



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

Number: **200845053**
Release Date: 11/7/2008

Date: August 11, 2008

501.30-00
501.32-00
501.36-01
501.33-00

Contact Person:

Identification Number:

Contact Number:

Employer Identification Number:

Form Required To Be Filed:

Tax Years:

SE:T:EO:RA:T:1

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.

Because 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. File the returns in accordance with their instructions, and do not send them to this office. Failure to file the returns timely may result in a penalty.

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, 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.

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 Choi
Director, Exempt Organizations
Rulings & Agreements

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



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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Date: May 22, 2008

501.30-00
501.32-00
501.36-01
501.33-00

Contact Person:

Identification Number:

Contact Number:

FAX Number:

Employer Identification Number:

Legend:

X =

Y =

Z =

State A =

Dear :

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

FACTS

You were formed in State A as a business corporation, but have requested classification as a tax exempt, publicly supported organization under sections 501(c)(3) and 509(a) of the Code.

You are organized as a stock corporation with three shares of stock, one each is issued to X, Y, and Z, the founders of your organization. You did not submit any stock certificates with your application and your articles of incorporation do not expressly prohibit the payment of dividends. You stated that you chose this form of organization to show ownership and responsibility. You indicate that no other shares of stock will be issued, and the three shares hold all of the voting power. In your financial statement, you show transactions with "owners" accounts of X, Y, and Z. These individuals are also your directors and officers. You intend to limit the number of directors to until you have raised dollars. Your three founding members may serve until they are seventy-six. Additional directors are limited to serving five year terms.

Your articles of incorporation state that your purpose is:

"to engage in any lawful act or activity for which an organization under the laws of State A other than the banning business, the trust company business or the

practice of a professional permitted to be incorporated by Corporation Code. In particular to support activities and endeavors that increase pollution free energy, a cleaner environment and water...."[sic]

Your mission statement is to "raise monies to promote and finance research, prototype design and commercialization of Pollution Free Energy processes."[sic]

You intend to make grants to inventors and entrepreneurs who are developing and patenting pollution free energy technologies. However, you have not developed any specific criteria or an application for selecting those that will receive funds. When asked to provide a description of how you will determine eligibility for your grants, you replied:

"the foundation was established to support and encouraged[sic] development of pollution free energy production by individuals or small organizations. We felt there are a lot of potentially good ideas that can solve this critical problem. Inventors however run into problems finding funding for their projects. In most cases our funding will be directed to initial research work on building small prototype units that demonstrate the technology to be developed. Our goal as a foundation is to promote thinking outside the box for clean energy production that inventors cannot find support for their projects at the early stages of development." [sic]

You have not provided any criteria or sample agreements setting out your requirements for the use of funds, publication requirements, or handling of any intellectual property generated by your grants. You provided conflicting information about the status of intellectual property generated by the activities you fund, stating both that "the intellectual property will be owned by the inventor" and that it "will go into the public domain as the paperwork goes through the patent process." You did not provide any financial information showing your expected sources of revenues and expenses.

You indicated that you will provide organization structuring, accounting set-up and procedures, engineering, operations consulting, etc. and that you have provided similar services, "start-up counseling" to an auto service company. You stated that you request a portion of the funding you provide be returned to the foundation so that the work of the foundation can continue in the future.

X, Y, and Z have developed a patent related to generating power without causing pollution. You stated that X, Y, and Z are eligible to receive funds from your organization, that the only individuals who decide who receives funds are X, Y, and Z, and that all of them will be able to vote on all grants, including those in which one of the directors is a recipient. You also indicated that you will use your funds to build an operating pilot plant based on the patent held by X, Y, and Z. You stated that you do not intend to compensate any of your officers or directors "at this time" but did not indicate whether you will compensate them in the future.

LAW

Section 501(c)(3) of the Code provides an exemption from taxation for organizations organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, 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 Income Tax Regulations provides that, in order to be exempt as an organization described in section 501(c)(3), an organization must be both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational test or the operational test, it is not exempt.

Section 1.501(c)(3)-1(b) of the regulations provides that in order to meet the organizational test, an organization's articles of organization (including articles of incorporation) must limit the purposes of the organization to one or more exempt purposes and ensure that the organization's assets are dedicated to an exempt purpose by requiring that the assets, upon dissolution of the organization, be distributed solely for exempt purposes.

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

Section 1.501(c)(3)-1(c)(2) of the regulations provides that an organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals.

Section 1.501(a)-1(c) of the regulations defines private shareholder or individual as a person having a personal and private interest in the activities of the organization.

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations provides that an organization is not organized or operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. To meet the requirement of this subsection, the burden of proof is on the organization to show that it is not organized or operated for the benefit of private interests, such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

Section 1.501(c)(3)-1(d)(5)(i) of the regulations states that "scientific" organizations include organizations that carry out scientific research in the public interest. Section 1.501(c)(3)-1(d)(5)(ii) provides that scientific research does not include activities of a type ordinarily carried on as an incident to commercial or industrial operations.

Section 1.501(c)(3)-1(d)(5)(iii) of the regulations states, in part, that scientific research will be regarded as carried on in the public interest if it is carried on for the purpose of obtaining scientific information that is published in a treatise, thesis, trade publication, or in any other form that is available to the interested public.

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

Rev. Rul. 72-369, 1972-2 C.B. 245, held that an organization formed to provide managerial and consulting services at cost to unrelated exempt organizations did not qualify for exemption under section 501(c)(3) of the Code. Providing managerial and consulting services on a regular basis for a fee is a trade or business ordinarily carried on for profit. The fact that the services were provided at cost and solely for exempt organizations was not sufficient to characterize the activity as charitable for purposes of section 501(c)(3) of the Code. "Furnishing the services at cost lacks the donative element necessary to establish this activity as charitable."

Rev. Proc. 2008-9, 2008-2 I.R.B. 258, provides that exempt status may be granted in advance of the organization's operations if the proposed activities are described in sufficient detail to permit a conclusion that the organization will clearly meet the particular requirements for exemption pursuant to the section of the Code under which exemption is claimed. The organization must fully describe all of the activities in which it expects to engage, including the standards, criteria, procedures or other means adopted or planned for carrying out the activities, the anticipated sources of receipts, and the nature of contemplated expenditures. A mere restatement of exempt purposes or a statement that proposed activities will be in furtherance of such purposes will not satisfy this requirement.

In Better Business Bureau of Washington D.C., 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 the exemption regardless of the number or importance of truly exempt purposes. The Court found that the trade association had an "underlying commercial motive" that distinguished its educational program from that carried out by a university.

In American Institute for Economic Research v. United States, 302 F. 2d 934 (Ct. Cl. 1962), the court considered an organization that provided analyses of securities and industries and of the economic climate in general. It sold subscriptions to various periodicals and also services providing advice for purchases of individual securities. The court noted that education is a broad concept, and assumed *arguendo* that the organization had an educational purpose. However, it held that it had a significant non-exempt commercial purpose that was not incidental to the educational purpose, and therefore was not entitled to be regarded as exempt.

In Bubbling Well Church of Universal Love, Inc. v. Commissioner of Internal Revenue, 74 T.C. 531 (1980), the court considered an adverse ruling by the Internal Revenue Service on an application for exempt status as a church. The court noted that the only voting members and directors of the organization were a husband and wife and their son, who had no affiliation with any denomination or ecclesiastical body or other outside influence. The applicant had declined to furnish some information, and made answers to other inquires that were vague and uninformative. On the basis of the record, the court held that the applicant had not shown that

no part of its net earnings inure to the benefit of the family or that petitioner was not operated for the private benefit of the family.

In Church of Scientology v. Commissioner of Internal Revenue, 823 F. 2d 1310 (9th Cir. 1987), the court upheld the Commissioner's revocation of exempt status and assessment of tax deficiencies because the organization allowed its assets to inure to the founder and his family. The founder had unrestrained and unaccounted for access to some Church funds, and the Church failed to prove that the funds were spent on behalf of the Church.

New Dynamics Foundation v. United States, 70 Fed.Cl. 782 (2006), was an action for declaratory judgment that the petitioner brought to challenge the denial of his application for exempt status. The court found that the actual purposes displayed in the administrative record supported the conclusion of the IRS. If the petitioner had evidence that contradicted these findings, it should have submitted it as part of the administrative process. "It is well-accepted that, in initial qualification cases such as this, gaps in the administrative record are resolved against the applicant."

In Exploratory Research, Inc. v. Commissioner of Internal Revenue, T.C. Memo 2008-89, the court found that the petitioner had not submitted a substantially completed Form 1023 and therefore was not entitled to relief from the court. The petitioner did not provide any concrete standards, criteria or procedures that it would use in selecting its planned projects. The court was also unable to determine any concrete activity from other information, such as budgets. The court concluded that the petitioner had not provided sufficient information for the Service to rule on exemption, and therefore the petitioner had not exhausted its administrative remedies.

ANALYSIS

Exemption from federal income taxation is not a right, it is a matter of legislative grace that is strictly construed. New Dynamics, supra. The burden is on the applicant to prove that it is entitled to exempt status. *Id.* An applicant must establish that it is organized and operated exclusively for exempt purposes and not for the private benefit of its creators, designated individuals or organizations controlled by such private interests. Treas. Reg. 1.501(c)(3)-1(d)(1)(ii). Exclusively does not mean "solely," but no more than an insubstantial part of an organization's activities may further a non-exempt purpose. Better Business Bureau, supra.

An applicant for exempt status must provide sufficient information for the Service to make an informed decision. The application must include details, figures, and documentation. Basic Bible Church, supra. Exempt status may be granted in advance of an organization's operations, but its activities must be described in sufficient detail to permit a conclusion that the organization will clearly meet the requirements for exemption. Rev. Proc. 2008-9, supra. If an applicant is asked to provide specific information about activities, merely repeating the organization's objectives is not sufficient. Exploratory Research, supra.

Based on the information submitted, you have failed to establish that you will conduct activities in furtherance of an exempt purpose, that no part of your net earnings will inure to private individuals and that you will be operated for a public rather than a private interest.

No Activities in Furtherance of an Exempt Purpose

In order to qualify for tax exemption, an organization must show that it is organized and operated exclusively for exempt purposes. See Section 1.501(c)(3)-1(c)(1). Your articles of incorporation state that your purpose is, in part, to "support activities and endeavors that increases [sic] pollution free energy, a cleaner environment and water." You indicated that you will make grants to organizations and individuals who are working to develop this technology, but did not provide the specific criteria you will use to award and monitor grants. When asked to supply this information, you merely repeated the objectives of your organization. Such a response does not provide the Service with sufficient information to grant tax exemption. Exploratory Research, supra. Therefore, you have not demonstrated that you are engaged in any activities that further an exempt purpose.

Commercial Purpose

In order to qualify for tax exemption, an organization must show that it is organized and operated exclusively for exempt purposes. See Section 1.501(c)(3)-1(c)(1). Your mission statement indicates that you will aid individuals in the "commercialization" of their ideas. In addition, you stated that you have and will provide start-up, counseling, accounting and similar services. You have not indicated whether you will charge for these services and you did not provide financial statements indicating your sources of revenue. Gaps in an application are resolved against the applicant. New Dynamics, supra. Providing consulting services, even if it is at cost to exempt organizations, is not an exempt purpose, it is a commercial purpose. See Rev. Rul. 72-369. Providing these business services is not incidental to promoting scientific research, therefore you have a substantial non-exempt purpose and do not qualify for tax exemption. American Institute for Economic Research v. United States.

Private Benefit

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations states that an organization cannot qualify for exemption if it is operated for private rather than public purposes. In addition, the regulation provides that the organization must demonstrate that it is not operated for the benefit of private individuals, such as its creator and his family. Where an organization is dominated by a small group of individuals, the potential for private benefit is greater. See National Association of American Churches, supra; Bubbling Well Church of Universal Love, supra; Church of Scientology, supra.

You stated that you do not intend to compensate any of your officers or directors "at this time" but did not indicate whether you will compensate them in the future. Your three founding directors are not limited to a set term and can serve until they are seventy-six. You do not intend to expand your board until you have generated significant revenues, and the selection of directors will be controlled by X, Y, and Z because they own the only voting shares of stock.

Based upon the facts presented, X, Y, and Z have unfettered control over your organization and its assets. You have not established that your organization will not be operated for the benefit of X, Y, and Z. Therefore, you have not met your burden to prove that

you will be operated for public rather than private purposes. Consequently, you are not eligible for exemption under section 501(c)(3) of the Code.

Private Inurement

An organization will be denied exemption if any of its net earnings inure to the benefit of private individuals. Treas. Reg. § 1.501(c)(3)-1(c)(2). Even a small amount of inurement will prevent recognition of exemption. X, Y, and Z are your incorporators, they control the only shares of voting stock, and they are the only board members. They have a personal interest in your activities. Thus, X, Y, and Z are private individuals within the meaning of section 1.501(a)-1(c) of the regulations.

The payment of a dividend is *per se* inurement because it transfers the earnings of a corporation to private individuals, its shareholders. Consequently, any corporation capable of paying dividends to its stockholders is not eligible for exemption because its earnings can inure to the benefit of private individuals. Your articles of incorporation do not prevent you from paying dividends and state law would allow you to pay dividends to your shareholders, therefore you are capable of paying dividends and are not eligible for exemption.

In addition, you plan to give grants to organizations and individuals, and X, Y, and Z are eligible to receive these funds. X, Y, and Z jointly hold a patent in your organization's area of interest, and one director has already submitted a request for funds. X, Y, and Z decide who receives the money from your organization and may vote to grant funding, even if they are the recipients of those funds. This is an inherent conflict of interest and it is not clear how your adopted conflict of interest policy would prevent the resulting private benefit. Your organization does not maintain any other safeguards to prevent X, Y, and Z from using the organization's funds for their personal benefit. In addition, there are no restrictions on the transfer of shares of stock of your corporation. This allows X, Y, and Z to transfer ownership of the organization and to profit from it.

In light of these facts, you have not established that no part of your net earnings will inure to the benefit of private individuals. As a result, you do not meet the requirements for tax exemption.

Organizational Test

Section 1.501(c)(3)-1(b) of the regulations requires that a corporation's articles of incorporation limit its purposes to those permitted by section 501(c)(3) of the Code and that the assets of the organization be dedicated to exempt purposes.

The purposes clause in your articles of incorporation is inadequate because it does not restrict your activities solely to those permitted by section 501(c)(3) of the Code. In addition, one of the powers conferred under the general business laws is the power to conduct business. An organization that has the power to carry on substantial business activities cannot be said to be organized exclusively for exempt purposes within the scope of section 501(c)(3).

Your articles of incorporation do not restrict the payment of dividends to your shareholders or the transfer of the stock for value at any time or in lieu of dissolution. This contravenes section 1.501(c)(3)-1(b)(4) of the regulations which requires an organization's assets to be permanently dedicated to exempt purposes. Even on its face your dissolution clause is inadequate. It does not require that your assets be distributed to an organization described in section 501(c)(3) of the Code. It names a specific organization, but does not require that the organization be described in section 501(c)(3) at the time of your dissolution, nor does it provide for an alternate means of disposing of your assets.

Conclusion

You have not established that you will operate in furtherance of an exempt purpose described in section 501(c)(3) of the Code. You have not established that you are not operated primarily for non-exempt commercial purposes. Nor have you demonstrated that no part of your net profits will inure to the benefit of private individuals. You have not established that you will be operated for public instead of private purposes. In addition, you are not organized exclusively for exempt purposes within the meaning of section 501(c)(3) because you are incorporated as a business corporation without the required restrictions on your activity and dissolution.

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

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.

Your protest statement should be accompanied by the following declaration:

Under penalties of perjury, I declare that I have examined this protest statement, including accompanying documents, and, to the best of my knowledge and belief, the statement contains all the relevant facts, and such facts are true, correct, and complete.

You also have a right to request a conference to discuss your protest. This request should be made when you file your protest statement. An attorney, certified public accountant, or an individual enrolled to practice before the Internal Revenue Service may represent you. If you want representation during the conference procedures, you must file a proper power of attorney, Form 2848, *Power of Attorney and Declaration of Representative*, if you have not already done so. For more information about representation, see 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, 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 protest 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.

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

Internal Revenue Service
TE/GE

1111 Constitution Ave, N.W.
Washington, DC 20224

You may also 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