



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

Number: 200910060

Release Date: 3/6/2009

Date: December 10, 2008

501.32-00

501.33-00

501.36-01

Contact Person:

Identification Number:

Contact Number:

Employer Identification Number:

Form Required To Be Filed:

Tax Years:

Dear :

This is our final determination that you do not qualify for exemption from Federal income tax under Internal Revenue Code section 501(a) as an organization described in Code section 501(c)(3).

We made this determination for the following reason(s):

You have not established that you operate exclusively for exempt purposes described in section 501(c)(3) of the Internal Revenue Code. You have failed to establish that you operate for "testing for public safety" under Code section 501(c)(3) and section 1.501(c)(3)-1(d)(4) of the Income Tax Regulations. You also have not established that you operate to lessen the burdens of government within the meaning of section 501(c)(3) and section 1.501(c)(3)-1(d)(2) of the regulations. Additionally, you are operated for the primary purpose of carrying on an unrelated trade or business within the meaning of section 1.501(c)(3)-1(e)(1) of the regulations.

Further, you have not established that you are not operated for the benefit of private persons and that your net earnings will not inure to private individuals within the meaning of section 1.501(c)(3)-1(c)(2) and (d)(1)(ii) of the regulations.

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.

If you decide to contest this determination under the declaratory judgment provisions of Code section 7428, you must initiate a suit in the United States Tax Court, the United States Court of Federal Claims, or the District Court of the United States for the District of Columbia before the

91st day after the date that we mailed this letter to you. Contact the clerk of the appropriate court for rules for initiating suits for declaratory judgment. Filing a declaratory judgment suit under Code section 7428 does not stay the requirement to file returns and pay taxes.

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.

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



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

Date: June 19, 2008

Contact Person:

501.32-00
501.33-00
501.36-01

Identification Number:

Contact Number:

FAX Number:

Employer Identification Number:

Legend:

A:
B:
C:
D:
\$X:

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.

FACTS

You were formed as a Non-Profit Corporation and have requested classification as an organization organized and operated exclusively for testing for public safety under sections 501(c)(3) and 509(a)(2) of the Code.

You provide carpool matching services to members of your organization. In exchange for a membership fee, members receive the ability to network with other members and arrange carpools. You pay members who give other members rides according to the number of people transported and the number of miles traveled. The services you provide are limited to members of your organization. You stated that in the future you may be "affiliated" with government entities such as transit authorities and pay them using a formula similar to that used to calculate payments to your members that give rides. Before accepting an individual into your organization, you submit them to a background check.

At present, your income comes from buying electronic items and selling them at a markup to various companies. However, in the future you will receive income from membership dues. From the evidence you provided, the sale of goods is your only current activity.

You are organized as a stock corporation and your articles of incorporation do not place any limits on the payment of dividends or the transfer of stock. Your creators, officers and directors are A, B, C, and D. Your outstanding stock is split evenly between these individuals.

Your articles of incorporation also provide that these individuals will each be compensated by the lesser of your gross sales minus "other expenses" or \$X, with a four percent annual increase. Your articles of incorporation also provide that upon dissolution of your organization, your assets may be used to compensate your officers, employees, and sub-contractors while they search for other jobs.

LAW

Section 501(c)(3) of the Internal Revenue 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(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)(4) of the regulations defines testing for public safety as including the testing of consumer products, such as electrical products, to determine whether they are safe for use by the general 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. 69-175, 1969-1 C.B. 149, describes an organization created to provide bus transportation for school children to a tax-exempt private school. The organization was formed by the parents of pupils attending the school. The organization provided transportation to and from the school for those children whose parents belonged to the organization. Parents were required to pay an initial family fee and an additional annual charge for each child. The organization's income approximately equaled the expenses involved in its operations. The IRS determined that "[w]hen a group of individuals associate to provide a cooperative service for themselves, they are serving a private interest."

Rev. Rul. 69-383, 1969-2 C.B. 113, provides an example of a possible inurement situation that did not jeopardize an organization's exempt status. In the revenue ruling a tax exempt hospital entered into a contract with a radiologist which provided that the radiologist would be compensated by receiving a percentage of the gross receipts of the radiology department. The contract was negotiated on an arm's-length basis, the radiologist did not control the hospital, the amount received under the contract was reasonable in terms of the responsibilities and duties assumed, and the amount received under the contract was not excessive when compared to the amounts received by other radiologists in comparable circumstances.

Rev. Rul. 71-395, 1971-2 C.B. 223, holds that a cooperative art gallery formed and operated by a group of artists for the purpose of exhibiting and selling their works does not qualify for exemption under section 501(c)(3) of the Code. The IRS concluded that the cooperative gallery served the private purposes of its members, even though the exhibition and sales of paintings were also educational in some respects.

Rev. Rul. 85-1, 1985-1 C.B. 177, applied the criteria set out in Rev. Rul. 85-2, *infra*, for determining whether an organization's activities are lessening the burdens of government. In this ruling, the organization was created to assist a county's law enforcement agencies in policing illegal narcotics traffic more effectively. The organization provided funds that allowed the county's agents to engage in certain activities for which funds were not otherwise available. This ruling concluded that by funding activities that the county treats as an integral part of its Program to prevent the trafficking of illegal narcotics, the county demonstrated that it considered these activities to be its burden. Thus, the organization was lessening the burdens of the county by enabling it to augment its law enforcement activities.

Rev. Rul. 85-2, 1985-1 C.B. 178, states that to determine whether an activity is a burden of government, the question is whether there is an objective manifestation by the government that it considers such activity to be part of its burden. The fact an organization is engaged in an activity that is sometimes undertaken by the government is insufficient to establish a burden of government. Similarly, the fact that the government or an official of the government expresses approval of an organization and its activities is also not sufficient to establish that the organization is lessening the burdens of government. The interrelationship between the organization and the government may provide evidence that the government considers the organization's activities to be its burden. To determine whether the organization is actually

lessening the burdens of government, all the relevant facts and circumstances must be considered. A favorable working relationship between the government and the organization is strong evidence that the organization is actually lessening the burdens of the government.

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 Mabee Petroleum Corp. v. United States, 203 F.2d 872 (5th Cir. 1953), the court acknowledged that payment of reasonable compensation to officers is not inurement. The court went on to say, however, that if the salaries paid are excessive and unreasonable then inurement of corporate net income will result. Such inurement would not allow an organization to claim tax exemption.

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 provided 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 Ginsberg v. Commissioner, 46 T.C. 47 (1966), the court considered a collective organization created to dredge waterways. The majority of the funds for this activity came from owners of property adjacent to the waterways. The court found that the primary beneficiaries were the adjacent property owners. Any benefit to the general public because these dredged waterways would be a safe harbor for boats during a storm was secondary. Therefore, the organization was not exempt because of the significant private benefit provided.

In B.S.W. Group, Inc. v. Commissioner of Internal Revenue, 70 T.C. 352 (1978), the Tax Court held that an organization did not qualify for exemption under section 501(c)(3) of the Code because it was primarily engaged in an activity that was characteristic of a trade or business and ordinarily carried on by for-profit commercial businesses. The Tax Court stated, "We must agree with the Commissioner that petitioner's activity constitutes the conduct of a consulting

business of the sort which is ordinarily carried on by commercial ventures organized for profit...." 70 T.C. at 358.

In People of God Community v. Commissioner of Internal Revenue, 75 T.C. 127 (1980), the court found that part of an organization's net earnings inured to the benefit of private individuals because their compensation was based on a percentage of the organization's gross receipts with no upper limit. The court held that the petitioner was not exempt as an organization described in section 501(c)(3) of the Internal Revenue Code of 1954. The court stated that the burden falls upon the petitioner to establish the reasonableness of compensation paid to private individuals.

In Columbia Park and Recreation Assoc. v. Commissioner of Internal Revenue, 88 T.C. 1 (1987), aff'd without published opinion, 838 F.2d 465 (4th Cir. 1998) ["Columbia Park"], the Court of Appeals upheld the decision of the Tax Court that the organization did not lessen any burden of government and thus, was not exempt under section 501(c)(3) of the Code. The organization provided a wide range of services and facilities to the residents of Columbia, Maryland. The organization contended that if it did not provide these services and facilities the local or state government would have to provide them. The Tax Court stated that this assertion does not mean that the organization's activities are, in fact, a burden of government. Instead, the organization must demonstrate that the State of Maryland and/or the county accept the organization's activities as their responsibility and recognize the organization as acting on their behalf. In addition, the organization must further establish that its activities actually lessen the burden of the state or local government.

In Miller & Sons Drywall, Inc. v. Commissioner of Internal Revenue, T.C. Memo 2005-114, the court set out several factors that should be considered when determining whether compensation is reasonable. These include the employee's qualifications, the nature, extent, and scope of the employee's work, the size and complexity of the business, prevailing general economic conditions, the employee's compensation as a percentage of gross and net income, the employee's compensation paid in prior years, and prevailing rates of compensation for comparable positions in comparable concerns.

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."

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. 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.

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

No Exempt Purpose

You stated that you are organized and operated for the exempt purpose of testing for public safety. Section 1.501(c)(3)-1(d)(4) of the regulations defines testing for public safety as testing of consumer products to determine whether they are safe for use by the general public. You do not test any products to determine whether they are safe for consumers. While you do conduct background checks on your members to confirm that they are safe to ride with, your members are not consumer products. Therefore, you are not organized or operated for the purpose of testing for public safety.

While your application did indicate that you may be "affiliated" with government transit systems, you did not provide any details about how or when this "affiliation" would take place. In addition, while you stated that you may compensate the bus systems when your members use the bus, you have not indicated whether this will merely replace the bus fare the member would normally pay. The evidence you provided is not sufficient to clearly demonstrate that you meet the definition of "lessening the burdens of government." See Rev. Rul. 85-1; Rev. Rul. 85-2; Columbia Park, supra. You have neither asserted nor provided evidence that you are organized for any other exempt purposes.

An organization that operates a cooperative service is not operated for an exempt purpose because the organization benefits its members rather than the public. The organizations described in Rev. Rul. 69-282 and Rev. Rul. 71-395 were not exempt because they were primarily operated to provide services to their members, transportation and art display respectively. Your organization is similar to these organizations because you are arranging transportation services for your members.

Therefore, you have not demonstrated that you will be organized and operated exclusively for exempt purposes described in section 501(c)(3) of the Code.

Commercial Activities

Under section 1.501(c)(3)-1(e)(1) of the regulations, an organization may carry on a trade or business as a substantial part of its activities so long as that trade or business is related to its exempt purpose. If an organization is substantially engaged in activities that are normally carried on by commercial entities for profit and those activities are not related to its exempt

purpose, that organization is not eligible for tax exemption under section 501(c)(3) of the Code. See, e.g., B.S.W. Group, Inc., supra.

You have been in existence for several years. The only activity you currently conduct is selling goods at a markup. While you have described other activities, we cannot determine whether your sales of goods will be a substantial part of your activities. Gaps in an application are resolved against the applicant. New Dynamics, supra. Therefore, we conclude that a substantial part of your activities will consist of buying and selling goods for profit. Buying and selling electronic goods for profit is not related to any of the exempt purposes you have asserted. Consequently, we conclude that you are not eligible for exemption because you carry on an unrelated trade or business as a substantial part of your activities.

Private Benefit

Section 1-501(c)(3)-1(d)(1)(ii) of the regulations requires an organization to show that it is not organized or operated for private interests in order to be exempt under section 501(c)(3) of the Code. When a group of individuals associate to provide a service for themselves, they are serving a private interest. See Rev. Rul. 69-175; Rev. Rul. 71-395; Ginsburg v. Commissioner. You help your members to find other members with which to carpool, therefore you provide a service to your members: enabling them to get to and from their place of employment or other destination. This is your sole planned activity, therefore a substantial purpose of your organization is to provide benefits to private persons, your members.

The presence of a single substantial non-exempt purpose will prevent the grant of tax-exemption. See Better Business Bureau of Washington D.C., Inc. v. United States. Accordingly, you are not operated exclusively for charitable purposes.

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 a grant of exemption. A, B, C and D are the incorporators of your organization, its executive officers, and its directors. They have control over the operations of your organization and have a personal interest in your activities. Thus, A, B, C and D are both private individuals within the meaning of section 1.501(a)-1(c) of the regulations.

If an organization pays unreasonable compensation to private individuals, this will constitute inurement. Mabee Petroleum Corp. v. United States, supra. Where the compensation of private individuals is based upon a percentage of an organization's gross receipts with no upper limit, the earnings of the organization inure to the benefit of private individuals and the organization is therefore not entitled to exemption. People of God Community, supra. Your articles of incorporation provide that your four officers will each be compensated with one fourth of your gross sales minus expenses or \$X with an increase of 4 percent each year, whichever is less. There are no upper limits to their compensation.

In addition, you have not presented any facts similar to those of Rev. Rul. 69-383. A, B, C and D control your organization and you have not shown that the salaries for A, B, C and D were negotiated on an arm's length basis.

Based upon these facts, you have not demonstrated that the compensation paid to A, B, C and D is reasonable, therefore you have not established that no part of the net earnings of your organization 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.

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. Your dissolution clause is also inadequate. It allows your assets to be distributed for the support of your officers and employees to support them for a reasonable time. This constitutes inurement and the use of your assets for non-exempt purposes. Therefore, you fail the organizational test for exemption.

Conclusion

You are not operated for testing for public safety or any other purpose described in section 501(c)(3) of the Code. Furthermore, you are engaging in commercial activities. You operate for the significant private benefit of providing a service to your members and the net earnings of your organization may inure to the benefit of private individuals. Finally, your articles of incorporation lack the required provisions.

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:

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