members whereas ORG displays only motto of its members.

ORG is not similar to the organization described in the Goldsboro Art League. In that case, the organization that retained its exemption also exhibited and sold art work of its members. However, in contrast to ORG, out of the 100+ exhibits, only 2% were that of members. ORG will only exhibit and sell member motto. This far exceeds the insubstantial 2% found in the Goldsboro Art League case. Also, as illustrated in the facts section of this report, ORG is not located in a part of country where there are no nearby museums or

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galleries. To the contrary it is located in an area of the country noted for its artistic culture and an abundance of galleries. Since the facts in this case are substantially different from the facts in Goldsboro Art League, the decision in the Goldsboro case may not be relied upon as support for the continued exempt status of ORG.

In many respects, ORG is factually similar to the organizations in Revenue Rulings 76-152 and 71-395 because the primary activity of said organization is selling the motto of its members, advancing the careers of its members, retaining commissions in doing so, and thus providing a private benefit to its members. The organizations in these rulings were denied exemption under Code §501(c)(3). In Revenue Ruling 71-395, the Service found that such activity “serves the private purposes of its members, even though the exhibition and sale of paintings may be an educational activity in other respects.” In Revenue Ruling 76-152 the Service ruled in a similar fashion. The Service ruled that the artists were being directly benefited by the exhibition and sale of their works with the result that a major activity of the organization was serving the private interests of those artists whose works were being displayed.

The fact that ORG is displaying and selling only the works of its active members in its gallery shows it is a vehicle for advancing careers and for promoting the sale of the works of active members. This activity serves the private interests of its active members by exhibiting and selling their . Therefore, it is the Government’s position that the Association’s exemption from federal income tax as an organization described in Code §501(c)(3) should be revoked because its primary purpose is providing private benefits to its active members.

The government proposes revocation of exemption effective July 1, 20XX.

TAXPAYER’S POSITION

The organization’s position is unknown at this point.

CONCLUSION

Issue 1 – The primary activity of ORG is the selling of member motto as demonstrated by the following key points:

- ✓ Over 90% of the organization’s gross receipts are generated from member motto sales;
- ✓ Nearly 75% of paid and volunteer staff hours were devoted to said activity;
- ✓ Nearly 90% of the organization’s expenditures were devoted to said activity;
- ✓ This activity has been ongoing and on the rise since at least the year 20XX.

Issue 2 – It has been determined that ORG does not qualify for exemption from federal income tax as an organization described in Code §501(c)(3). The organization has failed the operational test under Code §501(c)(3) and Regulations §1.501(c)(3)-1(a)(1). ORG fails the operational test because it is not operated

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exclusively for Code §501(c)(3) purposes. It has been shown that the primary activity of this organization serves the private interests of its members rather than public purpose contrary to the requirements of Regulations §1.501(c)(3)-1(d)(1)(ii).

The government proposes revocation of exemption effective July 1, 20XX. Forms 1120, U.S. Corporate Income Tax Return, should be prepared and filed by the organization for the period of examination forward.