Internal Revenue Service
Appeals Office
1375 E. Ninth Street
Cleveland, OH 44114-1739

Department of the Treasury

Person to Contact:

Employee ID Number:
Tel:
Fax:
Refer Reply to:

Date: AUG 11 2010

Number: **201044022**
Release Date: 11/5/2010

In Re:

Form Required to be Filed:

EIN:

Tax Period(s) Ended:

UIL:
501.03-05

Certified Mail

Dear :

This is a final adverse determination regarding your exempt status under section 501(c)(3) of the Internal Revenue Code (IRC). It is determined that you do not qualify as exempt from Federal income tax under IRC Section 501(c)(3) effective January 1, 2002.

Our adverse determination was made for the following reason(s):

> A substantial part of your activities consists of providing down payment assistance to home buyers. To finance the assistance you rely on home sellers and other real-estate related businesses that stand to benefit from these down payment assistance transactions. The manner in which you operate demonstrates you are operated primarily to further your insiders' business interests. Therefore, you are operated for a substantial nonexempt purpose. In addition, your operations further the private interests of the persons that finance your activities. Accordingly, you are not operated exclusively for exempt purposes described in section 501(c)(3).

Contributions to your organization are not deductible under section 170 of the Code.

You are required to file Forms 1120, U.S. Corporation Income Tax Return, for tax periods beginning on and after January 1, 2002 with the Cincinnati Service Center, Cincinnati, OH, 45999-0012.

You have waived your right to contest this determination under the declaratory judgment provisions of Section 7428 of the Code by your execution of Form 906, Closing Agreement Concerning Specific Matters, an executed copy of which is being sent to you under separate cover.

You also 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 is not able to reverse legally correct tax determinations, nor extend the time fixed by law that you have to file a petition in the U.S. 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. If you want Taxpayer Advocate assistance, please contact the Taxpayer Advocate for the IRS office that issued this letter. See the enclosed Notice 1214, *Helpful Contacts for Your "Notice of Deficiency"*, for Taxpayer Advocate telephone numbers and addresses.

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

Sincerely,

KAREN A. SKINDER
APPEALS TEAM MANAGER

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
Internal Revenue Service
4330 Watt Ave., SA-111
Sacramento, CA 95821

September 26, 2008

Taxpayer Identification Number:

Form:
990
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 exempt status under section 501(c)(3) of the Internal Revenue Code (Code) is necessary.

If you accept our findings, take no further action. We will issue a final revocation letter.

If you do not agree with our proposed revocation, you must submit to us a written request for Appeals Office consideration within 30 days from the date of this letter to protest our decision. Your protest should include a statement of the facts, the applicable law, and arguments in support of your position.

An Appeals officer will review your case. The Appeals office is independent of the Director, EO Examinations. The Appeals Office resolves most disputes informally and promptly. The enclosed Publication 3498, *The Examination Process*, and Publication 892, *Exempt Organizations Appeal Procedures for Unagreed Issues*, explain 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.

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

If we do not hear from you within 30 days from the date of this letter, we will process your case based on the recommendations shown in the report of examination. If you do not protest this proposed determination within 30 days from the date of this letter, the IRS will consider it to be a failure to exhaust your available administrative remedies. Section 7428(b)(2) of the Code provides, in part: "A declaratory judgment or decree under this section shall not be issued in any proceeding unless the Tax Court, the Claims Court, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted its administrative remedies within the Internal Revenue Service." We will then issue a final revocation letter. We will also notify the appropriate state officials of the revocation in accordance with section 6104(c) of the Code.

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:

Taxpayer Advocate

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,

Edward V. Hill
Revenue Agent, EO Examinations

Enclosures:
Publication 892
Publication 3498
Report of Examination

ISSUES

1. Whether XXX operated exclusively for purposes described in section 501(c)(3) of the Internal Revenue Code.

2. Whether revocation of the XXX tax-exempt status should be applied retroactively.

FACTS

XXX was organized and incorporated in the State of XXX on July , 19 . In February 20 , XXX filed Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code. On April , 20 , the Service issued a letter stating that the organization was recognized as exempt from Federal income tax because it was classified as an organization described in section 501(c)(3) of the Internal Revenue Code. It was also recognized as a public charity under section 509(a)(2) of the Code.

XXX's Form 1023 advised that its activities/purposes would be:

> "XXX will provide grants to first-time home buyers who meet certain criteria. These grants can be used for their down payment and/or closing costs to help them purchase their first home. They must qualify for a first mortgage loan from a lender. The grant will be a gift from the organization and does not have to be paid back."

The Form 1023 also stated sources of financial support as, ". . . Contributions from community businesses, private individuals, and government entities."

The organization's tax returns (Forms 990) for the 20 – 20 tax periods included the following statement to clarify that the organization makes grants primarily to low and moderate income homebuyers:

> "XXX provides grants primarily to qualified low and moderate income homebuyers. The grants may be used for down payment assistance and/or closing costs."

The original incorporators/directors of XXX were XXX, XXX, and XXX. On January , 20 , each of these individuals was replaced as a director of XXX. XXX continued to assist XXX in its operations to a limited extent until the Board formally appointed a new President, XXX, in September or October of 20 .

In February, 20 , at about the same time XXX was seeking exemption, XXX, XXX, and XXX organized a taxable Subchapter S Corporation, XXX, to conduct the sales and marketing functions for XXX, including development of XXX's nationwide network of

commissioned sales persons and promotion of its DPA program . From the formation of XXX until January , 20 , XXX, XXX, and XXX served as Directors of both XXX and were the principal shareholders of XXX. The formation of XXX or its intended purpose was not disclosed on the Form 1023. The Form 1023 also specifically advised XXX, XXX and XXX would not be compensated for their time.

A "Services Agreement" was executed between XXX and XXX effective as of the day of January 20 . This agreement appointed XXX to act as the non-exclusive, independent marketing representative of XXX. Under this agreement, XXX agreed to perform the following primary services:

1. XXX will find and solicit mortgage providers, so that they can provide grant information to their clients.

2. XXX will train, support, and monitor such mortgage providers to ensure their compliance with the grant program requirements.

3. XXX will provide marketing data to XXX concerning the FHA loan market and trends, regulatory changes, and other pertinent information concerning other down payment assistance program providers.

XXX provided most of its marketing services to XXX through staff employees and a network of independent contractor marketing specialists ("Marketing Representatives") located throughout the United States. As compensation under the contract, XXX received a "marketing fee" equal to seventy-five per cent (75%) of the Seller Service Fee paid by the seller to XXX.

The current XXX Board of Directors includes XXX, XXX, and XXX. Although XXX, XXX, and XXX resigned from XXX in January 20 , they remained as the officers of XXX until August 20 and continue to be its principal shareholders.

XXX paid the 75% amount to XXX until February, 200 , at which time the amount of the payment was reduced to a lower figure after complaints by XXX's new management that the sales and marketing fees paid to XXX were excessive. XXX paid the lower figure to XXX until August , 20 , when XXX purchased all of the assets of XXX to allow XXX to conduct all further sales and marketing efforts from within the exempt organization, and the relationship between the XXX and XXX was terminated. XXX paid XXX the following amounts pursuant to the above-described arrangements:

Table 1

.Year	Amount

Total

Every grant made by XXX was deemed attributable to marketing services provided by XXX, therefore, XXX received a "marketing fee" from every grant transaction made by XXX. If applicable, XXX agreed to provide XXX 30 days prior written notice that a grant transaction was not attributable to XXX.

This agreement was signed by XXX as Trustee for XXX, and by XXX as President of XXX. Although XXX had resigned as an officer or director of XXX in 20 , he continued to exert substantial influence over the affairs of the organization. On July , 20 , an Amendment to the Agreement was executed that emphasized the non-exclusive nature of the Agreement. XXX was free to perform services for other down payment assistance programs and to continue providing services for XXX. The term of the Agreement was extended to January , 20 , and was automatically extended for additional one-year periods thereafter unless either party terminated the Agreement upon 60 days written notice.

On August , 20 , XXX purchased all of the assets of XXX, including XXX's contractual rights with the Marketing Representatives. The purchase price for the assets was established by appraisal. The purchased assets were largely in the nature of intangible intellectual property rights derived from XXX's marketing efforts. XXX paid no further compensation to XXX (other than final amounts due under the purchase contract) and the relationship between XXX and XXX ceased to exist.

On May . 20 , XXX made the following announcement on their website, http://www. .com:

The following is the financial information taken from the 990 returns filed by XXX and shows the major categories of revenue and expenses from its operations:
Table 2

DPA Revenue

Other Revenue

Total Revenue

DPA Assistance

Marketing Fee
Charitable
Grants

Other Expenses

Total Expenses

Net Amount

The down payment assistance program at XXX is based on a home-buyer connecting with a seller who agrees to participate in the grant program and pay a Seller Service Fee (SSF) to XXX. The program worked as follows:

- A real estate contract is negotiated between the buyer and the seller and includes the seller's agreement to pay a service fee to XXX.
- The contract is forwarded to the title company for determination of the transaction amounts that will be required for the final real estate closing.
- The lender prepares a grant application in the name of the buyer. The grant amount is the amount needed by the buyer for the required down payment or for closing costs. When the application is completed, it is forwarded, usually by Fax, to XXX.
- XXX approves the grant. The grant award letter (gift letter) for the buyer is prepared by XXX and faxed to the lender. The grant to the buyer is a "gift" and does not have to be repaid by the buyer. Gift letters go out the same day the grant application is received.
- When all of the closing arrangements have been made and signed closing instructions have been received from the closing agent, grant funds are wired from XXX to the title company.

- During the closing process, the seller pays a "service fee" (SSF) that was wired to XXX. This fee consists of two parts: 1) the grant amount, typically 3 to 10 percent of the sales price of the home (it is the same amount that was granted to the purchaser), and; 2) a transactional service fee.

- After XXX receives the SSF, seventy-five (75%) per cent of the service fee charge (not the grant amount) was forwarded to XXX as compensation under the Services Agreement.

Additional Details About the Downpayment Assistance Program

- The program is compatible with FHA, conventional, or sub-prime loans.

- Approximately 98% of the grants awarded were associated with FHA insured loans.

- For the non-FHA loans, grant proceeds were allowed be used to pay off existing debt.

- No roof certifications, homeowner's warranties, or home buyer's education were required for buyer or seller participation in the program. The organization had no standards for habitability, and home inspection reports were not required for participation in the program.

- XXX provided national and local "Personal Account Executives" to set up grant transactions for home buyers, and also provided account executives who provided consulting and training services for real estate professionals.

- Participants were not required to be first-time homebuyers.

- There were no income or asset restrictions (limits) for homebuyers.

- No credit checks or employment history were required for participation in the program.

- There were no geographic restrictions for home purchases and sales.

- Buyers must qualify for a loan program that allows gift funds from nonprofit organizations.

- The grant to buyers could be used for a down payment or closing costs, and if the loan was non-FHA, it could be used to pay off existing debt. Maximum grant amount was $25,000 and the average grant amount was approximately $5,000.

- There are no Department of Housing and Urban Development (HUD) rules or regulations required of the exempt organization. The lenders and loan officers are responsible to ensure compliance with FHA guidelines and procedures.

LAW

ISSUE 1

Section 501(a) of the Code provides for the exemption from federal income taxation of corporations described in section 501(c)(3) of the Code. To be described in section 501(c)(3), an organization must be organized and operated exclusively for charitable, educational or other exempt purposes and may not permit any of its net earnings to inure to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(c)(1) of the Income Tax Regulations provides that an organization operates exclusively for exempt purposes only if it engages primarily in activities that accomplish exempt purposes specified in section 501(c)(3) of the Code. An organization must not engage in substantial activities that fail to further an exempt purpose. In Better Business Bureau of Washington, D.C. v. U.S., 326 U.S. 279, 283 (1945), the Supreme Court held that the "presence of a single . . . [nonexempt] purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly . . . [exempt] purposes." If a substantial part of an organization's activities furthers non-charitable purposes, the organization is not operated exclusively for charitable purposes even though its other activities further charitable purposes. See Old Dominion Box Co., Inc. v. U.S., 477 F.2d 340 (4th Cir. 1973), cert. denied, 413 U.S. 910 (1973).

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

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations provides that an organization is not organized or operated exclusively for exempt purposes unless it serves a public rather than a private interest. To meet this requirement it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests.

Section 1.501(c)(3)-1(d)(2) of the regulations defines the term "charitable" as used in section 501(c)(3) of the Code as including the relief of the poor and distressed or of the underprivileged, advancement of education, combating community deterioration and lessening the burdens of government.

Section 1.501(c)(3)-1(d)(3)(i) of the regulations provides, in part, that the term "educational" as used in section 501(c)(3) of the Code relates to the instruction of the public on subjects useful to the individual and beneficial to the community.

Section 1.501(c)(3)-1(e) of the regulations provides that an organization that operates a trade or business as a substantial part of its activities may meet the requirements of section 501(c)(3) of the Code if the trade or business furthers an exempt purpose, and provided the organization's primary purpose does not consist of carrying on an unrelated trade or business.

Rev. Rul. 2006-27, 2006-21 I.R.B. 915, sets forth standards for determining when an organization that provides funds to homebuyers for down payment or closing costs qualifies for exemption from Federal income tax under section 501(c)(3). In Situation 2, an organization provides down payment assistance to low-income individuals and families. It offers financial counseling seminars and conducts other educational activities to help prepare potential low-income homebuyers for the responsibility of home ownership. Under the organization's grantmaking procedures, the staff considering a particular applicant's application knows the identity of the party selling the home to the grant applicant and may also know the identities of other parties, such as real estate agents and developers, who may receive a financial benefit from the sale. Moreover, in substantially all of the cases in which the organization provides down payment assistance to a homebuyer, the organization receives a payment from the home seller. Further, there is a direct correlation between the amount of the down payment assistance provided by the organization to the homebuyer and the amount of the home seller's payment to the organization. Finally, the organization does not conduct a broad based fundraising campaign to attract financial support. Rather, most of the organization's support comes from home sellers and real estate-related businesses that may benefit from the sale of homes to buyers who receive the organization's down payment assistance.

The revenue ruling holds that the organization described in Situation 2 is not exempt from Federal income tax under section 501(c)(1) because it finances its down payment assistance activities with contributions from sellers and individuals that stand to benefit from the transactions that the organization facilitates. The fact that the organization relies on seller's payments for most of its funding and in substantially all of the transactions the payment from a home seller corresponds to the amount that the organization gives to a homebuyer indicate that the benefit to the home seller is a critical aspect of an organization's operations. Rev. Rul. 2006-27, also holds that the payments to homebuyers in Situation 2 are not gifts, but rebates or purchase price reductions because sellers make the payments not out of detached and disinterested generosity, but in response to an anticipated economic benefit, namely the sale of their home at a higher price and in less time.

Rev. Rul. 2006-27, Situations 1 and 3 describe organizations that provide down payment and closing costs to qualified homebuyers, in the manner that could qualify for exemption from Federal income tax under section 501(c)(3). In Situation 1, the organization's purposes and activities relieve the poor, distressed and underprivileged by enabling low-income individuals and families to obtain decent, safe and sanitary

homes. In Situation 3, the organization's purposes and activities combat community deterioration in a specific, economically depressed area that has suffered a major loss of population and jobs. Importantly, these organizations conduct broad based fundraising programs to attract gifts, grants, and contributions from several foundations, businesses, the general public, and receive funding from government agencies. See Rev. Rul. 2006-27. Their policies and procedures prevent the grantmaking staff from knowing identities of the parties involved in the transaction and whether anyone related to the transaction had made or agreed to make or made a contribution to the organization.

In Easter House v. U.S., 12 Cl. Ct. 476, 486 (1987), aff'd, 846 F.2d 78 (Fed. Cir.) cert. denied, 488 U.S. 907 (1988), the court held that an organization that operated an adoption agency was not exempt under section 501(c)(3) of the Code because a substantial purpose of the agency was a nonexempt commercial purpose. The court concluded that the organization did not qualify for exemption under section 501(c)(3) because its primary activity was placing children for adoption in a manner indistinguishable from that of a commercial adoption agency. The court rejected the organization's argument that the adoption services merely complemented the health related services to unwed mothers and their children. Rather, the court found that the health-related services were merely incident to the organization's operation of an adoption service, which, in and of itself, did not serve an exempt purpose. The organization's sole source of support was the fees it charged adoptive parents, rather than contributions from the public. The court also found that the organization competed with for-profit adoption agencies, engaged in substantial advertising, and accumulated substantial profits. Accordingly, the court found that the "business purpose, and not the advancement of educational and charitable activities purpose, of plaintiff's adoption service is its primary goal" and held that the organization was not operated exclusively for purposes described in section 501(c)(3). Easter House, 12 Cl. Ct. at 485-486.

In American Campaign Academy v. Commissioner, 92 T.C. 1053 (1989), the court held that an organization that operated a school to train individuals for careers as political campaign professionals, but that could not establish that it operated on a nonpartisan basis, did not exclusively serve purposes described in section 501(c)(3) of the Code because it also served private interests more than incidentally. The court found that the organization was created and funded by persons affiliated with entities of a particular political party and that most of the organization's graduates worked in campaigns for the party's candidates. Consequently, the court concluded that the organization conducted its educational activities with the objective of benefiting the party's candidates and entities. Although the candidates and entities benefited were not organization "insiders," the court stated that the conferral of benefits on disinterested persons who are not members of a charitable class may cause an organization to serve a private interest within the meaning of section 1.501(c)(3)-1(d)(1)(ii) of the regulations. The court concluded by stating that even if the political party's candidates and entities did "comprise a charitable class, [the organization] would bear the burden of proving that its activities benefited members of the class in a non-select manner."

In Aid to Artisans, Inc. v. Commissioner, 71 T.C. 202 (1978), the court held that an organization that marketed handicrafts made by disadvantaged artisans through museums and other nonprofit organizations and shops was operated for exclusively charitable purposes within the meaning of section 501(c)(3) of the Code. The organization, in cooperation with national craft agencies, selected the handicrafts it would market from craft cooperatives in communities identified as disadvantaged based on objective evidence by the Bureau of Indian Affairs or other government agencies. The organization marketed only handicrafts it purchased in bulk from these communities of craftsmen. It did not select individual craftsmen based on the needs of the purchasers. The court concluded that the overall purpose of the activity was to benefit disadvantaged communities. The organization's commercial activity was not an end in itself but merely the means through which the organization pursued its charitable purposes. The method it used to achieve its purpose did not cause it to serve primarily private interests because the disadvantaged artisans directly benefited by the activity constituted a charitable class and the organization showed no selectivity with regard to benefiting specific artisans. Therefore, the court held that the organization operated exclusively for exempt purposes.

In Airlie Foundation v. Commissioner, 283 F. Supp. 2d 58 (D.D.C., 2003), the court relied on the "commerciality" doctrine in applying the operational test to an organization that operated a conference center as its primary activity and derived most of its revenues from user fees. Because of the commercial manner in which this organization conducted its activities, the court found that it was operated for a non-exempt commercial purpose, rather than for a tax-exempt purpose. In reaching this conclusion, the court stated that "[a]mong the major factors courts have considered in assessing commerciality are competition with for profit commercial entities; extent and degree of below cost services provided; pricing policies; and reasonableness of financial reserves. Additional factors include, *inter alia,* whether the organization uses commercial promotional methods (e.g. advertising) and the extent to which the organization receives charitable donations."

Rev. Rul. 67-138, 1967-1 C.B. 129, held that helping low income persons obtain adequate and affordable housing is a "charitable" activity because it relieves the poor and distressed or underprivileged. The organization carried on several activities directed to assisting low-income families obtain improved housing, including (1) coordinating and supervising joint construction projects, (2) purchasing home sites for resale at cost, and (3) helped low income people obtain home construction loans.

Rev. Rul. 70-585, 1970-2 C.B. 115, discussed four situations of organizations providing housing and whether each qualified as charitable within the meaning of section 501(c)(3) of the Code. Situation 1 described an organization formed to construct new homes and renovate existing homes for sale to low-income families who could not obtain financing through conventional channels. The organization also provided

financial aid to eligible families who do not have the necessary down payment. When possible, the organization recovered the cost of the homes through very small periodic payments, but its operating funds were obtained from federal loans and contributions from the general public. The revenue ruling held that by providing homes for low-income families who otherwise could not afford them, the organization relieved the poor and distressed.

Situation 2 described an organization formed to ameliorate the housing needs of minority groups by building housing units for sale to persons of low and moderate income on an open-occupancy basis. The housing was made available to members of minority groups who were unable to obtain adequate housing because of local discrimination. The housing units were located to help reduce racial and ethnic imbalances in the community. As the activities were designed to eliminate prejudice and discrimination and to lessen neighborhood tensions, the revenue ruling held that the organization was engaged in charitable activities within the meaning of section 501(c)(3) of the Code.

Situation 3 described an organization formed to formulate plans for the renewal and rehabilitation of a particular area in a city as a residential community. The median income level in the area was lower than in other sections of the city and the housing in the area was generally old and badly deteriorated. The organization developed an overall plan for the rehabilitation of the area; it sponsored a renewal project; and involved residents in the area renewal plan. The organization also purchased apartment buildings that it rehabilitated and rented at cost to low and moderate income families with a preference given to residents of the area. The revenue ruling held that the organization is described in section 501(c)(3) of the Code because its purposes and activities combated community deterioration.

Situation 4 described an organization formed to alleviate a shortage of housing for moderate-income families in a particular community. The organization planned to build housing to be rented at cost to moderate-income families. The revenue ruling held that the organization failed to qualify for exemption under section 501(c)(3) of the Code because the organization's program was not designed to provide relief to the poor or further any other charitable purpose within the meaning of section 501(c)(3) and the regulations.

Rev. Rul. 85-1, 1985-1 C.B. 177, holds that an activity is a burden of government only if there is an objective manifestation by a governmental unit that it considers the activity to be its burden. The ruling also provides that little weight should be given to government officials that merely praise or express approval of an organization and its activities. Instead, the government must formally recognize the organization and its operations as relieving its burdens. Several factors set forth in the revenue ruling bear on whether the governmental unit has made an objective manifestation. These factors are:

- A statute specifically creates the organization and clearly defines the organization's structure and purposes.
- The activity is an integral part of a larger governmental program, or is acted jointly with a governmental unit.
- The governmental unit controls the activities of the organization, for example by appointing the board members.
- The organization pays governmental expenses.
- Regular government funding of the organization's activities through grants or general obligation bonds backed with the full faith and credit of the governmental (as opposed to general revenue bond financing).
- The governmental unit is not prohibited from performing the particular activity.

Rev. Rul. 85-2, 1985-1C.B. 178, holds that an organization lessens the burden of government if it engages in activities that a governmental unit considers to be its burden and such activities actually lessen such governmental burden. An organization must demonstrate through all the relevant facts and circumstances that a governmental unit considers the organization to be acting on its behalf, thereby freeing up the government assets that would otherwise be devoted to the particular activity.

In Columbia Park and Recreational Association, Inc. v. Commissioner, 88 T.C. 1 (1987), aff'd without published opinion 838 F. 2d 465 (4th Cir. 1988), the court provided that expending funds for services and items similar to those in the budget of a municipal government is insufficient to establish that a governmental unit accepted the activities as its responsibility.

In Public Industries, Inc. v. Commissioner, T.C. Memo 1991-3, the court stated that even if a governmental unit considers an activity to be a proper governmental function, an organization must establish that it has a solid relationship with the governmental unit to support a finding that the organization was acting on the governmental unit's behalf. On the issue of whether the organization's activities actually lessen the burdens of government, the court noted that showing that an organization's activities might improve general economic conditions or might reduce the negative consequences if the activities are not conducted is not enough to demonstrate that organization's activities actually lessen the government's burden.

In Quality Auditing Company, Inc. v. Commissioner, 114 T.C. 498 (2000), an organization that developed a certification program for safe construction claimed that it was lessening the burdens of government. Governmental agencies were among those that requested that the organization develop the certification program. The court held that the government's concern with obtaining high quality work in public construction projects falls short of establishing that the government considers the certification

program to be its own responsibility and that the organization was acting on its behalf. In addition, the court stated that even if the certification program lessened the burdens of government, because it also conferred benefit on private owners and developers, it furthered a substantial nonexempt purpose by lessening the burdens on private parties.

Even if an organization's activities serve a charitable class or are otherwise charitable within the meaning of section 501(c)(3), to qualify for exemption from Federal income tax under section 501(a) as on organization described in section 501(c)(3), the organization must demonstrate that its activities serve a public rather than a private interest within the meaning of Reg. Section 1.501(c)(3)-1(d)(1). Rev. Rul. 72-147, 1972-1 C.B. 147, held that an organization that provided housing to low income families did not qualify for exemption under section 501(c)(3) of the Code because it gave preference to employees of a business operated by the individual who also controlled the organization. The ruling reasoned that, although providing housing for low income families furthers charitable purposes, doing so in a manner that gives preference to employees of the founder's business primarily serves the private interest of the founder rather than a public interest.

In KJ's Fund Raisers v. Commissioner, T.C. Memo 1997-424 (1997), aff'd, 1998 U.S. App. LEXIS 27982 (2d Cir. 1998), the Tax Court held that an organization formed to raise funds for distribution to charitable causes did not qualify for exemption under section 501(c)(3) because the primary purpose of its activities was to attract customers to its founders' private business. The founders of the organization were the sole owners of KJ's Place, a lounge at which alcoholic beverages were served. The founders served as officers of the organization and, at times, also controlled the organization's board. The Tax Court found that the founders exercised substantial influence over the affairs of the organization. The organization's business consisted of selling "Lucky 7" or similar instant win lottery tickets exclusively to patrons of KJ's Place. The lottery tickets were sold during regular business hours by the owners of the lounge and their employees. The organization derived most of its funds from its lottery ticket sales. The organization solicited no public donations. From the proceeds of the sales of the lottery tickets, the organization made grants to a variety of charitable organizations. Although supporting charitable organizations may be a charitable activity, the Tax Court nevertheless upheld the Commissioner's denial of exemption to the organization on the ground that the organization's operation resulted in more than incidental private benefit to KJ's Place and, indirectly, its owners. The Second Circuit affirmed.

An organization does not serve a public rather than a private interest within the meaning of Reg. Section 1.501(c)(3)-1(d)(1) if any of its net earnings inure to the benefit of any insiders. Treas. Reg. section 1.501(c)(3)-1(d)(1)(ii). Although stated in terms of the "net earnings" of an organization, the inurement doctrine applies to any of an organization's charitable assets. See People of God Community, 75 T.C. 127, 133 (1980). Payment of excessive compensation is a form of inurement. For example, in

Mabee Petroleum Corp. v. U.S., 203 F. 2d 872, 875 (5th Cir. 1953), the Fifth Circuit held that the organization's payment of a full-time salary for part-time work was inurement.

Receipt by an exempt organization of less than fair market value in a sale or exchange of property with an insider is also a form of inurement. In Sonora Community Hospital v. Commissioner, 46 T.C. 519 (1966), two doctors transferred their private practice of medicine, including the building in which the practice was housed, to a non-profit hospital they controlled. A portion of the building was occupied by a for-profit laboratory under a prior agreement with the two doctors. The doctors caused the hospital to acquiesce in the arrangement with the laboratory. The hospital received no consideration for the assignment of its space to the laboratory either as part of the sale or through a share of the laboratory's gross revenues. Payments in consideration of the assignment that should have been paid to the hospital were paid directly to the two doctors. The doctors performed no services for the laboratory. The Tax Court held that the arrangement resulted in an inurement of the hospital's charitable assets to the two doctors.

In Anclote Psychiatric Ctr. v. Commissioner, T.C. Memo 1998-273 (1998), an organization's board of directors caused the organization to sell its largest asset – a hospital – to a for-profit entity formed by the directors. The board of directors obtained an independent appraisal of the hospital and hired independent counsel to represent the organization. The closing, however, occurred almost two years after the appraisal. The parties failed to make adjustments to the values established in the appraisal. The Tax Court determined that the purchase price received by the organization on the sale of the hospital was not within a reasonable range of what could be considered fair market value. Accordingly, the Tax Court held that the sale transaction resulted in inurement within the meaning of section 501(c)(3).

The provision of inurement can be direct or indirect. In Anclote Psychiatric Ctr., *supra*, the sale transaction giving rise to the inurement was between an exempt organization and a for-profit corporation formed by the organization's directors. Although the for-profit corporation was the direct beneficiary of the below-market sale transaction, the Tax Court held that the transaction resulted in "an advantage" to the shareholders of the for-profit corporation and that this "advantage" constituted inurement of the organization's charitable assets to the shareholders.

In Church by Mail, Inc. v. Commissioner, 765 F.2d 1387 (9th Cir. 1985), the Ninth Circuit treated as inurement compensation paid by a controlled entity to the organization's insiders. In Church by Mail, two individuals, Reverend Ewing and Reverend McElrath, ran a church that mailed printed sermons to several million homes. They also owned a for-profit advertising agency which provided the Church's printing and mailing services. The Ninth Circuit found that the combined compensation paid to Reverend Ewing and Reverend McElrath by the Church and the advertising agency was excessive. The Ninth Circuit rejected the Church's argument that the portion of the compensation paid

by the advertising agency should not be included in the determination of reasonableness and treated this portion as indirect inurement of the Church's earnings to the Church's insiders. Id. The Ninth Circuit based its conclusion on the following legal principle: "[W]hen a second organization is created which serves to funnel income to the individual who controls the purportedly exempt organization and the income exceeds a reasonable salary, the income inures to the benefit of a private person within the meaning of I.R.C. section 501(c)(3)." Id.

Indirect inurement can occur even if the organization's insiders are not formally in control of the intermediary used to funnel the funds from the organization to the insiders. In Church of Scientology of California v. Commissioner, 823 F.2d 1310, 1315 (9th Cir. 1987), the organization transferred in excess of $ 3.5 million to a for-profit corporation incorporated by the organization's founder and his wife. The directors of the corporation were high-ranking members of the Church of Scientology. At the time of the transfer, the founder and his wife were not directors, officers or employees of the corporation. The founder was no longer serving as the head of the church but continued to exert significant control over the church by making policy statements, directives and orders. 823 F.2d at 1314. In particular, his approval was required for all financial planning. *Id.* The directors of the corporation approved the founder's decision to transfer $ 2 million from the corporation's account to the ship *Apollo* aboard which the founder and his family lived. The Ninth Circuit held that the organization's funds funneled through the corporation constituted inurement to the founder and his family. 823 F.2d at 1318.

The prohibition on inurement in section 501(c)(3) is absolute. The Service has the authority to revoke an organization's exempt status for inurement regardless of the amount of inurement. See Spokane Motorcycle Club v. U.S., 222 F.Supp. 151 (E.D. Wash. 1963); The Founding Church of Scientology, 412 F.2d 1197, 1202; Airlie Foundation, 283 F. Supp. 2d 58. Moreover, for purposes of establishing that inurement occurred, it is not necessary to calculate the precise amount of inurement as long as it is shown that the value of the transfer giving rise to inurement is not within a reasonable range of what could be considered fair market value. See Anclote Psychiatric Ctr. v. Commissioner, T.C. Memo 1998-273.

An organization may ordinarily rely on a favorable determination letter received from the Internal Revenue Service. Treas. Reg. §1.501(a)-1(a)(2). See also Rev. Proc. 2008-9, An organization may not rely on a favorable determination letter, however, if the organization omitted or misstated a material fact in its application or in supporting documents. Id. In addition, an organization may not rely on a favorable determination if there is a material change, inconsistent with exemption, in the organization's character, purposes, or methods of operation after the determination letter is issued. Id.

The Commissioner may revoke a favorable determination letter for good cause. Treas. Reg. § 1.501(a)-1(a)(2). Revocation of a determination letter may be retroactive if the

organization omitted or misstated a material fact or operated in a manner materially different from that originally represented. Id.

ANALYSIS

ISSUE 1

XXX does not qualify as an organization described in I.R.C. section 501(c)(3) because it operates a program that:

1. does not exclusively serve an exempt purpose described in section 501(c)(3);
2. provides substantial private benefit to persons who do not belong to a charitable class, and;
3. results in inurement of a substantial portion of it's net earnings to the benefit of the founders and original board members of the exempt organization.

Charitable purposes include relief of the poor and distressed. See section 1.501(c)(3)-1(d)(2) of the regulations. XXX's down payment assistance program does not operate in a manner that establishes that its primary purpose is to address the needs of low-income people by enabling low-income individuals and families to obtain decent, safe housing. See Rev. Rul. 70-585, Situation 1. The down payment assistance program did not serve exclusively low-income persons. Despite the representations in its application for exemption, XXX does not have any income limitations for participation in its DPA program. Instead, the program is open to anyone, without any income limitations, who otherwise qualified for these loans. The program is not even limited to first-time homebuyers as XXX stated in its intentions on its Form 1023.

XXX's DPA program does not limit assistance to certain geographic areas or target those areas experiencing deterioration or neighborhood tensions. See Rev. Rul. 70-585, Situation 4. Down payment assistance is available for any property that is otherwise able to qualify for a mortgage. Arranging or facilitation for the purchase of homes in a broadly defined geographic area does not combat community deterioration or serve other social welfare objectives within the meaning of section 501(c)(3) of the Code.

Only an insubstantial portion of the activity of an exempt organization may further a nonexempt purpose. As the Supreme Court held in Better Business Bureau of Washington D.C., Inc. v. United States, 326 U.S. 279, 283 (1945), 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. Even if XXX's DPA program were directed to exclusively low-income individuals or disadvantaged communities, XXX's total reliance for financing its DPA activities on home sellers or other real-estate related businesses standing to benefit from the transactions

demonstrates that the program is operated for the substantial purpose of benefiting private parties.

Like the organization considered in American Campaign Academy v. Commissioner, 92 T.C. 1053 (1989), XXX is structured and operated to assist the private parties who fund it and give it business. Sellers who participate in XXX's DPA program benefit from achieving access to a wider pool of buyers, thereby decreasing their risk and the length of time the home is on the market. They also benefit by being able to sell their home at the home's full listed price or by being able to reduce the amount of the negotiated discount on their homes. Buyers who participate in XXX's DPA program benefit by being able to purchase a home without having to commit more of their own funds. Real estate professionals who participate in XXX's DPA program, from real estate brokers to escrow companies, benefit from increased sales volume and the attendant increase in their compensation. It is evident from the foregoing that XXX's DPA program provides ample private benefit to the various parties in each home sale.

The manner in which XXX operated its DPA program shows that the private benefit to the various participants in XXX's activities was the intended outcome of XXX's operations rather than a mere incident of such operations. XXX's down payment assistance procedures are designed to channel funds in a circular manner from the sellers to the buyers and back to the sellers in the form of increased home prices. To finance its down payment assistance activities, XXX relies exclusively on sellers and other real-estate related businesses that stand to benefit from the transactions it facilitates. XXX neither solicits nor receives funds from other sources. Before providing down payment assistance, XXX's grantmaking staff takes into account whether there is a home seller willing to make a payment to cover the down payment assistance the applicant has requested. XXX requires the home seller to reimburse it, dollar-for-dollar, for the amount of funds expended to provide down payment assistance on the seller's home, plus an administrative fee of $ or $ per home sale. XXX secures an agreement from the seller stipulating to this arrangement prior to the closing. No DPA assistance transactions take place unless XXX is assured that the amount of the down payment plus the fee is or will be paid by the seller upon closing. XXX's instructions to title and escrow companies provide that at the close of escrow the seller's contribution, along with any XXX fees, must be sent to XXX. XXX's receipt of a payment from the home seller corresponding to the amount of the down payment assistance in virtually every transaction indicates that the benefit to the home seller (and others involved in the transaction) is not a mere accident but rather an intended outcome of XXX's operations. In this respect, XXX is like the organization considered in Easter House which provided health care to indigent pregnant women, but only when a family willing to adopt a woman's child sponsored the care financially.

XXX's promotional material and its marketing activities show that XXX operated in a manner consistent with a commercial firm seeking to maximize sales of services, rather than in a manner that would be consistent with a charitable or educational organization

seeking to serve one or more of the charitable purposes enumerated in section 501(c)(3). The manner in which XXX operated its DPA program shows that XXX was in the business of facilitating the sales of homes in a manner indistinguishable from an ordinary trade or business. In this respect XXX's operations were similar to an organization which was denied exemption because it operated a conference center for commercial purposes. See Airlie Foundation v. Commissioner, 283 F. Supp. 2d 58 (D.D.C., 2003).

Operating a trade or business of facilitating home sales is not an inherently charitable activity. Unlike the trade or business in Aid to Artisans, Inc. v. Commissioner, 71 T.C. 202 (1978), XXX's trade or business was not utilized as a mere instrument of furthering charitable purposes but was an end in itself. XXX provided services to home sellers for which it charged a market rate fee. XXX did not market its services primarily to persons within a charitable class. XXX's primary goal consisted of maximizing the fees it derived from facilitating the sales of real property. XXX did not solicit or receive any funds from parties that did not have interest in the down payment transactions. Like the organizations considered in American Campaign Academy, supra, and Easter House v. U.S., 12 Cl. Ct. 476, 486 (1987), aff'd, 846 F. 2d 78 (Fed. Cir.) a substantial part of XXX's activities furthered commercial rather than exempt purposes. XXX is substantially similar to example 2 of Rev. Rul. 2006-27.

Furthermore, XXX's activities were structured to provide substantial private benefit to XXX's insiders. Facts establish that XXX and XXX entered into a marketing agreement, effective January 1, 2001. Under the terms of the agreement XXX performed all of the marketing and processing for the DPA activities of XXX. The agreement called a fee equal to 75% of the seller service fee paid by the seller to XXX. Every grant made by XXX was deemed attributable to marketing services provided by XXX, therefore, XXX received a fee from every grant transaction made by XXX. For the years at issue, XXX was the source of substantially all of XXX's gross revenues. Like the organization in KJ's Fund Raisers, supra, XXX's operations resulted in a substantial private benefit to XXX's insiders.

XXX's operations also resulted in inurement to insiders, XXX, XXX and XXX who are the sole shareholders of XXX. In the year ended December , 20 XXX paid to XXX a marketing service fee of $ and in the year ended December , 20 they paid a marketing service fee of $. In a valuation report prepared by XXX, CPA, CVA, Valuation/Economist Specialist of the Internal Revenue Service, dated April , 20 , the fair market service fee for the 20 year was determined to be $ and for the 20 year the fee was $. The excess marketing fees paid to XXX allowed the for-profit S Corporation to accumulate a large net income and constitutes inurement of XXX's assets to the benefit of the three insiders.

XXX's operations are the same as those of organization Y in Situation 2 of Rev. Rul. 2006-27. Under that revenue ruling, which is controlling in this case, Y does not

operate exclusively for a charitable purpose but instead operates primarily for the private benefit of other participants in the home sales transactions it facilitates. For the same reasons that Y is held not to be exempt in Rev. Rul. 2006-27, XXX is not exempt as an organization described in section 501(c)(3).

XXX's (" ") program does not meet the operational test set forth in Treas. Reg. § 1.501(c)(3)-1(c) because its program is nearly identical to the program discussed in situation 2 of Rev. Rul. 2006-27. Rev. Rul. 2006-27 articulates the Service's position on when an organization that provides down payment assistance operates in a manner that is consistent with section 501(c)(3), and when it does not. In Rev. Rul. 2006-27, the IRS held that an organization that relies on funding primarily from home sellers to provide downpayment assistance to home buyers is not operated exclusively for charitable purposes. Just like organization Y in situation 2 of the revenue ruling, the critical aspect of XXX's operations is the receipt of a payment from the home seller corresponding to the amount of its downpayment assistance.[1]

Rev. Rul. 2006-27 is factually on point, and it is controlling in this case.
In addition, Rev. Rul. 2006-27 restates existing applicable law in effect at the time XXX began and operated its Down Payment Assistance (DPA) program. Therefore, even if there were not a revenue ruling directly on point, XXX fails to meet the requirements set forth in the Internal Revenue Code and in Treasury Regulations. As discussed below, like Y in Situation 2, XXX is not operated exclusively for charitable purposes, and as discussed below, like Y, more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Rev. Rul. 2006-27 sets forth the Service's position on applicable rules and standards for determining whether organizations that provide down payment assistance to home buyers qualify as tax-exempt organizations described § 501(c)(3). Revenue rulings are binding on the Service and constitute formal statements of policy and the official position of the Internal Revenue Service on the application of existing tax law to specific facts. See Tualatin Valley Builders Supply, Inc. v. United States, 2008-1 USTC 50,280 (9th Cir. April 10, 2008)[2] citing Omohundro v. United States, 300 F.3d 1065 (9th Cir.

* * * *

[1] Actually, XXX's operations are even more egregious than the organization described in situation 2 of the revenue ruling. In situation 2, only low income homebuyers received down payment assistance. Under XXX's program there are no income limitations. Any homebuyer is able to receive down payment assistance from XXX as long as the home buyer buys a home from a seller that has enrolled the home with XXX's program.

[2] The 9th Circuit in Tualatin Valley describes an IRS revenue ruling in the following manner:

> A revenue ruling is "an official interpretation by the Service that has been published in the Internal Revenue Bulletin ... for the information and guidance of taxpayers, Internal Revenue Service officials, and others concerned." Statement of Procedural Rules § 601.601(d)(2)(i)(a). Revenue rulings "do not have the force and effect of Treasury Department Regulations ..., but are published to provide precedents to be used in the

footnote continues next page

2002); Sidell v. Commissioner, 225 F.3d 103, 111 (1st Cir. 2000); and Weisbart v. U.S. Dep't of Treasury, 222 F.3d 93, 98 (2nd Cir. 2000).

Situation 1 of Rev. Rul. 2006-27 describes an organization whose activities exclusively further a charitable purpose and do not confer more than incidental private benefit, and therefore qualifies for tax exemption. Situation 2 describes an organization that does not qualify as a tax-exempt organization because its activities do not exclusively further a charitable purpose, and the substantial private benefit it confers on home sellers and its commercial focus overshadow any charitable purposes served. XXX's down payment assistance activities lack even the favorable elements described in both Situations 1 and 2, and include all of the problematic elements flagged by Situation 2. Therefore, XXX does not qualify for tax exemption.

In both Situation 1 and Situation 2, the organizations were conducting the following activities which are consistent with tax exempt status. XXX lacks all of these favorable elements:

- Making assistance available exclusively to low-income individuals (XXX's program is open to everyone, regardless of their income or assets).
- Using a standard, such as the standards set by Federal housing statutes and administered by the Department of Housing and Urban Development, to determine who is a low-income individual. (XXX's program does not use any standards to determine who is a low-income individual; it is open to everyone, regardless of their income or assets).
- Providing assistance to low-income individuals who have the employment history and financial history necessary to qualify for a mortgage, and would so qualify *but for* the lack of a down payment. (XXX does not limit its assistance to low-income individuals who would otherwise be able to purchase a home and qualify for a mortgage *but for* the lack of a down payment.)
- Offering financial counseling seminars and conducting other educational activities to help prepare potential low-income home buyers for the responsibility of home ownership. (XXX does not offer financial counseling seminars and does not conduct other educational activities to help prepare potential low-income home buyers for the responsibility of home ownership, other than posting educational information about homeownership on its website.)

continued footnote

disposition of other cases, and may be cited and relied upon for that purpose." § 601.601(d)(2)(v)(d).

- Establishing that a home purchased through the program meets standards for habitability by requiring a home inspection report. (XXX does not attempt to establish that a home purchased through the DPA program is habitable, and does not require a home inspection report.)

In the areas where Situations 1 and 2 differ, XXX lacks all of the favorable elements described in Situation 1 and goes beyond the negative elements described in Situation 2.

- In Situation 1, X organization conducted a broad based fundraising program that attracted gifts, grants and contributions from several foundations, businesses, and the general public to fund its down payment assistance program and other activities. In Situation 2, Y organization did not conduct a broad based fundraising campaign to attract financial support but rather was supported mostly from the home sellers and real estate-related businesses that may benefit from the sale of homes to buyers who received Y's downpayment assistance. Like Y, XXX does not conduct a broad based fundraising program that attracts gifts, grants and contributions; instead, it relies almost exclusively on payments from its client home sellers, which are contingent on the sale of particular properties.

- In Situation 1, X organization structured the grantmaking process in a way to ensure that its grantmaking staff did not know the identity of the party selling the home to the grant applicant or the identities of any other parties, such as real estate agents or developers, who may receive a financial benefit from the sale; and also did not know whether any of the interested parties to the transaction had been solicited for contributions or had made pledges or actual contributions to the organization. In Situation 2, Y organization's staff considering an application for downpayment assistance knew the identity of the party selling the home to the applicant and sometimes also knew the identities of other parties, such as real estate agents and developers, who may receive a financial benefit from the sale. Even worse than situation 2, XXX's staff not only knew the identity of the party selling the home to the downpayment assistance applicant and the identities of any other parties who may receive a financial benefit from the sale, it contractually required such interested parties to make payments to the organization that would cover the "assistance" provided to the buyer, plus XXX's service fees.

- In Situation 1, X organization did not accept any contributions contingent on the sale of a particular property or properties. In Situation 2, in substantially all of the cases in which Y organization provided down payment assistance to a home buyer, Y received a payment from the home seller, and there was a direct correlation between the amount of the down payment assistance provided by Y and the amount of the home seller's payment to Y. Even worse than Situation 2, in every situation where XXX's transfers funds to a buyer, it has previously

contractually required the home sellers to make a payment that would cover the "assistance" provided, plus XXX's service fees.

In Rev. Rul. 2006-27, Situation 2, the Service concluded that Y organization did not qualify for exemption from federal income tax as an organization described in §501(c)(3). As described above, XXX's operations are even further removed from being charitable than those described in Situation 2; thus, XXX does not qualify for exemption from federal income tax as an organization described in §501(c)(3).

ISSUE 2

An organization may not rely on a favorable determination letter if the organization omitted or misstated a material fact in its application or in supporting documents. See Rev. Proc. 2008-9. In addition, an organization may not rely on a favorable determination if there is a material change, inconsistent with exemption, in the organization's character, purposes, or methods of operation after the determination letter is issued. Id. The examination of XXX's operations revealed that XXX omitted or misstated material facts in its Form 1023 and that the organization operated materially different from the representations the organization made to the Service on its Form 1023 and subsequent filings.

First, XXX entered into a series of marketing relationships with XXX, a for profit entity, that resulted in the inurement of its net earnings to individuals, mainly XXX's founders, XXX, XXX and XXX.

Second, XXX operated contrary to its representations on Form 1023 that it would provide grants to, "first-time homebuyers who meet certain criteria. These grants can be used for their downpayment and/or closing costs to help them purchase their first home." In fact, XXX did not limit eligibility for its DPA program to first-time home buyers. Moreover, its operations show that the DPA program was open to any one who qualified for a FHA loan, regardless of a homebuyer's income, status as the first-time homebuyer, or the location of a participating home. XXX did nothing to ensure that the homebuyers would in fact be able to afford the homes purchased through its program or that the homes were safe.

Section 501(c)(3) of the Code and the regulations thereunder establish certain tests that an organization must meet to qualify for tax-exempt status. One of the tests is the prohibition on inurement of the organization's net earnings to the benefit of any private shareholder or individual. See IRC § 501(c)(3), Treas. Reg. § 1.501(c)(3)-1(c)(2). Section 4958 of the Code imposes certain excise taxes on excess benefit transactions that provide excess economic benefits to certain disqualified persons with respect to public charities described in sections 501(c)(3). The term "excess benefit transaction" includes, but is potentially broader than, the term "inurement." See IRC § 4958(c)(4).

XXX admits that a portion of its net earnings inured to the private benefit of XXX and its shareholders.

In the 1996 House Report on section 4958, Congress stated that "intermediate sanctions for excess benefit transactions may be imposed by the IRS in lieu of (*or in addition to*) revocation of the organization's tax-exempt status." H. Rep. No. 104-506, 104th Cong., 2d Sess., at 59 (1996) (emphasis added). The Report also stated, in a footnote, that, in general, revocation of tax-exempt status, with or without the imposition of excise taxes, would occur only if an organization no longer operates as a charitable organization. H. Rep. No. 104-506, 104th Cong., 2d Sess., at 53, 59, note 15. The implementing regulation, Treas. Reg. § 1.501(c)(3)-1(f)(2), became effective on March 28, 2008 for excess benefit transactions occurring after March 28, 2008.

Although the regulation was not effective at the time the transactions in this case occurred, it provides a framework for analysis and is helpful in applying previously existing general principles to this case. The regulation states that the IRS will consider all relevant facts and circumstances in determining whether to combine revocation of exempt status with intermediate sanctions. Five factors are listed, but the list is not exhaustive and the Service can take into account the many unique factors that may arise in any given case or affect the Service's ultimate discretion on the issue of revocation. Id. An application of the five factors to this case makes it clear that revocation of XXX's exempt status is appropriate, even with the imposition of excess benefit taxes.

The first factor looks to the size and scope of XXX's activities furthering an exempt purpose. XXX did not operate to further an exempt purpose, so this factor weighs in favor of revocation. The second factor looks to the size and scope of the excess benefit transactions relative to the size and scope of the exempt purpose activities. Again, XXX did not operate to further an exempt purpose. Therefore, its excess benefit transactions are not offset or put into any kind of perspective by an extensive record of charitable activities. Thus, the second factor also weighs in favor of revocation.

XXX argues that the third, fourth, and fifth factors listed in the regulation weighed against revocation, because XXX it implemented safeguards to prevent future excess benefit transactions, and it made good faith efforts to seek correction from the disqualified persons involved. XXX can be given credit for the pre-audit voluntary compliance it made in this regard. The third, fourth and fifth factors could help to compensate for excess benefit transactions conducted by an organization that otherwise qualified for exemption. However, because XXX's activities failed to further an exempt purpose in the first place, it does not qualify for tax exempt status.

Consistent with the legislative history to section 4958, the final regulations under section 4958 provide that the substantive requirements for exemption under § 501(c)(3) still apply even if an organization engages in transactions that are also subject to excise

taxes under § 4958. Treas. Reg. § 1.501(c)(3)-1(f)(2). Unlike the health care organizations in Caracci v. Commissioner, 456 F.3d 444 (5th Cir. 2006), XXX did not otherwise engage in substantial activities that furthered a charitable purpose. Remedial actions taken by XXX, although commendable, do not negate this fact. Therefore, revocation in response to the inurement is appropriate.

Revocation of an organization's determination letter recognizing exempt status may be retroactive if the organization omitted or misstated a material fact, operated in a manner materially different from that originally represented, or engaged in a prohibited transaction for the purpose of diverting corpus or income from its exempt purpose, and if the transaction involved a substantial part of the corpus or income of the organization. See The Statement of Procedural Rules § 601.201(n)(6)(i). XXX made several material misstatements on its application for exemption, justifying a retroactive revocation. These include, but are not limited to, misstatements about how XXX would help only first-time homebuyers obtain downpayments and that the organization would be "targeting those members of the community at the lower end of the income scale . . ."

In addition, XXX misstated and omitted material facts concerning its financial support sources. On Form 1023, XXX indicated that its ability to provide Grants would be, "predicated on contributions received by the organization from community businesses, private individuals, or government entities. Hopefully, we can help many worthy families." Form 1023, Part I, Statement 1. In fact, XXX had only one main source of financial support -- sellers' contingent payments.

XXX has not operated consistently with some of the statements made in the application, and its operations are materially different from what was described. Consequently, it is appropriate to revoke XXX's determination letter recognizing it as a tax-exempt organization described back to effective date of the determination letter. Moreover, revocation in this case is both retroactive and prospective.

CONCLUSION

In order to qualify for exemption under IRC section 501(c)(3) an organization must be both organized and operated to achieve a purpose that is described under that Code section. XXX's DPA program is not operated in accordance with Internal Revenue Code section 501(c)(3) and the regulations there under governing qualification for tax exemption under the Code. XXX provides down payment assistance, purportedly in the form of a gift, to individuals and families for the purchase of a home. XXX offers its down payment assistance to interested buyers regardless of the buyers' income levels or need. XXX's DPA activities do not target neighborhoods in need of rehabilitations or other relief such as lessening neighborhood tensions or eliminating prejudice and discrimination.

XXX operates in a manner indistinguishable from a commercial enterprise. XXX's primary activity is brokering transactions to facilitate the selling of homes. XXX's primary goal is to maximize the fees from these transactions. XXX's brokering services are marketed to homebuyers, sellers, realtors, lenders, home builders, and title companies regardless of the buyers' income level or need and regardless of the condition of the community in which the home is located. Alliances are built with the realtors, lenders, home builders, and title companies to assure future business for the mutual benefit of the participants. There are no roof certifications, homeowner's warranties or home buyer's education required for buyer or seller participation in the program. XXX has no standards for habitability, and home inspection reports are not required for participation in the program. XXX does not engage in any counseling or other activities that further charitable purposes. Because XXX's primary activity is not conducted in an manner designed to further section 501(c)(3) purposes, XXX is not operated exclusively for exempt purposes within the meaning of section 501(c)(3).

In addition, XXX's activities have resulted in inurement of charitable assets to XXX's insiders. Under the terms of a marketing agreement XXX had with XXX all of the DPA activities of XXX were carried out through XXX. For the years at issue, XXX was the source of substantially all of XXX's gross revenue and existed for a substantial nonexempt purpose of creating a market for XXX. The marketing fees paid by XXX to XXX have been determined to be excessive by a Valuation/Economist Specialist of the Internal Revenue Service and resulted in substantial private benefit to XXX and inurement to the three owners of XXX,XXX, XXX and XXX.

For the foregoing reasons, revocation of exempt status is proposed. The facts show that in 20 and 20 XXX operated in a manner materially different from that represented in its form 1023 application the government proposes that the revocation be effective retroactively to the date of the organization's inception, July , 19 .

TAXPAYER'S POSITION

XXX's position with respect to the issues, facts, applicable law and government's position as discussed in this report is unknown. XXX will be allowed 30 days to review this report and respond with their position.