TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

Release Number: **201129043**
Release Date: 7/22/2011
Date: April 26, 2011
Uniform Issue List:
501.00-00
501.03-08
501.32-00
501.33-00

Contact Person:

Identification Number:

Contact Number:

Employer Identification Number:

Form Required To Be Filed:

Tax Years:

Dear

This is our final determination that you do not qualify for exemption from Federal income tax as an organization described in Internal Revenue Code section 501(c)(3). Recently, we sent you a letter in response to your application that proposed an adverse determination. The letter explained the facts, law and rationale, and gave you 30 days to file a protest. Since we did not receive a protest within the requisite 30 days, the proposed adverse determination is now final.

Because you do not qualify for exemption as an organization described in Code section 501(c)(3), donors may not deduct contributions to you under Code section 170. You must file Federal income tax returns on the form and for the years listed above within 30 days of this letter, unless you request an extension of time to file. File the returns in accordance with their instructions, and do not send them to this office. Failure to file the returns timely may result in a penalty.

We will make this letter and our proposed adverse determination letter available for public inspection under Code section 6110, after deleting certain identifying information. Please read the enclosed Notice 437, *Notice of Intention to Disclose,* and review the two attached letters that show our proposed deletions. If you disagree with our proposed deletions, follow the instructions in Notice 437. If you agree with our deletions, you do not need to take any further action.

If you have any questions about this letter, please contact the person whose name and telephone number are shown in the heading of this letter. If you have any questions about your Federal income tax status and responsibilities, please contact IRS Customer Service at

1-800-829-1040 or the IRS Customer Service number for businesses, 1-800-829-4933. The IRS Customer Service number for people with hearing impairments is 1-800-829-4059.

Sincerely,

Lois G. Lerner
Director, Exempt Organizations

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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

Date: March 8, 2011

Uniform Issue List:
501.00-00
501.03-08
501.32-00
501.33-00

Contact Person:

Identification Number:

Contact Number:

FAX Number:

Employer Identification Number:

LEGEND:

Taxpayer	=
Show	=
Characters	=
LLC	=
Director1	=
Director2	=
Officer1	=
Officer2	=
Year1	=
Year2	=
Corporation	=
Date1	=
Date2	=
x1	=
x2	=
x3	=
x4	=
Third-Party	=
Country	=

Dear

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

FACTS:

You, Taxpayer, are a not for-profit corporation. You filed a Form 1023 seeking exemption from federal taxation under section 501(c)(3) of the Code. You were "formed to create children's educational television programs designed to nurture children's capacity to values such as kindness, helpfulness, personal responsibility and respect for others." In furtherance of this purpose, you will produce a "children's television series . . . called Show."

Show will feature Characters, which were created by LLC. LLC owns all intellectual property rights to the characters, publications, and programs. LLC also publishes books and sells products based on Characters. X1 of your x2 directors and officers are part owners of LLC. According to the partnership returns that you submitted, Director1 has a 50% share in the profits LLC. Director1 is also listed as the tax matters partner for LLC. In Year1 and Year2, Corporation, a for-profit corporation, also had a 50% share in the profits of LLC. In Year2, Director2 had a 15% share of the capital of LLC. You state that the majority of your board members do not benefit from the work of LLC. You also stated that Director1 and Director2 will receive compensation only when LLC makes a profit, and only after you are paid your 20% share.

You entered into a loan agreement with LLC whereby LLC agreed to lend you x3 interest free for one year. The loan agreement was signed on behalf of LLC by Officer1, who is also your Chief Financial Officer.

In addition to the loan agreement, you also entered into a License Agreement with LLC. According to that agreement, if you wish to create any new characters, you must obtain LLC's permission. Additionally, you must pay LLC 50% of the going commercial rate for a license to use any existing songs, lyrics, drawings, or recordings. Finally, the contract specifically provides that "all trademark uses of the Intellectual Property by [Taxpayer] shall inure to the benefit of [LLC], which shall own all trademarks and trademark rights created by such uses of the Trademarks." The same individual, Director1, appears to have signed these contracts for both you and LLC. This contract was amended on Date2 to additionally require that you pay LLC or Third-Party a license fee of x4 for each episode produced by you and/or Third-Party. In this revised agreement, a different individual signed on behalf LLC.

You also entered a sales agreement with LLC. This agreement granted you a royalty free limited license to Characters, voices, and concepts for use in producing your television show. In return, you granted LLC the exclusive rights to sell ancillary products (e.g. DVDs, CDs, plush toys, etc.) derived from the television show. LLC would provide you with 20% (or a minimum payment of $50,000) of the future royalties earned on the sale of these ancillary products and you had to "purchase the ancillary products from the LLC as a condition to the LLC's no-fee license" to "use the LLC's intellectual property. An unspecified portion of this 20% will be given as grants to the charities featured on each show. The sales agreement has been eliminated and all information regarding royalties is contained in the License Agreement.

Your purposes include generating ideas, storylines, and characters; satisfying conformity with standards for public broadcast, selecting charitable partners, raising funds from corporate and foundation sources, and distributing show to public broadcast stations.

LLC has entered into a contract with for-profit Third-Party to develop and pitch in Country a "television series, series of television programs, and/or made for videos (DVD) or Specials based on the . . . books featuring [Characters] created by Director1 and Officer2 and owned by LLC . . . . " The contract states that if the series goes into production, Third-Party will be the production company and contribute customary producer and executive producer services, shall oversee physical production, and be responsible for cash flow and banking arrangements. Third-Party shall endeavor to deliver the financing not contributed by LLC from sources outside the US. The activities that Third-Party is performing in Country is similar to the activities that you are performing.

LAW:

Section 501(c)(3) of the Code provides that an organization may be exempted from tax if it is organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes and "no part of the net earnings of which inures to the benefit of any private shareholder or individual . . . . "

Section 1.501(c)(3)-1(a)(1) of the regulations provides that in order to be exempt under section 501(c)(3) of the Code, an organization must be both organized and operated exclusively for one or more of the exempt purposes specified in that section.

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

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

Section 1.501(c)(3)-1(c)(2) of the regulations provides that "[a]n 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 one or more exempt purposes unless it serves a public rather than a private interest. To meet the requirement of this subsection, the burden of proof is on the organization to show that it is not organized or operated for the benefit of private interests, such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

Section 1.501(c)(3)-1(d)(iii), Example (3) of the Regulations describes an educational organization that uses a curriculum that had been developed by the president. All of the rights to the curriculum are owned by a for-profit company which is owned by the president. The educational organization licenses the right to use the curriculum in exchange for royalties. Any new materials that the organization develops must be assigned to the for-profit without consideration when the license agreement terminates. The example concludes that the arrangement causes the organization to be operated for the benefit of the president and the for-profit in violation of the restriction on private benefit in section 1.501(c)(3)-1(d)(1)(ii), regardless of whether the royalty payments are reasonable.

Section 1.501(c)(3)-1(e)(1) of the regulations provides that an organization may meet the requirements of section 501(c)(3) although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business as defined in section 513. In determining the existence or nonexistence of such primary purpose, all the circumstances must be considered, including the size and extent of the trade or business and the size and extent of the activities which are in furtherance of one or more exempt purposes. An organization which is

organized and operated for the primary purpose of carrying on an unrelated trade or business is not exempt under section 501(c)(3).

Rev. Rul. 55-231, 1955-1 C.B. 72 held that an organization whose primary purpose is to promote the circulation of books written by one of its incorporators by purchasing them and making them available for the public, is not organized and operated exclusively for educational purposes within the meaning of section 501(c)(3).

Rev. Rul. 70-186, 1970-1 C.B. 129 held that A nonprofit organization formed to preserve and improve a lake used extensively as a public recreational facility qualifies for exemption under section 501(c)(3) of the Code.

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." Better Business Bureau of Washington, D.C. v. United States, 326 U.S. 279, 283 (1945).

An organization's net earnings may inure to the benefit of private individuals in ways other than by the actual distribution of dividends or payment of excessive salaries. Founding Church of Scientology v. United States, 188 Ct. Cl. 490 (1969), cert. denied, 397 U.S. 1009 (1970).

In Harding Hospital, Inc., 505 F.2d 1068 (6th Cir. 1974), the court denied exempt status under section 501(c)(3) of the Code to a non-profit hospital due to a contract that the hospital entered into with a partnership composed of physicians. The contract gave the physicians control over care of the hospital's patients and the stream of income generated by the patients while also guaranteeing the physicians thousands of dollars in payment for various supervisory activities. The Court concluded by holding that the benefits derived from the contract constituted sufficient private benefit to preclude exemption.

In Church by Mail v. Commissioner, 765 F.2d 1387, 1392 (9th Cir. 1985), the court in determining that a non-profit was operated for substantial non-exempt purposes and that income inured to the benefit of private persons stated that "[t]he critical inquiry is not whether particular . . . payments to a related for-profit organization are reasonable or excessive, but whether the entire enterprise is carried on in such a manner that the for-profit organization benefits substantially from the operation of the [non-profit]." The court additionally upheld the Tax Court's determination that the church was operated for substantial nonexempt purpose of providing a market for services of advertising agency, a for-profit organization owned and controlled by ministers of church.

In Airlie Foundation v. Commissioner, 283 F. Supp. 2d 58 (D.D.C. 2003), the court concluded that an organization did not qualify for tax-exemption under I.R.C. § 501(c)(3) because it was operated for nonexempt commercial purposes rather than for exempt purposes. Among the major factors the court considered in reaching this conclusion was the organization's competition with for-profit commercial entities, the extent and degree of below cost services provided, the pricing policies, and the reasonableness of financial reserves. Additional factors included whether the organization used commercial promotional methods, such as advertising, and the extent to which the organization received charitable donations.

In Ginsberg v. Commissioner, 46 T.C. 47 (1966) a corporation that was organized and operated primarily for the benefit of those persons owning property adjacent to certain waterways did not qualify for tax-exemption under I.R.C. § 501(c)(3).

A finding of private benefit does not require that payments for goods or services be unreasonable or exceed fair market value. est of Hawaii v. Commissioner, 71 T.C. 1067 (1979)

An application for tax-exempt status "calls for open and candid disclosure of all facts bearing upon [an Applicant's] organization, operations, and finances to assure [that there is not] abuse of the revenue laws. If such disclosure is not made, the logical inference is that the facts, if disclosed, would show that the [Applicant] fails to meet the requirements of section 501(c)(3)." Bubbling Well Church of Universal Love, Inc. v. Commissioner, 74 T.C. 531 (1980). See also, Founding Church of Scientology v. United States, 188 Ct. Cl. at 498.

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

In American Campaign Academy v. Commissioner, 92 T.C. 1053 (1989) the court stated that even though the prohibitions against private inurement and private benefit have common elements, each has separate requirements which must be independently evaluated. See also Goldsboro Art League, Inc. v. Commissioner, 75 T.C. 337 (1980); Church of Ethereal Joy v. Commissioner, 83 T.C. 20 (1984); Canada v. Commissioner, 82 T.C. 973 (1984).

An organization will not satisfy the operational test of section 501(c)(3) if its net earnings inure, in whole or part, to the benefit of private individuals. Colorado State Chiropractic Society v. Commissioner, 93 T.C. 487, 497-498 (1989).

ANALYSIS:

To qualify for exemption under section 501(c)(3) of the Code, a taxpayer must demonstrate that it is organized and operated exclusively for exempt purposes and that no part of its earnings inure to private individuals. I.R.C. § 501(c)(3); Treas. Reg. § 1.501(c)(3)-1. Even though you may have an educational purpose within the meaning of section 501(c)(3) of the Code, your assets and income may inure to the benefit of your founders and LLC. Additionally, you appear to operate for the benefit of some of your officers and directors and a for-profit entity in which your some of your officers and directors have a financial interest. Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii). Therefore, we can not recognize you as exempt from taxation. See Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii).

An organization is not operated exclusively for exempt purposes if any of its net earnings inure to the benefit of private shareholders or individuals with a personal and private interest in its activities. I.R.C. § 501(c)(3); Treas. Reg. § 1.501(c)(2)-1(c); Treas. Reg. § 1.501(c)(3)-1(c)(2); see also Colorado State Chiropractic Society, 93 T.C. at 497-498. Inurement of net earnings may occur through a wide range of means and is not limited to the actual distribution of dividends or payment of excessive salaries. Founding Church of Scientology v. United States, 412 F.2d at 1200. Moreover, although stated in terms of net earnings, the inurement prohibition

applies to any of an organization's charitable assets. See Harding Hospital, Inc., 505 F.2d at 1072; People of God Community, 75 T.C. at 133.

The burden is on the taxpayer to demonstrate that it is not organized or operated for the benefit of private interests, such as designated individuals, the creator or his family, the shareholders of the organizations, or persons controlled, directly or indirectly, by such private interests, and will not allow its assets to inure to such private interests. Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii); see also Church of Spiritual Technology, 18 Cl.Ct. at 250 (the applicant "must put into the record sufficient materials to warrant the grant of tax exempt status."); Bubbling Well Church of Universal Love, 74 T.C. 531 (stating that an application for tax-exempt status "calls for open and candid disclosure of all facts . . . If such disclosure is not made, the logical inference is that the facts, if disclosed, would show that the [Applicant] fails to meet the requirements of section 501(c)(3).") Any gaps contained in the administrative record are resolved in favor of the Service. New Dynamics Foundation, 70 Fed. Cl. at 802 ("in initial qualification cases such as this, gaps in the administrative record are resolved against the applicant").

Two of your directors are also the owners of LLC. Additionally, two of your officers were affiliated with LLC. Officer1 signed on behalf of LLC in loan documents and Officer2 is described as a co-creator of Characters owned by LLC. Director1, Director2, Officer1, and Officer2 are all in positions to exert substantial influence over your affairs, even if they do not control the majority of the board. Both their positions with LLC and as creators of the Characters on which Show will be based , indicate that they will be in a position to exert influence over your direction. The dual interest of these officers and directors provides a risk of inurement because four of your insiders have the incentive and the means to direct your assets and revenues to themselves rather than to you and the public. You have not described any structure to prevent such inurement.

In addition to the absolute prohibition on inurement, the law requires exempt organizations to operate for public, not private benefit. Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii). To be sure, an exempt organization may generate some private benefits as a necessary byproduct of the benefits it provides to the community. However, such private benefits must be incidental in two meanings of the term. First, the private benefit must be inextricably linked to the public benefit. See Rev. Rul. 70-186, supra ("[a]ny private benefits derived by the lake front property owners do not lessen the public benefits flowing from the organization's operations. In fact, it would be impossible for the organization to accomplish its purposes without providing benefits to the lake front property owners.") Second, the private benefit must also be relatively minor compared to the public benefit. See Ginsberg v. Commissioner, 46 T.C. at 55 ("[a]ny objective to benefit the general public by providing a storm haven for small craft, if it existed at all, was a secondary one.")

However, an entity that is organized or operated to serve private rather than public interests cannot be recognized as operating exclusively for exempt purposes. See Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii); American Campaign Academy, 92 T.C. at 1065 (1989) (stating that prohibited private benefits may include an "advantage, profit, fruit, privilege, gain, or interest.") Private benefits may flow to a related party, or they may flow to a disinterested party. American Campaign Academy, 92 T.C. at 1069. A finding of private benefit does not require that payments for goods or services be unreasonable or exceed fair market value. See est of Hawaii, 71 T.C. 1067; Church by Mail, 765 F.2d at 1392 ("[t]he critical inquiry is not whether particular . . . payments to a related for-profit organization are reasonable or excessive, but

whether the entire enterprise is carried on in such a manner that the for-profit organization benefits substantially from the operation of the [non-profit].")

Here, the private benefits that your operation will provide to LLC and to Director1, Director2, Officer1, and Officer2 are significant rather than incidental and are unrelated to your exempt purposes. By using and promoting intellectual property created and owned by a for-profit in exchange for royalties, you both provide a stream of income from the property and, by giving it wide distribution, enhance its value. This is very similar to the benefit earned by the president and his for-profit entity from licensing a training program to the organization of which he is president. Treas. Reg. § 1.501(c)(3)-1(d)(iii), Example 3.

You have entered into contracts with LLC that may grant a private benefit to LLC. Under your contracts with LLC, LLC retains all trademarks and trademark rights for Characters. In order for you to create any new character, you must obtain LLC's permission. Additionally, you must pay LLC 50% of the going commercial rate for a license to use any existing songs, lyrics, drawings, or recordings. Finally, the contract specifically provides that "all trademark uses of the Intellectual Property by [Taxpayer] shall inure to the benefit of [LLC], which shall own all trademarks and trademark rights created by such uses of the Trademarks." Finally, you must pay LLC or Third-Party a license fee of x4 for each episode produced by you and/or Third-Party.

Essentially, you exist to market the intellectual property of another entity. Rev. Rul. 55-231. You do not have, nor can you acquire, any ownership interest in the intellectual property. Therefore, all of your efforts to produce and promote television shows, books, and ancillary products will enhance the value of the Characters completely owned by the for-profit LLC.

While your activities appear to be educational within the meaning of section 501(c)(3) of the Code, the risk of inurement and the substantial private benefit (non-exempt purposes) preclude you from being recognized as exempt. See Better Business Bureau of Washington, D.C. 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"). Therefore, you do not qualify for tax exempt status under section 501(c)(3) of the Code.

CONCLUSION:

Based on the information provided in your Form 1023 and supporting documentation, we conclude that you are not operated exclusively for purposes described in section 501(c)(3) of the Internal Revenue Code.

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

Contributions to you are not deductible under section 170 of the Internal Revenue Code.

You have the right to file a protest if you believe this determination is incorrect. To protest, you must submit a statement of your views and fully explain your reasoning. You must submit the statement, signed by one of your officers, within 30 days from the date of this letter. We will consider your statement and decide if the information affects our determination.

Your protest statement should be accompanied by the following declaration:

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

You also have a right to request a conference to discuss your protest. This request should be made when you file your protest statement. An attorney, certified public accountant, or an individual enrolled to practice before the Internal Revenue Service may represent you. If you want representation during the conference procedures, you must file a proper power of attorney, Form 2848, *Power of Attorney and Declaration of Representative,* if you have not already done so. For more information about representation, see Publication 947, *Practice before the IRS and Power of Attorney.* All forms and publications mentioned in this letter can be found at www.irs.gov, Forms and Publications.

If you do not file a protest within 30 days, you will not be able to file a suit for declaratory judgment in court because the Internal Revenue Service (IRS) will consider the failure to protest as a failure to exhaust available administrative remedies. Code section 7428(b)(2) provides, in part, that a declaratory judgment or decree shall not be issued in any proceeding unless the Tax Court, the United States Court of Federal Claims, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted all of the administrative remedies available to it within the IRS.

If you do not intend to protest this determination, you do not need to take any further action. If we do not hear from you within 30 days, we will issue a final adverse determination letter. That letter will provide information about filing tax returns and other matters.

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

Internal Revenue Service
TE/GE
1111 Constitution Ave, N.W.
Washington, DC 20224

You may also fax your statement using the fax number shown in the heading of this letter. If you fax your statement, please call the person identified in the heading of this letter to confirm that he or she received your fax.

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

Sincerely,

Lois Lerner
Director, Exempt Organizations