DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
TE/GE: EO Examinations
625 Fulton Street, Room 503
Brooklyn, NY 11201

501.03-00

TAX EXEMPT AND GOVERNMENT ENTITIES DIVISION

August 18, 2010

Number: **201050039**
Release Date: 12/17/2010

LEGEND
ORG = Organization name
XX = Date Address = address

Taxpayer Identification Number:
Person to Contact:
Identification Number:
Contact Telephone Number:

ORG
ADDRESS

CERTIFIED MAIL

Dear :

This is a final adverse determination regarding your exempt status under section 501(c)(3) of the Internal Revenue Code (the Code). Our favorable determination letter to you dated October 27, 19XX is hereby revoked and you are no longer exempt under section 501(a) of the Code effective January 1, 19XX.

The revocation of your exempt status was made for the following reason(s):

We have determined that you are not operating exclusively for charitable or educational purposes. 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. Your receipt of payment from the home seller corresponds to the amount of the down payment assistance provided in substantially all of your 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 your president, executive director and the persons that finance your activities. Accordingly, you are not operated exclusively for exempt purposes described in section 501(c)(3) and your income inured to the benefit of private individuals.

Contributions to your organization are no longer deductible under IRC §170.

You are required to file income tax returns on Form 1120. These returns should be

filed with the appropriate Service Center for the tax year ending December 31, 20XX and for all tax years thereafter in accordance with the instructions of the return. In addition to the filing of Form 1120, although your status as an exempt organization is revoked, you are also required to file Form 990-PF, Return of Private Foundation, see Treas. Reg. section 1.6033-2(a)(2)(i), since your status as a private foundation has not been terminated pursuant to section 507. See Internal Revenue Code section 509(b).

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

If you decide to contest this determination under the declaratory judgment provisions of section 7428 of the Code, a petition to 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 must be filed before the 91st Day after the date this determination was mailed to you. Please contact the clerk of the appropriate court for rules regarding filing petitions for declaratory judgments by referring to the enclosed Publication 892. You may write to these courts at the following addresses:

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

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

Sincerely,

Nanette M. Downing
Director, EO Examinations

Enclosure:
Publication 892

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
Internal Revenue Service
230 S Dearborn, 17th Floor MC4923CHI
Chicago, IL 60604.

November 30, 2009

ORG
ADDRESS

Taxpayer Identification Number:

Form:

Tax Year(s) Ended:

Person to Contact/ID Number:

Contact Numbers:
Telephone:
Fax:

Certified Mail - Return Receipt Requested

Dear

We have enclosed a copy of our report of examination explaining why we believe revocation of your 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:

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,

Sunita Lough
Director, EO Examinations.

Enclosures:
Publication 892
Publication 3498
Report of Examination

Form **886A**	Department of the Treasury - Internal Revenue Service **Explanation of Items**	Schedule No. or Exhibit 990-PF
Name of Taxpayer **ORG**	**EIN#: EIN**	**Year/Period Ended** 20XX12, 20XX12, 20XX12, 20XX12

LEGEND
ORG = Organization name XX = Date City = city State = state President = president DIR-1, DIR-2 & DIR-3 = 1ST, 2ND & 3RD DIRECTORS RA-1 & RA-2 = 1ST & 2ND RA CO-1, CO-2 & CO-3 = 1ST, 2ND & 3RD COMPANIES

I. ISSUES

A. Issue 1: Whether ORG ("ORG" or "Organization") operated exclusively for exempt purposes within the meaning of § 501(c)(3) of the Internal Revenue Code ("IRC" or "Code").[1]

B. Issue 2: Whether ORG's tax-exempt status should be revoked as of January 01, 19XX, the date it began operating its DPA program.

II. FACTS

A. Organization History

1. Brief history of ORG

ORG is a not-for-profit corporation incorporated on February 12, 19XX in City, State by President to conduct charitable activities and help build a community center for the city of City. The initial board of directors consisted of President, DIR-1, DIR-2, and DIR-3. Based on its representations on Form 1023, ORG received a determination letter from the Internal Revenue Service ("IRS" or "Service") recognizing the Organization as exempt from tax under § 501(c)(3). The Organization was classified as a private foundation in a letter from the IRS dated March 12, 19XX.

By 19XX, ORG became inactive, apparently due to the illness of President. It remained dormant through 19XX when RA-1, who was in the building/construction business, agreed with President to take over the management of ORG. There are no minutes of the meeting between RA-1 and President, nor is there a written agreement memorializing the terms of the agreement between the two men. In 19XX RA-1 became ORG's president. Since then, ORG's sole activity has been the promotion and operation of a seller-funded Down Payment Assistance ("DPA") program, described in detail below.

Since 19XX the Organization's operations have had no resemblance to the operations ORG described on its Form 1023. The Organization's Form 1023 does not indicate that the Organization's actual or planned activity would be the operation of a seller-funded DPA program in the manner conducted by ORG. After starting the operation of the DPA program, ORG never notified the IRS of the change in its activities, funding, and operations.

During the years under examination, RA-1, together with his wife, RA-2, controlled ORG. He was the only member of ORG's board of directors, and served as the Organization's president, treasurer and secretary. At

[1] Unless otherwise stated, all section references are to the Internal Revenue Code of 1986, as amended (the "Code"). All regulatory references are to the regulations promulgated under the Code.

the same time, RA-2 served as the executive director of the Organization and was the only alleged employee of the Organization. In the years under examination, the operation of the DPA program was ORG's sole activity.

2. Application for recognition of tax-exempt status

On June 1,19XX, ORG filed Form 1023 ("application for exemption" or "application") with the IRS, under penalties of perjury, to apply for recognition of tax-exempt status under § 501(c)(3). The application stated that:

> ... [ORG] has no past or present activities. The income for [ORG] will be used for charitable activities. Donations will be made to other organizations which are recognized by I.R.C. § 501(c)(3), including local organizations qualified under said code section. The ultimate goal of [ORG] would be to assist in the construction of a community center for the City of City.

The articles of incorporation stated that the purposes of the organization are to:

> ... receive and maintain a fund or funds of real and/or personal property, or both, and, subject to the restrictions and limitations hereinafter set forth, to use and apply the whole or any part of the income therefrom and the principal thereof exclusively for charitable, religious, scientific, testing for public safety, literary, or educational purposes either directly or by contributions to organizations that qualify as exempt organizations under section 501(c)(3) of the Internal Revenue Code of 1954 and its regulations ...

During the initial application review, the IRS sent a letter dated September 21, 19XX to ORG requesting additional information and clarification regarding its exempt activities. The letter requested (a) a detailed description of past, present and proposed activities and information regarding b) when they would be initiated, (c) how they would be conducted, (d) the requirements to participate and receive benefits, (e) fees and (f) what the activities would accomplish.

ORG responded in a letter dated October 9, 19XX, stating that:

> ... (a) As stated, the corporation has no definite activities at the present time. Form 1023 states that the ultimate goal of the corporation is to assist in building a community center in City, City, State. Until further details are worked out for this project, the corporation will limit itself to making contributions to other organizations which are exempt under State Revenue Code Section 501(c)(3) or the state or city governments.
> (b) It is hoped that a fund drive will be initiated for the community center at an early date by the corporation. Until such time, the corporation will limit its activities to those stated above in Paragraph (a).
> (c) See the answers to (a) and (b) above.
> (d) At the present time, only organizations exempt under Section 501(c)(3) or governmental organizations would be eligible to receive any benefit from the corporation.

(e) There are no charges or fees that will be charged or assessed by the corporation.
(f) The community center, if constructed, will provide a central meeting place for residents of City, State, a recreational center for youth of the community, and other related community activities. Donations to city or county government or organizations exempt under Section 501(c)(3) will be used by that entity for its charitable purposes.

Based on the information ORG provided in its application for exemption, additional information provided during the application process, and the assumption that the Organization would operate in the manner represented in its application, on October 27, 19XX, the IRS issued a determination letter recognizing ORG as a tax-exempt organization as described in § 501(c)(3). In the letter the IRS determined that ORG would be treated as a publicly supported organization and not as a private foundation during the advance ruling period, which ended December 31, 19XX. At the end of the advance ruling period, in a letter dated March 12, 19XX, the IRS notified the Organization that it would be classified as a private foundation.

3. Private foundation status

ORG is a private foundation. Before RA-1 took over the management of ORG, the Organization had been classified as a private foundation and after the change in management, ORG continued to hold itself out as a private foundation. The Organization filed Forms 990-PF and 4720 for the calendar years ended December 31, 20XX and December 31, 20XX. In Publication 78, Cumulative List of Organizations described in § 170(c) of the Internal Revenue Code of 1986, ORG is listed as a private foundation. ORG's private foundation status was never terminated as provided in § 507 and the accompanying regulations.

B. Operation of ORG's Down Payment Assistance Activity

During the examination, the Organization provided the following list of its activities: "... Down payment Grant Activity, Closing Cost Grants, Interest Rate Buy Down, Non-Conventional, Non-Conforming Financing, Rental Housing site acquisition to build affordable homes, Contract to build and manage cooperative homes, and Debt Consolidation/Debt Pay-Off ..." See the document titled "ORG - Activities and Operational Information."

Despite the list of activities provided, during the years under examination, ORG's sole activity was the operation of a DPA program. The Organization promoted its DPA program through solicitation of real estate agents, mortgage lenders, loan officers, title insurers, sellers, buyers, and builders to identify potential homebuyers in need of assistance for the purchase of a home. A document titled, "Down-payment Assistance," prepared by ORG during the examination, described the advantage to realtors as follows: "Real Estate Agent is able to help both clients (buyer and seller) while also increasing their business. Why cancel a sale due to lack of down payment resources when the funds are available?" The document described the advantages to sellers as including the ability "to sell their home in a timely manner without the need to reduce their price...," and to buyers as the ability "to purchase a home using our down payment assistance program."

Essentially, through its DPA program, the Organization channeled funds for downpayment and closing costs from the participating sellers to the participating homebuyers purchasing a home. This activity was entirely

financed with fees paid to the Organization by the participating sellers. In all four years under examination, ORG provided DPA grants to any home buyer using a mortgage company that would accept a "gift" from an § 501(c)(3) organization as the down payment for the purchase of a house. ORG followed these steps for its DPA program:

1. A real estate contract prepared by the realtor is negotiated between a buyer and seller. In most cases, the realtor knows about ORG's DPA program through either the mortgage broker or a builder. Both seller and homebuyer are encouraged to participate in ORG's DPA program.

2. The realtor provides the buyer with a gift application. The gift application contains the applicant's information (e.g., requested gift, total household income, family size), the seller's information, lender's information, type of loan and closing agent information. The gift letter must be accompanied by a copy of mortgage application, purchase agreement, participating home agreement, HUD Settlement statement and a 15% service fee (at closing) payable by seller.

3. The participation agreement enrolls the seller's property into ORG's DPA program. The form states in part that

   > ... in consideration of the foregoing, seller(s) agrees to make a contribution to ORG in the amount of $_____. Seller understands that the contribution will not be used to provide assistance to the Buyer of the Participating Home, and that the gift funds provided to the Buyer toward the purchase of the Seller(s) home are derived from preexisting ORG funds. Seller further understands that the seller(s) is only obligated to make the contribution if a homebuyer utilizing the ORG Program purchases the participating home.

   The agreement further stated that:

   > It is understood by this agreement that any gift deposited by ORG with escrow or closing agent shall be returned without recourse within three (3) days to ORG in the event Buyer's loan closing is terminated. Seller shall not be obligated to make a contribution upon termination of loan closing of participating home.

4. The amount of the seller's contribution almost always equals exactly the amount of the gift provided to the buyer of the seller's home plus the "service fee," which generally equals 15% of the gift amount. The seller generally agrees to pay the 15% service fee as a condition of participating in the DPA program.

5. The participation agreements are signed by the seller and the buyer and ORG staff. ORG reviews the application and decides on the amount of gift to provide to buyer. The amount of gift varies from one transaction to another. The service fee is added to the buyer's gift and the total amount (i.e. gift plus the service fee) represents the amount of the seller's contribution to ORG. The gift is not limited to a particular percentage. The gift amount can be whatever the buyer requires to close the loan.

6. On the day of closing, ORG staff prepares a Closing Fax Transmittal and faxes the form directly to the title company or closing agent. The Closing Fax Transmittal contains closing instructions and information (e.g., borrower's name, contributor's name, property address, loan originator, name of nonprofit, "contribution" amount payable to ORG, gift amount, 15% service fees and closing date). The title company or closing agent then confirms to ORG that the transaction is scheduled, and confirms the grant amount needed by the buyer. The closing agent also signs closing instructions stating it will return the grant amount if the loan does not close, and agrees to collect ORG's seller service fee from the seller. ORG then wires the down payment grant directly to the title or escrow office by the requested closing date. If the loan does not close within five business days of requested closing date, the title or escrow officer will return the grant money directly back to ORG.

In 20XX, ORG completed over 120 DPA transactions. It completed less than 60 in 20XX. In 20XX and 20XX, ORG completed less than 20 transactions in each year. In nearly all of these transactions, the home seller's contribution, exclusive of ORG's service fee, corresponded exactly to the amount of DPA ORG provided to the home buyer.

ORG's promotional materials advised participating sellers that payments made to ORG may be deductible as charitable contributions under § 170. For instance, in one promotional document titled "Down Payment Assistance" ORG stated: "[a] contribution may be used as either a charitable deduction which may have limitations or as a 100% cost of sale deduction required to sell the home."

Regarding income limits and financial need, publications produced by ORG stated that ORG offers downpayment and or closing cost assistance to help low- to moderate-income households purchase new or rehabilitated dwellings for use as their primary residence. However, the manner in which ORG operated its DPA program shows that the Organization did not have any income limitations and did not screen applicants for DPA based on income. In addition, DPA was made available regardless of whether the buyer was a first time buyer and regardless of the geographical location of the home being purchased.

In regard to fundraising and contributions, ORG's application for exemption stated that the Organization would receive donations from the general public and the contributions would be invested, with the investment income being used for the Organization's exempt purposes. However, the review of the books and records for 20XX through 20XX disclosed that 100% of ORG's revenue comes from payments received from the sellers that participated in the ORG DPA Program.

ORG filed Forms 990-PF for 20XX and 20XX. Part IX - A (Summary of Direct Charitable Activities) of the 20XX Form 990-PF stated that the direct charitable activities engaged in during 20XX were downpayment assistance, interest rate buy-down assistance, debt reduction or other assistance to help households purchase dwellings for use as their primary residence. ORG answered Part IX - A of the 20XX Form 990-PF as "N/A."

According to its 20XX Form 990-PF, in 20XX ORG received $$ from home sellers. It reported this amount under "contributions, gifts, grants received." Of this amount, ORG paid out $$ as specific assistance to home buyers, reported under "contributions, gifts, grant paid." The Organization paid the remaining balance for

administration of the DPA program, reported as "other expenses" on the Form 990-PF. The Organization's 20XX Form 990-PF, Part II, line 30 reported that as of January 01, 20XX, ORG's net assets or fund balance was $$; this grew to $$ by December 31, 20XX.

According to its 20XX Form 990-PF, ORG received $$ from home sellers. It reported this amount under "contributions, gifts, grants received." Of this amount, ORG paid out $$ as specific assistance to home buyers, reported under "contributions, gifts, grant paid." The Organization paid the remaining balance for salaries, accounting fees, and general administration of the DPA program. The Organization's 20XX Form 990-PF, Part II, line 30 reported that as of December 31, 20XX, ORG's net assets or fund balance was $$.

ORG did not file Forms 990-PF for 20XX and 20XX. However, based upon a review of the Organization's books and records it was determined that ORG received $$ in contributions from home sellers and paid out $$ as specific assistance to home buyers in 20XX. In 20XX ORG received $$ in contributions from home sellers and paid out $$ as specific assistance to home buyers.

ORG's DPA program facilitated real estate transactions and, as a result, provided private benefit to the participating sellers, buyers, realtors, builders, lenders. In addition, the Organization's officers and insiders benefited more than incidentally from ORG's operations. The benefits included:

Sellers. ORG's DPA program benefited sellers by providing them with ready buyers, enabling the sellers to sell for higher prices and allowing them to sell faster due to the larger pool of potential buyers, thereby reducing the costs associated with real estate remaining unsold for an extended period. One of ORG's promotional documents stated the advantage to the seller as "the seller is able to sell their home in a timely manner without the need to reduce their price."

Realtors. The realtors are able to increase their business; as more buyers and sellers are introduced into the program; sales increases generate increased commissions.

Builders. The participating home builders in ORG's DPA program received benefits similar to the home sellers in that their participation in ORG's DPA program allowed them access a larger pool of homebuyers, thereby allowing the home builders to sell homes faster and at a higher price.

Lenders. Review of the transactions undertaken by ORG during the years under examination disclosed that the transactions in which DPA was provided were concentrated in a few lenders and a few contact persons. The main bank is Bank, which provided over % of the mortgages. There are two or three individuals from this bank whose names occur frequently on the closing papers. Like realtors, lenders also benefit from increased sales in the form of increased commissions.

RA-1 and his son. RA-1 commingles the activities of his personal for-profit company with those of ORG. Three of the for-profit home builder companies participating in ORG's DPA program are owned by either RA-1 or his son. RA-1 owns CO-1, a company specializing in residential construction and sales. RA-1's son owns two construction companies, CO-2 and CO-3, which specialize in single family home construction. As owners of these for-profit home construction companies, RA-1 and his son benefit materially from

participating in ORG's DPA program.

In 20XX, CO-1, owned by RA-1, "contributed" over $$ to ORG and CO-3, owned by RA-1's son, "contributed" over $$. IN all, companies owned by RA-1 and son accounted for 11.5% of ORG's revenue in 20XX. In 20XX, CO-3 "contributed" $$; CO-2s, $$; and RA-1 and RA-2, $$. In total, companies owned by RA-1 and son accounted for 16.7% of ORG's revenue in 20XX. As discussed above, the amounts "contributed" were circulated through ORG to homebuyers purchasing the homes constructed by these companies.

RA-2. As executive director, RA-2 was responsible for the overall administration of ORG and its DPA program. RA-2 and RA-1 were both signatories on the Organization's checking account. However, RA-2 wrote and signed the majority of the checks.

During the examination, it was discovered that 62 checks, paid in irregular intervals and amounts and totaling $$, were written to RA-2 during 20XX. RA-2 admitted that she received the funds and that the funds were not used for ORG's business purposes but, rather, for her own personal purposes. The Organization did not have an employment contract with RA-2. There was no written agreement regarding compensation amount, pay day, or frequency of pay. During the initial interview, RA-1, ORG's president, alleged that RA-2's annual compensation was $$. This amount was recorded in the Organization's ledgers in 20XX as salary. The 20XX Form 990-PF, line 13, reported "Compensation of officers, directors, trustees, etc." as "-0-," and Line 14, "Other employee salaries and wages," contained no entry. In the chart on Line 1 of Part VIII of the 20XX Form 990-PF, where ORG listed its officers, directors, and foundation managers and their compensation, ORG only listed RA-1 (as director, president, secretary, and treasurer) with $0 in compensation; it did not list the name of RA-2 or report that any compensation was paid to her. In addition, ORG did not file Forms 941, W-2 or 1099 with respect to any of its payments to RA-2 in 20XX or in any other year.

As noted above, RA-2 received a total of $$ during the year ending December 31, 20XX. ORG reported the difference between the total amount RA-2 received during the year ($$) and the amount alleged as her salary ($$), or $$, as "Receivable due from Officers, directors, trustee and other disqualified person" on the Form 990-PF balance sheet. At the end of the year a promissory note (the "Note") for $$ was prepared. The amount listed on the promissory note was presumably an attempt to characterize the noncompensatory payments to RA-2 as a loan to her from ORG. The Note stated, in relevant part, the following:

> ... the undersigned, each as principal, jointly and severally promise(s) to pay to the order of ORG at City, State, the sum of $$ with interest thereon from December 31, 20XX, payable on December 31, 20XX at the rate of 6 percent per annum until payment hereof, as follows $$ annual payment each year commencing on December 31, 20XX with interest, December 31, 20XX with interest & payment in full on December 31, 20XX with interest.

The amount reported on the Note was $$ less than the amount reported on the balance sheet as "Receivable due from Officer."

The Note had an execution date of December 31, 20XX and was signed by RA-2 only, as follows: "RA-2 (signature), By: RA-2 (typed out), Title: Executive Director." No collateral was provided.

The transaction was reported on ORG's 20XX and 20XX Forms 990-PF at Part II, Balance Sheets, line 6 ("Receivables due from officers, directors, trustees, and other disqualified persons"). In addition, in Part VII-B ("Statements Regarding Activities for Which Form 4720 May be Required") of the 20XX Form 990-PF, ORG checked "Yes" to the question, "During the year did the organization (either directly or indirectly) borrow money from, lend money to, or otherwise extend credit to (or accept it from) a disqualified person?" ORG also checked "Yes" in response to the question, "If any answer is 'yes' to 1a(1)-(6), did any of the acts fail to qualify under the exceptions described in Regulations section 53.4941(d)-3 ...?" The 20XX Form 990-PF contains identical or nearly identical information.

In addition to the information reported on the Forms 990-PF, ORG filed Forms 4720 reporting the transactions. These forms reported the transactions as a loan to a disqualified person.

At the end of 20XX, the "Receivables due from officers" on the Form 990-PF balance sheet had a balance of $$, which included $$ reported as interest accrued for 20XX. Although ORG did not file Forms 990-PF for 20XX and 20XX, as of December 31, 20XX, the Organization's books and records continued to reflect the balance that existed at the end of 20XX ($$). RA-2 never made any payments on the loans.

ORG did not report the payments to RA-2 on Forms W-2 or 1099, nor did the Organization file Form 941 (Employers Quarterly Federal Tax Returns) for the years under examination. In fact, the Organization has never filed any Forms 941, W-2 or 1099.

ORG's Form 990-PF reported the following revenue & expense balances for 20XX, 20XX and 20XX:

	20XX	20XX	20XX
Total Revenue	$	$	$
Total Expenses	$	$	$
Excess or Deficit	($)	$	$

ORG's Form 990-PF showed the following balance sheet balances for 20XX, 20XX and 20XX

	20XX	20XX	20XX
Assets			
Cash - Non Interest Bearing	$	$	$
Receivables due from disqualified persons	$	$	-
Other notes and loans receivable	$	$	$
Total assets	$	$	$
Liabilities			
Mortgages & other notes payable	$	$	-

Unrestricted Fund Balance	$	$	$
Total Liabilities	$	$	$

In 20XX, ORG reported a profit of $$; in 20XX, ORG's profits increased considerably to $$. At year end 20XX, the Organization reported no outstanding receivables from disqualified persons. However, as ORG began showing more substantial profits in 20XX, RA-2 received disbursements totaling $$, $$ of which it now alleges was a loan.

At year end 20XX, ORG had total reported assets of $$. Of that amount $$, or 69% of ORG's total assets, was tied up in the alleged loan to RA-2. At year end 20XX, ORG's total assets were $$. The alleged loan amount had risen to $$ because of unpaid accrued interest. Thus, at year end 20XX, the alleged loan represented 64% of ORG's total assets.

C. GAO's November 20XX Report

In November 20XX the Government Accountability Office (GAO) issued a report on seller-funded DPA from nonprofit organizations. See GAO's November 20XX report, Mortgage Financing: Additional Action Needed to Manage Risks of FHA-insured Loans with Down Payment Assistance (GAO-06-24) (copy attached). GAO states that it found that because seller-funded DPA programs run by nonprofit organizations require payments from home sellers to cover the amount of the down payment, the DPA provided to the home buyers actually comes from the home sellers. In addition, GAO found that houses purchased pursuant to seller-funded nonprofit DPA transactions sold for about two to three percent more than comparable homes and had lower-than-average home appreciation rates. Also, GAO concluded that the FHA loans issued pursuant to these types of DPA transactions had higher delinquency and insurance claim rates than similar loans not involving DPA assistance.

III. LAW

A. Issue 1: Whether ORG operated exclusively for charitable and other exempt purposes within the meaning of § 501(c)(3).

Section 501(a) provides for the exemption from federal income tax of corporations described in § 501(c)(3). To be described in § 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.

Treas. Reg. § 1.501(c)(3)-1(c)(1) provides that an organization operates exclusively for exempt purposes only if it engages primarily in activities that accomplish exempt purposes specified in § 501(c)(3). An organization must not engage in substantial activities that fail to further an exempt purpose. In Better Business Bureau of Washington, D.C. v. United States, 326 U.S. 279, 283 (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." If a substantial part of an organization's activities furthers

noncharitable purposes, the organization is not operated for charitable purposes even though its other activities further charitable purposes. See Old Dominion Box Co., Inc. v. United States, 477 F.2d 340, 344 (4th Cir. 1973), cert. denied, 413 U.S. 910 (1973).

Treas. Reg. § 1.501(c)(3)-1(d)(2) defines the term "charitable" for § 501(c)(3) purposes as including the relief of the poor and distressed or of the underprivileged, and the promotion of social welfare by organizations designed to lessen neighborhood tensions, to eliminate prejudice and discrimination, or to combat community deterioration. The term "charitable" also includes the advancement of education.

Revenue Ruling 70-585, 1970-2 C.B. 115, discussed four situations involving organizations that provided providing housing and whether each qualified as charitable within the meaning of § 501(c)(3). 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 § 501(c)(3) because the organization's program was not designed to provide relief to the poor or further any other charitable purpose within the meaning of § 501(c)(3) and the regulations.

1. Revenue Ruling on DPA organizations

Revenue Ruling 20XX-27, 20XX-1 C.B. 915, sets forth standards for determining when an organization that provides funds to home buyers for down payment or closing costs qualifies for exemption from Federal income tax under § 501(c)(3). In Situation 2 an organization provides DPA exclusively 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 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 DPA to a homebuyer, the organization receives a payment from the seller. Further, there is a direct correlation between the amount of the DPA provided by the organization to the home buyer 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 DPA.

The revenue ruling holds that the organization described in Situation 2 is not exempt from Federal income tax under § 501(c)(3) because it finances its DPA activities with contributions from sellers and individuals that stand to benefit from the transactions 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 the organization gives to a home buyer indicate that the benefit to the home seller is a critical aspect of the organization's operations and that the organization's business purpose overshadows any educational or charitable purpose. Rev. Rul 20XX-27 also holds that the payments to home buyers 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 homes at higher prices and in less time.

In Revenue Ruling 20XX-27, Situations 1 and 3 describe organizations that provide down payment and closing costs to qualified home buyers in a manner that could qualify for exemption from Federal income tax under § 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 organizations 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 and the general public and receive funding from government agencies. Their policies and procedures prevent the grantmaking staff from knowing the identities of the parties involved in the transaction and whether anyone related to the transaction had made or agreed to make a contribution.

2. Operating for the benefit of private interests

Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) 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.

In American Campaign Academy v. Commissioner, 92 T.C. 1053 (1989), the Tax Court held that an organization that operated a school to train individuals for careers as political campaign professionals did not exclusively serve purposes described in § 501(c)(3) 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 § 1.501(c)(3)-1(d)(1)(ii).

In KJ's Fund Raisers v. Commissioner, T.C. Memo 1997-424 (1997), aff'd 166 F.3d 1200 (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 § 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.

Revenue Ruling 72-147, 1972-1 C.B. 147, held that an organization that provided housing to low income families did not qualify for exemption under § 501(c)(3) because it gave preference to employees of 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.

3. Operating for a non-exempt commercial purpose

Treas. Reg. § 1.501(c)(3)-1(e) provides that an organization that is organized and operated for the primary purpose of carrying on an unrelated trade or business is not exempt under § 501(c)(3) even though its profits do not inure to the benefit of individual members of the organization.

In Airlie Foundation v. Commissioner, 283 F. Supp.2d 58, 63 (D.D.C., 20XX), the court relied on the "commerciality doctrine" in applying the operational test. Because of the commercial manner in which the organization conducted its activities, the court found that it was operated for a non-exempt commercial purpose, rather than for a tax-exempt purpose. As the court stated:

> Among 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.

See also Living Faith, Inc. v. Commissioner, 950 F.2d 365 (7th Cir. 19XX) (holding that a religious organization that ran restaurants and health food stores in furtherance of its health ministry did not qualify for tax-exempt status because it was operated for substantial commercial purposes and not for exclusively exempt purposes).

In Easter House v. United States, 12 Cl. Ct. 476, 486 (19XX), aff'd, 846 F. 2d 78 (Fed. Cir.), the U.S. Court of Federal Claims considered whether an organization that provided prenatal care and other health-related services to pregnant women, including delivery room assistance, and placed children with adoptive parents qualified for exemption under § 501(c)(3). The court concluded that the organization did not qualify for exemption under § 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 incidental 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. In addition, although the organization provided health care to indigent pregnant women, it only did so when a family willing to adopt a woman's child sponsored the care financially. 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 § 501(c)(3). Easter House, 12 Cl. Ct. at 485-486.

4. Private inurement

Treas. Reg. § 1.501(c)(3)-1(c)(2) 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.

Treas. Reg. § 1.501(a)-1(c) defines "private shareholder or individual" as an individual having a personal and private interest in the activities of the organization. Such private shareholders or individuals are commonly referred to for convenience as "insiders".

In People of God Community v. Commissioner, 75 T.C. 127, 133 (1980), the Tax Court held that, even though the statutory prohibition on inurement is stated in terms of net earnings, the inurement doctrine applies to unjust enrichment from an organization's gross earnings as well.

In The Founding Church of Scientology v. United States, 412 F.2d 1197, 1200-02 (Ct. Cl. 1969), the court listed unexplained payments in the form of loans to and from insiders among the examples of inurement. In that case, the church made various payments to its founder--who one of the organization's three trustees along with his wife--and his family that the church alleged were loans but for which it failed to produce documentation demonstrating that the loans were repaid or advantageous to the church. Given the absence of explanation regarding the alleged loans, the court concluded that "the logical inference can be drawn that these payments were disguised and unjustified distributions of plaintiff's earnings" and that the family "was entitled to make ready personal use of the corporate earnings." Id. at 1201-02. The court also noted that, "if in fact a loan or other payment in addition to salary is a disguised distribution or benefit from the net earnings, the character of the payments as inurement would not change even if the amounts, if added to the recipient's salary, would result in a total amount of compensation that was reasonable." Id. at 1202. Finally, the court stated that "the very existence of a private source of loan credit from an organization's earnings may itself amount to inurement of benefit." Id.

In John Marshall Law School & John Marshall University v. United States, 81-2 USTC 9514 (Ct. Cl. 1981), the court upheld the Service's revocation of two exempt schools on the ground that part of the net earnings of the organizations inured to the benefit of the controlling officers and their families. The inurement included a series of interest-free, unsecured loans (only some amounts of which had been repaid) from one of the schools to its dean and payment by the other school of personal expenses of its president for travel, health spa membership and entertainment. The court noted that loans from an organization to insiders constitute prohibited inurement "where the loans are without interest (or even at rates more favorable than market) and

without dates for repayment." As a result, the court concluded that the loans at issue resulted in inurement that warranted revocation. See also Lowry Hosp. Ass'n v. Comm'r, 66 T.C. 850 (1976) (concluding that a hospital did not qualify for exemption under § 501(c)(3) because some of its net earnings inured to the benefit of the physician who was the organization's founder when most of the hospital's assets were loaned to a nursing home owned by the founder without security and at interest rates that were below-market (given the level of risk involved) and not repaid until nearly 6 to 8 years later); Orange County Agric. Soc'y v. Comm'r, 893 F.2d 529, 534 (2d Cir. 1990) (concluding that a nonprofit corporation taxpayer's unsecured, interest-free loans to another corporation formed by the taxpayer's three largest shareholders, only part of which had been repaid, resulted in inurement of the taxpayer's earnings, causing the taxpayer to lose its exempt status).

In Airlie Foundation v. Commissioner, 826 F. Supp. 537, 552 (D.D.C., 1993), aff'd 55 F.3d 684 (D.C. Cir. 1995), the court held that forgiveness of interest was a form of inurement.

A number of courts have held that unaccounted for diversions of a charitable organization's resources by one who has complete and unfettered control can constitute inurement. See, e.g., Parker v. Comm'r, 365 F.2d 792, 799 (8th Cir. 1966); Kenner v. Comm'r, 318 F.2d 632 (7th Cir. 1963); Church of Scientology, 823 F.2d 1310,1316-17, 1319 (9th Cir. 19XX).

The prohibition on inurement in § 501(c)(3) is absolute. In Founding Church of Scientology, 412 F.2d at 1202, the court concluded, based on "an examination of the statute and the decided cases, that Congress, when conditioning the exemption upon 'no part' of the earnings being of benefit to a private individual, specifically intended that the amount or extent of benefit should not be the determining factor." Id. at 1202. Accordingly, the court determined that the fact "[t]hat the benefit conveyed may be relatively small does not change the basic fact of inurement." Id. at 1200. See also Spokane Motorcycle Club v. United States, 222 F. Supp. 151 (E.D. Wash. 1963) (holding that the organization's provision of goods, services and refreshments to its members constituted inurement). Moreover, for purposes of establishing that inurement occurs, 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. Comm'r, T.C. Memo 1998-273.

5. Whether payments are a bona fide loan

In Livernois Trust v. Commissioner, 433 F.2d 879 (6th Cir. 1970), the court considered payments by corporations to a trust that controlled them, recorded as a loan and evidenced by unsecured notes bearing 6% interest but on which no interest and no significant payments of principal had been paid to or demanded by the corporations. In determining whether or not the payments in fact constituted a bona fide loan, the court noted that "it is certain that the form of a transaction (here the duly executed 6% Notes) does not by itself control its nature, as opposed to the intent of the parties as demonstrated by the facts." Id. at 882. In addition, the court noted that "[w]hile in many cases various factors must be weighed in determining for income tax purposes the true character of a purported loan, there is one essential without which a transaction cannot be recognized as a loan. The parties must have entered into the transaction with the intention that the money advanced be repaid." Id. at 883 (internal quotation marks omitted). As factors indicating such an intent of repayment, the court listed "[n]ormal security, interest and repayment arrangements (or efforts to secure

same)." Id. at 882. Finally, the court noted that related party transactions between a corporation and a party that controls it "are subject to the closest scrutiny." Id. at 881. Given that the trust receiving the funds controlled the corporation, the court noted that the parties' testimony that they intended the loans to be repaid had to "be viewed with some diffidence unless supported by other facts which bring the transaction much closer to a normal arms-length loan." Id. at 882. Because the notes were unsecured and no interest or significant payments of principal had been paid to or demanded by the corporations, the court affirmed the Tax Court's determination that the notes did not represent bona fide indebtedness.

In Tollefsen v. Commissioner, 431 F.2d 511 (2d Cir. 1970), the Second Circuit affirmed the Tax Court's decision that amounts paid by a subsidiary corporation to a shareholder of the subsidiary's parent corporation (who, together with his wife, wholly-owned the parent) were not bona fide loans. The purported loans were recorded on the company's books and evidenced by promissory notes. Nonetheless, the court noted that the substance not the form of the transaction should dictate the result and concluded that the facts that the shareholder made no formal repayment until after the audit had begun and that the withdrawals were used for the shareholder's personal purposes supported the Tax Court's conclusion that the shareholder did not intend to repay the withdrawn amounts.

In Van Anda's Estate v. Commissioner, 12 T.C. 1158 (1949), the Tax Court considered a husband that advanced $25,700 to his wife, taking in exchange a promissory note in that amount, secured by shares of the capital stock of a cooperative apartment house. Although, in form, the transaction "appear[ed] to have possessed every element necessary to establish a debtor-creditor relationship," the court noted that "[t]he giving of a note or other evidence of indebtedness which may be legally enforceable is not in itself conclusive of the existence of a bona fide debt." Id. at 1162. Rather, it "must be clearly shown that it was the intention of the parties to create a debtor-creditor status." Id. More specifically, "when the bona fides of promissory notes is at issue, the taxpayer must demonstrate affirmatively that there existed at the time of the transaction a real expectation of repayment and an intent to enforce the collection of the indebtedness." Id. (internal quotation marks omitted). The court also noted that "[i]ntrafamily transactions are subject to rigid scrutiny, and transfers from husband to wife are presumed to be gifts." Id. In analyzing whether or not the facts and circumstances indicated a debtor-creditor relationship was intended by the parties, the court noted that the security available to the husband in the event of the wife's default would have been the homes in which he, as well as the wife, resided; that there was no evidence that the husband ever demanded or requested payment from his wife, and that in the 3-year period during which the note was outstanding there was but one payment made by the wife. Based in part on these factors, the court concluded that the advances did not constitute bona fide debt.

6. Promoting improper charitable deductions

Section 170(a)(1) allows as a deduction, subject to certain limitations and restrictions, any charitable contribution (as defined in § 170(c)), payment of which is made within the taxable year.

Section 170(c) defines a charitable contribution as a contribution or gift to or for the use of an entity described in one of the paragraphs of §170(c). Section 170(c)(2) describes certain entities organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes.

Generally, to be deductible as a charitable contribution under §170, a transfer to a charitable organization must be a contribution or gift. A charitable contribution is a transfer of money or property without receipt of adequate consideration, made with charitable intent. United States v. Am. Bar Endowment, 477 U.S. 105, 117-18 (1986). A payment generally cannot be a charitable contribution if the payor expects a substantial benefit in return. Id. at 116-117; see also Singer Co. v. United States, 449 F.2d 413, 423 (Ct. Cl. 1971); Treas. Reg. § 1.170A-1(h)(1). Substantial benefits are those that are greater than those that inure to the general public from transfers for charitable purposes (which benefits are merely incidental to the transfer). Singer, 449 F.2d at 423. Substantial benefits for this purpose can include services that the taxpayer receives or expects to receive in exchange for the payment. See, e.g., Arceneaux v. Comm'r, T.C. Memo 1977-363 (finding that amount paid to a religious organization could not be deducted under § 170 when payment was made in exchange for services in connection with an adoption); Treas. Reg. § 1.170A-1(h)(1) (providing the general rule that no part of a payment that a taxpayer makes in consideration for services is a contribution or gift within the meaning of § 170(c)).

Section 102 provides that the value of property acquired by gift is excluded from gross income. A gift "proceeds from a 'detached and disinterested generosity,' ...'out of affection, respect, admiration, charity or like impulses.'" Commissioner v. Duberstein, 363 U.S. 278, 285 (1960). Payments that proceed from "the constraining forces of any moral or legal duty," or from " 'the incentive of anticipated benefit' of an economic nature," are not gifts. Id. Thus, payments attendant to ordinary business or commercial transactions, or that proceed primarily from the moral or legal obligations attendant to such transactions, are not gifts.

Organizations that promote tax avoidance schemes do not qualify for exemption under § 501(a) as organizations described in § 501(c)(3). See Church of World Peace, Inc. v. Commissioner, T.C. Memo 1994-87 (1994), aff'd, 52 F.3d 337 (10th Cir. 1995). In Church of World Peace the church used its tax-exempt status to create a circular tax-avoidance scheme. Individuals made tax-deductible charitable donations to the church. The church then returned the money to the individuals in the form of tax-free "housing allowances" and also reimbursed the individuals for "church expenses" that were in fact unrelated to church operations. The Church emphasized tax advice in connection with this tax-avoidance scheme. The Tax Court held, and the Tenth Circuit affirmed, that the church did not comply with the requirements of § 501(c)(3) because, by promoting a circular flow of funds from donors to the church and back to the donors and facilitating improper charitable contribution deductions, the church did not operate exclusively for exempt purposes enumerated in § 501(c)(3).

B. Issue 2: Whether ORG's tax-exempt status should be revoked retroactively.

An organization may ordinarily rely on a favorable determination letter received from the Internal Revenue Service. Treas. Reg. §1.501(a)-1(a)(2); Rev. Proc. 20XX-4, 20XX-1 I.R.B. 118, §14.01 (cross-referencing §13.01 et seq.). 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. Rev. Proc. 20XX-9, 20XX-2 I.R.B. 256, § 11.02. 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. Treas. Reg. § 601.201(n)(3)(ii); Rev. Proc. 20XX-9, § 11.02.

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. Treas. Reg. § 601.201(n)(6)(i); Rev. Proc. 20XX-9, § 12.01; Rev. Proc. 20XX-4, § 14.01 (cross-referencing § 13.01 et seq.).

IV. THE GOVERNMENT'S POSITION

A. Issue 1: ORG did not operate exclusively for exempt purposes within the meaning of § 501(c)(3).

To be operated exclusively for purposes described in § 501(c)(3), only an insubstantial portion of the activity of an exempt organization may further a non-exempt purpose. As the Supreme Court held in Better Bus. Bureau, 326 U.S. at 283, 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. ORG is not operated exclusively for exempt purposes described in § 501(c)(3). Indeed, it does not operate in furtherance of any charitable or educational purposes. Rather, like the organization described in Situation 2 of Rev. Rul. 20XX-27, it operates primarily for the private benefit of home sellers and other individuals and entities (including entities owned by ORG President RA-1 and his son) that stand to benefit from the real estate transactions it facilitates and for non-exempt commercial purposes. Additionally, the Organization's net earnings inured to the benefit of its officers and other insiders, in particular its executive director RA-2. Finally, ORG did not operate exclusively for purposes described in § 501(c)(3) because it promoted improper charitable contribution deductions in connection with its DPA program.

1. ORG operates similarly the organization in Situation 2 of Rev. Rul 20XX-27.

Rev. Rul. 20XX-27 sets forth the Service's position on applicable rules and standards for determining whether organizations that provide DPA to home buyers qualify as tax-exempt organizations described in § 501(c)(3). A revenue ruling is "an official interpretation by the Service that has been published ... to provide precedents to be used in the disposition of other cases, and may be cited and relied upon for that purpose." Statement of Procedural Rules § 601.601(d)(2)(i)(a), (v)(d). Revenue rulings, other than those relating to the qualification of pension, annuity, profit-sharing, stock bonus, and bond purchase plans, apply retroactively unless the revenue ruling includes a specific statement indicating, under the authority of § 7805(b), the extent to which it is to be applied without retroactive effect. Statement of Procedural Rules § 601.601(d)(2)(v)(c). Rev. Rul. 20XX-27 was based on existing legal principles and does not represent a change in the law and thus does not contain any statement limiting its retroactive effect.

Situation 1 of Rev. Rul. 20XX-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. ORG's DPA 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, ORG 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 but which ORG failed to perform:

- Making assistance available exclusively to low-income individuals. (ORG's program is open to everyone, regardless of their income or assets.)
- Using a standard, for example, the standards set by Federal housing statutes and administered by the Department of Housing and Urban Development ("HUD"), to determine who is a low-income individual. (ORG's program does not screen the home buyers participating in its DPA program using HUD definitions of low-income individuals; rather, 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. (ORG does not limit its assistance to low-income individuals.)
- Offering financial counseling seminars and conducting other educational activities to help prepare potential low-income home buyers for the responsibility of home ownership. (ORG 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.)
- Establishing that a home purchased through the program meets standards for habitability by requiring a home inspection report. (ORG 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, ORG 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 DPA 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 DPA. Like Y, ORG 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 DPA 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, ORG's staff not only knew the identity of the party selling the home to the DPA applicant and the identities of 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 ORG'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 DPA to a home buyer, Y received a payment from the home seller, and there was a direct correlation between the amount of the DPA provided by Y and the amount of the home seller's payment to Y. Even worse than Situation 2, in every situation where ORG transfers funds to a buyer, it has previously contractually required the home sellers to make a payment that would cover the "assistance" provided, plus ORG's service fees.

In Rev. Rul. 20XX-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, ORG's operations are even further removed from being charitable than those described in Situation 2; thus, ORG does not qualify for exemption from federal income tax as an organization described in § 501(c)(3).

2. ORG does not further charitable purposes.

ORG does not qualify as an organization described in § 501(c)(3) because its sole activity, the operation of a DPA program, does not exclusively serve any exempt purpose described or enumerated in § 501(c)(3) and the regulations thereunder. Charitable purposes include relief of the poor and distressed or of the underprivileged. See Treas. Reg. § 1.501(c)(3)-1(d)(2). However, to provide relief of the poor and distressed or underprivileged, a charity's activities must be directed at such a charitable class. Because ORG has no income or any other meaningful limitations for participation in its DPA program and the program is open to anyone who otherwise qualifies for a mortgage, ORG's DPA program does not serve the poor and distressed or any other charitable class. Although some down payments and closing cost grants may be made to low income individuals, any such results are merely an accidental, incidental consequence of ORG's operations and not the intended object or purpose of the Organization.

In addition, ORG has not demonstrated that its DPA program actually "relieves" the poverty or distress of any low-income homebuyers that the program happens to assist. Indeed, as discussed above, a report from the GAO found that houses purchased through seller-funded DPA transactions, such as ORG's DPA program, (1) sold for about 2 or 3 percent more than comparable homes, giving the buyers smaller equity stakes; (2) had higher delinquency and claim rates; and (3) tended to have lower-than-average house price appreciation rates. See U.S. Gov't Accountability Office, Mortgage Financing: Additional Action Needed to Manage Risks of FHA-Insured Loans with Down Payment Assistance (Nov. 20XX). If ORG's low-income beneficiaries receive an overpriced home and a mortgage they cannot afford, it is questionable whether they are helped at all.

Charitable purposes also include the promotion of social welfare by organizations designed to lessen neighborhood tensions, eliminate prejudice and discrimination, or combat community deterioration. Treas. Reg. § 1.501(c)(3)-1(d)(2). However, ORG has not taken any steps to target or limit its assistance to homes

located in geographic areas experiencing economic depression, deterioration, or to neighborhoods undergoing racial tensions. Instead, ORG makes DPA available for any property, so long as the homebuyer is able to qualify for a mortgage and the seller or homebuilder agree to remit the amount corresponding to the amount ORG transfers to the homebuyer and pay the service fee. Arranging or facilitating the purchase of homes in a broadly defined geographic area without targeting such activity to areas suffering adverse conditions does not combat community deterioration or serve any other social welfare objectives within the meaning of § 501(c)(3).

By merely facilitating real estate transactions through the transfer of cash from home sellers to homebuyers without any meaningful limitations, ORG does not operate in furtherance of any charitable or other exempt purpose enumerated in § 501(c)(3) and hence does not qualify for exemption under § 501(c)(3).

3. ORG operates primarily for the private benefit of home sellers.

An organization is not organized or operated exclusively for one or more charitable purposes unless it serves a public rather than a private interest. Treas. Reg. § 1.501(c)(3)-1(d)(ii). 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. Id. Private benefit has been defined as "nonincidental benefits conferred on disinterested persons [that] serve private interests." Am. Campaign Acad. v. Comm'r, 92 T.C. at 1069. In general, providing a product or service in return for a market rate fee furthers the private purpose of persons purchasing the product or service. See Am. Ass'n of Christian Schools Voluntary Employees Beneficiary Ass'n Welfare Plan Trust by Janney v. United States, 850 F. 2d 1510, 1513-14 (11th Cir. 1988).

ORG's activities, promotional materials, and marketing strategies make clear that ORG confers nonincidental benefits that serve the private interests of the home sellers, home builders, lenders, and real estate professionals participating in its program. ORG's promotional materials note that its DPA program helps realtors "increase[] their business" and avoid the need to "cancel a sale due to lack of down payment resources" and allows sellers "to sell their home in a timely manner without the need to reduce their price." Home sellers' and builders' willingness to pay a fee for ORG to act as conduit between them and homebuyers to facilitate home sales further demonstrates their belief that they derive substantial benefits from the transactions. See Am. Ass'n of Christian Schools, 850 F. 2d at 1513-14. Sellers and builders who participate in ORG's DPA program benefit from achieving access to a wider pool of buyers, thus enabling them to sell their homes faster and for a higher price. Among these sellers and builders participating in ORG's DPA program are three companies owned by ORG President and sole director RA-1 or his son; together, these companies accounted for about 11.5% and 16.7% of the fees from home sellers and builders that ORG received in 20XX and 20XX, respectively. Other real estate professionals who participate in ORG's DPA program, from real estate brokers to escrow companies, also benefit from increased sales volume and the attendant increase in their compensation. As ORG's operations are structured in a way that they necessarily and intentionally result in a substantial private benefit to real estate professionals generally and to its president/sole director and his son in particular, ORG does not qualify for exemption under § 501(c)(3).

4. ORG's operations constitute a trade or business which is not in furtherance of exempt purposes.

An organization may meet the requirements of § 501(c)(3) although it operates a trade or business as a substantial part of its activities only if the operation of such trade or business is in furtherance of the organization's exempt purpose(s) and the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business, as defined in § 513. Treas. Reg. § 1.501(c)(3)-1(e)(1). Serving as a conduit between seller and buyer to facilitate a financing arrangement is normally an activity undertaken by commercial for-profit entities. The operation of such a trade or business is ORG's predominant activity, and for the reasons explained above and below, it does not further an exempt purpose. Thus, ORG does not qualify for tax-exempt status.

In looking to whether organizations are operating a trade or business for a commercial purpose rather than for charitable purposes, courts have looked to the following factors, each of which indicates that ORG has a substantial non-exempt business purpose:

(1) Whether the organization advertises and uses promotional materials and "commercial catch phrases" to enhance sales. (ORG promotes its program through solicitation of real estate agents, mortgage lenders, loan officers, title insurers, sellers, buyers, and builders through materials that promise an increase in business and more timely sales that will help avoid the need for price reductions.)

(2) Whether the organization is funded entirely by fees. (Virtually all of ORG's funds come from payments it receives from its client home sellers.)

(3) Whether the organization receives charitable contributions. (ORG does not receive any charitable contributions; the payments it collects do not arise from disinterested generosity but are payments for facilitating real estate transactions.)

(4) Whether the organization has commercial activities as part of its overall activities or as its sole activity. (ORG's commercial activities are its sole activity.)

See, e.g., Airlie Found. v. Internal Revenue Service, 283 F. Supp. 2d at 63; Living Faith, Inc., 950 F.2d at 372-73; Scripture Press Found. v. United States, 285 F.2d 800, 803 (Ct. Cl. 1961); American Inst. for Economic Research v. United States, 302 F.2d 934, 938 (Ct. Cl. 1962); Fides Publishers Ass'n v. United States, 263 F. Supp. 924 (N.D. Ind. 1967); Easter House v. United States, 12 Cl. Ct. at 491..

ORG does not engage in widespread fundraising. As mentioned above, rulings and the courts consider an organization's source of financing to be a very important factor in determining whether an organization qualifies for tax-exemption. In B.S.W. Group, Inc. v. Commissioner, 70 T.C. 352 (1978), for example, the organization relied exclusively on fees for consulting services and did not solicit or receive voluntary contributions from the general public. The court determined that the organization's primary purpose was "neither educational, scientific, nor charitable, but rather commercial" in part because the organization's financing did "not resemble that of a typical § 501(c)(3) organization." Id. at 359, 360. Likewise, in Columbia Park and Recreation Assoc. v. Commissioner, 88 T.C. 1 (19XX), the court found that a key factor in determining whether the organization qualified for exemption was its source of revenues: "Petitioner does not solicit or receive voluntary contributions from the public. Rather, its source of revenue is from the

members whom it serves. Petitioner thus lacks this normal trait of a § 501(c)(3) organization or, more specifically, an organization which operates primarily for a public interest." Id. at 19-20. Similarly, ORG's source of support is from the fees its client home sellers pay, and it receives no contributions from the general public that proceed from disinterested generosity.

In addition, ORG's business has a distinct "commercial hue." See Airlie Found., 283 F. Supp. 2d at 65. By facilitating real estate transactions for any seller or buyer willing to adhere to the DPA program's terms and promoting its DPA program to realtors and sellers as means to increase business and achieve more timely sales, ORG maximized the number of transactions between its client home sellers and home buyers and maximized the amount of fees it could generate. Similar to a commercial real estate enterprise, in exchange for real estate services, ORG charged contingent fees and made significant revenues. ORG did not facilitate a DPA transaction unless it was assured that a home seller would cover the amount of the down payment and pay ORG the required service fee. Thus, ORG structured and operated its DPA program like a commercial business.

Accordingly, ORG operates its DPA program primarily for the non-exempt purpose of operating a commercial business and hence does not qualify for exemption under § 501(c)(3).

5. A substantial portion of ORG's net earnings inured to the benefit of its insiders.

In addition, beginning in 20XX, a substantial portion of ORG's net earnings inured, directly or indirectly, to the benefit of ORG's officers and insiders, in particular to ORG's executive director, RA-2. In 20XX, a year in which its profits increased substantially, ORG made 62 payments to RA-2 totaling $$. ORG claims that $$ of this amount represents compensation for RA-2's services. As for the remaining $$ of the $$, ORG alleges that these payments represented a loan from the Organization to RA-2 that was documented by the Note in the amount of $. However, RA-2 did not make a single payment on the Note and was not required to provide any collateral as security for it. In addition, ORG stopped accruing interest on the Note by the end of 20XX and has provided no evidence that it took any steps to demand or enforce repayment of any of the amount owed. ORG also did not make the advances totaling $$ according to any pre-existing agreement but rather in irregular amounts and intervals that presumably corresponded to RA-2's personal needs and the Organization's increased profits ORG only attempted to characterize these transfers as a loan after-the-fact, by enacting the Note at the very end of 20XX. Furthermore, the transfers that allegedly constituted a loan were from the Organization to an individual that controlled it together with her husband and are therefore subject to "the closest scrutiny." Livernois Trust, 433 F.2d at 881; see also Van Anda's Estate, 12 T.C. at 1162; Kaplan v. Comm'r, 43 T.C. 580, 595 (1965) ("[W]here the withdrawing party is in substantial control of the corporation, such control invites a careful scrutiny of the situation."). These facts and circumstances, taken together, indicate that the transfers of $$ were not made to RA-2 with any intention that they be repaid, an intention that is essential for a transaction to be characterized as a loan. See Livernois Trust, 433 F.2d at 882-83 (lack of security and significant payments of principal or interest or efforts to secure such payments were sufficient proof of a lack of intent for advances to be repaid in a related party transaction, notwithstanding existence of duly executed notes bearing 6% interest). Consequently, the Note does not evidence a bona fide indebtedness, and hence the $$ in excess payments in 20XX were simply gratuitous

disbursements of ORG's profits to RA-2, an "insider" of the Organization both by virtue of her position as its executive director and her marriage to its sole director, president, treasurer, and secretary.

Moreover, ORG's net earnings inured to the benefit of RA-2 even if the alleged loan is respected as bona fide indebtedness. ORG has provided no evidence that a third party, commercial lender would have been willing to lend RA-2 more than $80,000 without any collateral at an interest rate of 6% in 20XX. And clearly a commercial lender would not stop accruing interest on a loan only one-year into a four-year term and permit RA-2 to make none of her required payments on the loan without demanding repayment or trying to enforce collection. Accordingly, to the extent the alleged loan is respected as bona fide debt, it was a loan with terms that RA-2 could not have secured on the market from a third party. Thus, to the extent the $$ transfer was a loan at all, it was an unsecured, below-market loan that bestowed a significant financial advantage on an insider. The courts have consistently held that such loans constitute prohibited inurement. See, e.g., John Marshall, 81-2 USTC 9514; Lowry Hosp. Assoc., 66 T.C. at 858-59; Orange County Agric. Soc'y, T.C. Memo 1988-380.

Indeed, the courts have opined that even the "very existence of a private source of loan credit from an organization's earnings may itself amount to inurement of benefit." Founding Church of Scientology, 412 F.2d at 1202; John Marshall, 81-2 USTC 9514. Thus, the mere fact that RA-2 was using ORG's earnings as a private source of loan credit – not to mention the unreasonably favorable terms of the credit and the fact that RA-2 never repaid the amounts advanced – may itself constitute prohibited inurement.

Finally, even if one respects the Note as a bona fide debt, such a favorable assumption would still leave $$ in "receivables" unaccounted for. Unaccounted for diversions of a charitable organization's resources by one who has complete and unfettered control generally constitutes inurement, Church of Scientology, 823 F.2d 1319, and the Service has the authority to revoke an organization's exempt status for inurement regardless of the amount of inurement involved, Founding Church of Scientology, 412 F.2d at 1200, 1202. Thus, RA-2's receipt of the $$ not documented in the Note would alone justify revocation of ORG's exempt status.

Thus, the net earnings of ORG inured to the benefit of RA-2, and, as such, ORG does not qualify for exemption under § 501(c)(3).

6. ORG promoted improper charitable deductions.

ORG is also not entitled to exemption under § 501(c)(3) because it promoted improper charitable contribution deductions. A payment of money generally cannot be deducted as a charitable contribution if the payor expects to receive a substantial benefit in return. Am. Bar Endowment, 477 U.S. at 116-117; Singer, 449 F. 2d at 423; Treas. Reg. § 1.170A-1(h)(1). A seller's payment to ORG is not tax deductible as a charitable contribution under § 170 because the seller receives valuable consideration in return for the payment – namely, services that facilitate the seller's sale of a home. Furthermore, the payments from the home sellers to ORG also do not qualify as gifts under § 102. The payments from the home sellers do not proceed from detached and disinterested generosity but, rather, in response to an anticipated economic benefit, which again is the facilitation of the sale of the seller's home. Under Commissioner v. Duberstein, 363 U.S.278 (1960), such payments are not gifts for purposes of § 102.

An organization that promotes an abusive tax avoidance scheme is not entitled to exemption as an organization described in § 501(c)(3). See Church of World Peace, Inc., T.C. Memo 1994-87. ORG used the prospect of a charitable contribution deduction as an inducement for sellers to participate in its DPA program. In claiming that the seller-participants in its DPA program would be entitled to a charitable contribution deduction, ORG falsely misrepresented the quid pro quo nature of these payments. Because ORG has promoted improper charitable contribution deductions in connection with its DPA program, ORG does not operate exclusively for exempt purposes enumerated in § 501(c)(3) and does not qualify for exemption as an organization described in § 501(c)(3).

7. Analysis Conclusion

ORG is not operated exclusively for purposes described in § 501(c)(3) because: (1) its primary activity does not exclusively serve any exempt purposes within the meaning of § 501(c)(3); (2) it primarily operates for the benefit of home sellers, other individuals, and entities connected to the real estate transactions, including the Organization's president, RA-1, its executive director, RA-2, and their son; (3) its primary purpose was the operation of a business for a commercial purpose; (4) a substantial portion of its net earnings inured to the benefit of the Organization's officers and other insiders, in particular RA-2; and (5) it promoted improper charitable contribution deductions.

B. Issue 2: ORG's tax-exempt status should be revoked retroactively.

An organization may not rely upon a determination letter or ruling recognizing exemption if there is a material change, inconsistent with exemption, in the character, the purpose, or the method of operation of the organization or if the determination letter was based on any inaccurate material factual representations. Rev. Proc. 20XX-9 at §11.02. The Commissioner may revoke a favorable determination letter for good cause, Treas. Reg. § 1.501(a)-1(a)(2), and such revocation may be retroactive if the organization omitted or misstated a material fact or operated in a manner materially different from that originally represented. Rev. Proc. 20XX-9 at § 12.01.

The examination of ORG's operations revealed that ORG omitted or misstated material facts in its Form 1023 and that the Organization operated in a manner materially different from the representations the Organization made to the Service on its Form 1023 and subsequent filings. ORG has never operated according to the representations on its Form 1023 application for exemption. In its Form 1023 application ORG stated that its "ultimate goal" was to "assist in the construction of a community center for the City of City." The Organization's Form 1023 does not indicate that the Organization's actual or planned activity would be the operation of a seller-funded DPA program in the manner conducted by ORG. However, since January 19XX the Organization's operations have consisted solely of its DPA activities. After starting the operation of the DPA program, ORG never notified the IRS of the change in its activities, funding, and operations.

Accordingly, it is appropriate to revoke ORG's determination letter recognizing it as a tax-exempt organization described in § 501(c)(3) back to the date it began operating its DPA program, on January 01, 19XX.

V. CONCLUSIONS

Issue 1

ORG is not operated exclusively for purposes described in § 501(c)(3) and therefore its tax-exempt status is revoked.

Issue 2

ORG's tax-exempt status is revoked retroactively to the date it began operating its DPA program, January 01, 19XX, because that is when it began operating in a manner that is materially different from its representations on Form 1023, by operating a DPA program without having notified the government of the change in its operations.

VI. TAXPAYER's POSITION

The government is unaware of ORG's position. ORG will be allowed 30 days to review this report and respond with a protest.