



TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

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

Number: **201210043**  
Release Date: 3/9/2012

Date: December 13, 2011

UIL: 501.03-30; 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.

Since 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.

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

Letter 4038(CG) (11-2005)  
Catalog Number 47632S

In accordance with Code section 6104(c), we will notify the appropriate State officials of our determination by sending them a copy of this final letter and the proposed adverse letter. You should contact your State officials if you have any questions about how this determination may affect your State responsibilities and requirements.

If you have any questions about this letter, please contact the person whose name and telephone number are shown in the heading of this letter. If you have any questions about your federal income tax status and responsibilities, please contact IRS Customer Service at 1-800-829-1040 or the IRS Customer Service number for businesses, 1-800-829-4933. The IRS Customer Service number for people with hearing impairments is 1-800-829-4059.

Sincerely,

Lois Lerner  
Director, Exempt Organizations

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



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

TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

Date: October 18, 2011

Contact Person:

Identification Number:

Contact Number:

FAX Number:

Employer Identification Number:

LEGEND:

H = business

P = state

U = date

UIL:

501.03-30

501.33-00

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.

**Issue**

Does your primary activity of operating an art gallery preclude you from exemption under section 501(c)(3) of the Code? Yes, for the reasons given below.

**Facts**

You are a corporation formed on date U, pursuant to the laws of the State of P. Your Articles of Incorporation state that you shall be organized as a 501(c)(3) and will operate for civic, charitable and educational purposes. Your Articles also indicate that on dissolution

assets will be distributed within the meaning of Section 510(c)(3) of the Code.

You were formed when a group of local artists got together to form an organization to further education in the arts and to provide a venue for regional artists to display, promote and sell their work. You have four board members who are artists and sell their work through your gallery. You provided a promotional brochure that advertises the following:

### *Mission*

*The H (you) is dedicated to furthering education in the arts and providing a venue for regional artists to display, promote, and sell their work. The H (you) offers a supportive environment for regional P artists to share their ideas and philosophies as-well-as market their work. As a cooperative gallery, members share in the decision making and staffing of the gallery. . . .*

### *Membership*

*Membership in the gallery is divided into three categories: Active, Associate, and Supporting members. Active and Associate member artists display and sell their work at the gallery. In addition, Active members volunteer their time to work in the gallery during business hours. Patrons of the gallery show their support through the Friends of the Gallery program.*

### *Services*

*Along with workshops and exhibitions, the H (you) also offers custom framing and matting. Space within the gallery can be reserved for meetings and special events.*

### *Gallery hours*

*Thursday 10:00 A.M. to 5:00 P.M. Friday 10:00 A.M. to 5:00 P.M.  
Saturday 10:00 A.M. to 5:00 P.M. Sunday 12:00 A.M. to 5:00 P.M.  
Seasonal evening hours*

While your brochure describes three types of members in addition to your "Friends of" supporters your bylaws differentiate three different members levels – Artists, Representatives and Supporting. Founding members are defined as any individual that joins prior to the gallery opening and pays a one-time membership fee of \$100.00. Founding members have the jury process waived when displaying works. Artists are juried and can be either active, associate, on leave of absence, inactive or suspended. Active members retain their status by fulfilling their contractual member agreement and volunteering to work at the gallery; associate members are the same without the volunteering. Non voting members are your "Friends of" supporters. Your Bylaws initially outlined member dues and commissions as well as procedures for addressing guest artists and consignors. You later revised your Bylaws to remove these provisions.

Your initial activity was to provide a gallery for artists to display and subsequently sell their work. The gallery would have a featured artist on a monthly basis to showcase their work. The displayed artworks were consigned to you for sale. You performed all the sales activity and charged 20% commission to active members and 40% commission to non-members. The sale price of artwork was set by the consignee and the commission was based on the sale price. You also provided a custom framing and matting service to the public at market price, which was 5% of your activity. Free, educational workshops consisted of 1% of your total activity.

You submitted a member contract agreement that provided further details about the members' consignment operation. Some notables are as follows:

- You provide the artists with monthly statements that contain a description of the work sold, date, price and terms of sale, the name of the purchasers, commission paid to the gallery, amount due to the artist.
- The artists do the set-up of the artworks and are given three days for the set up.
- The artist retains the right to conduct his/her business in the usual manner, but will not knowingly solicit business away from the gallery.
- The artists shall not knowingly solicit sales from clients on the gallery's mailing list.
- The gallery is due 20% commission for a period of six months after customer first contacts an artist.
- You provide incentives to volunteer artists.

You also provided a non-member consignment agreement form.

When questioned about the commercial nature of some activities, you eliminated the 20% commission and the custom framing and matting service. In eliminating the commission, you will allow 100% of all sales proceeds to go to the artist. In lieu of imposing a commission, you will ask for voluntary donations from the artists.

You provided a new membership contract agreement, which reflects your changes regarding commissions. The new member agreement does not contain commission and consignment related items, however, it stipulates that an artist agree to pay a monthly donation of \$40 beginning the month the artist joins the gallery. Also, artists who are contacted by patrons are encouraged to donate for a period of six months after that contact. You had stated that there would just be contact information to get in touch with the artist displayed with their work and you would no longer be involved with managing money for the artists. The member agreement states that you will take payment for any items and turn 100% over to the artist as well as giving them a statement of account and taking payments.

You have indicated no changes to your gallery operations. You proposed changes to your educational activities by adding more workshops and seminars. You stated that these

additional activities will not affect your budget since all instruction and workshop materials will be donated.

You do not have any fundraising activities. Currently, you project revenue through donations from member artists and 'friends of' support as well as membership fees.

## Law

Section 501(c)(3) of the Code provides for the exemption from federal income tax of corporations organized and operated exclusively for charitable or educational purposes, provided no part of the net earnings inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(a)(1) of the Income Tax Regulations provides that in order to be exempt as an organization described in section 501(c)(3), an organization must be both organized and operated exclusively for one or more purposes specified in such section. If an organization fails to meet either the organizational test or the operational test, it is not exempt.

Section 1.501(c)(3)-1(d)(1)(i) of the Regulations states an organization may be exempt under 501(c)(3) if it operates exclusively for educational purposes.

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

Revenue Ruling 71-395, 1971-2 C.B. 228, found that a cooperative art gallery formed and operated by a group of artists for the purpose of exhibiting and selling their works does not qualify for exemption under section 501(c)(3) of the Code because the organization served the private purposes of its members, even though the exhibition and sale of painting may be an educational activity in other respects.

In Rev. Rul. 76-152, 1976-1 C.B. 151, the Service found that a nonprofit organization formed by a group of art patrons to promote community understanding of modern art trends by selecting exhibiting, and selling art works of local artists, and which retained 10% commission on sales less than customary commercial charges but insufficient to cover the cost of operating the gallery, does not qualify for exemption under section 501(c)(3) of the Code. The ruling concluded that the direct benefits to artists cannot be dismissed as being merely incidental to other purpose and activities since ninety percent of all sales proceeds are turned over to the individual artists.

In Better Business Bureau of Washington D.C., Inc. v. United States, 326 U.S. 279 (1945), the Supreme Court held that the presence of a single non-exempt purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly exempt

purposes. The Court found that the trade association had an "underlying commercial motive" that distinguished its educational program from that carried out by a university.

In American Institute for Economic Research v. United States, 302 F. 2d 934 (Ct. Cl. 1962), the Court considered an organization that provided analyses of securities and industries and of the economic climate in general. It sold subscriptions to various periodicals and services providing advice for purchases of individual securities. The court noted that education is a broad concept, and assumed for the sake of argument that the organization had an educational purpose. However, the totality of the organization's activities, which included the sale of many publications as well as the sale of advice for a fee to individuals, was indicative of a business. Therefore, the court held that the organization had a significant non-exempt commercial purpose that was not incidental to the educational purpose, and was not entitled to be regarded as exempt.

In Goldsboro Art League, Inc., Petitioner v. Commissioner of Internal Revenue, 75 T.C. 337, 1980, the court found that the corporation was entitled to exemption from Federal taxation and entered a decision in its favor. The corporation contended that it was operated exclusively for exempt purposes, that the sale of artwork in its galleries was an incidental activity, but one which helped it pursue its exempt purposes, that it was not operated in furtherance of a substantial commercial purpose, and that the primary purpose of its sales and other activities was to further the public's appreciation of art and not to serve private interests. The Commissioner argued that since the corporation's activities were indistinguishable from activities required in operating a commercial art gallery for profit, the corporation was operated for a substantial commercial purpose and could not qualify for exemption under Section 501(c)(3) of the Code despite the presence of any number of truly exempt purposes. The court found that the purpose of the corporation's art gallery and art market was primarily to foster community awareness and appreciation of contemporary artists and to provide a constant flow of art for students to study art and painting techniques. The corporation's sales activities were incidental to its other activities and served the same overall objective of art education.

In Salvation Navy v. Commissioner, T.C.M. 2002-275 (2002), the Tax Court found that one of the reasons why the organization did not qualify for exemption from federal income tax was because it could not prove that it was not organized to serve the private interests of its founder.

### **Application of the Law**

Based on the information you provided in your application and supporting documentation, we conclude that you are not operated for exempt purposes under section 501(c)(3) of the Code. You are organized for a substantial private purpose and to benefit your members through the sale of their artwork. In addition, you failed to provide an assurance that earnings will not inure to your members.

Section 1.501(c)(3)-1(a)(1) of the Income Tax Regulations provides that to be exempt an

organization must be both organized and operated exclusively for purposes specified in such section.

You do not meet the organizational test as your purposes are not limited to those allowable under 501(c)(3). Your Articles of Incorporation state that, in part, you are formed to operate for civic purposes. Civic is not an exclusive purpose under 501(c)(3). Further, your dissolution clause is invalid as it indicates 510 rather than 501; 510 is not a valid Code section.

You fail to meet the operational test because you are not operated for an exclusive 501(c)(3) purpose, but for the private purpose of your members. While promotion of the arts is an accepted exempt purpose, you were not formed solely for this reason. Even though you do conduct some classes and workshops the majority of your time is spent on the operation of the gallery. Your educational activities took only 1% of your total time. While you have added some more workshops your primary activity still remains that of operating the gallery. You were formed for and engage in the substantial non-exempt activity of perpetuating sales of art works for your members.

Section 1.501(c)(3)-1(d)(1)(ii) of the Regulations provide that an organization is not organized or operated exclusively for exempt purposes unless it serves a public rather than a private interest. Your member agreement, clause eight, indicates that the artist is responsible for the cost of show materials when they become a featured artist. This featured artist segment, which places exhibit details and invitation selection with the artist, demonstrates private benefit rather than community art education in allowing an individual to openly promote and display and potentially sell works of their choice. Because you operate for the private interests of your members in providing a space and a means for artwork to be viewed and sold rather than promoting the arts in general you are not serving public purposes and do not qualify.

In Better Business Bureau of Washington D.C., Inc. v. United States, 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. You devote more than substantial amount of time and activities in supporting the sale of artworks displayed by your members and for this reason do not meet the qualifications under 501(c)(3).

Section 1.501(c)(3)-1(d)(3)(i) of the Regulations provide, in part, that the term "educational" relates to the instruction of the public on subjects useful to the individual and beneficial to the community. The educational aspect of an art exhibition cannot overcome the commerciality of the exhibition and the private benefits to your members because your main purpose is to sell art works to benefit your members as a cooperative. Therefore, the educational impact of the exhibitions is merely incidental to your non-exempt activity, selling artworks for your members.

Revenue Ruling 71-395 found that a cooperative art gallery formed and operated by a group of artists for the purpose of exhibiting and selling their works does not qualify for exemption under section 501(c)(3).

In your brochure, you advertise:

*"The H (you) offers a supportive environment for regional Q artists to share their ideas and philosophies as-well-as market their work. As a cooperative gallery, members share in the decision making and staffing of the gallery. . . ."*

You made a change that you will not charge commissions anymore. However, you will ask voluntary donations, which are merely a different form of compensation. You do not have any other fundraising activities to support the operation of the gallery – members will be responsible for sustaining your operations. Your operation directly competes with other commercial art galleries, you are solely dependant on the member contributions, and you are a cooperative that runs an artwork sale business for the benefit of the members. You define yourself as a marketer and a cooperative of local artists. Thus, you are operated for your members benefit, not the general public

The court in American Institute for Economic Research v. United States, above applied an even more stringent interpretation. The court held that an educational organization was not entitled to the exemption because it conducted the sale of many publications as well as the sale of advice for a fee to individuals. You are similar to this organization in terms of running a business and having an educational component in your activity. In your case, the products are artwork exhibitions and seminars. Your main purpose and operation is running a cooperative art gallery to benefit your artist members.

You are different from the organization in Goldsboro Art League, Inc., Unlike this organization the sale of artwork is a substantial portion of your activities. In addition, all artists that display and sell art works are your members. Finally, your educational activities account for only a small component of your overall activities. Rather than serving an educational purpose through art appreciation you were established to aid in members selling art work. Whereas in Goldsboro the sales activities were incidental to educational activities, here, the opposite is true. Your educational activities are incidental to your overall purpose of providing a venue for artists to display, promote and sell work.

In Revenue Ruling 76-152, a gallery that retained 10% of sales and turned over the remainder to the artist was held to not be exempt. Direct benefits to artists in this case could not be dismissed as being merely incidental to any other qualifying purposes. Here, you will turn 100% of proceeds over to the artist. The artist has control over selecting works, setting prices and even, in the case of being a featured artist, inviting patrons to and advertising for a select exhibit of their works. Any qualifying activities that may be conducted, such as workshops and classes, are incidental to your purpose of promoting and selling works of art for your member artists. As these direct benefits cannot be overlooked, much as in the ruling, you do not qualify for exemption.

Furthermore, since the individuals who will be selling and retaining any proceeds are members they are also insiders. As insiders, any direct benefit derived through your operations is inurement. As seen in Salvation Navy v. Commissioner, when an organization is formed to benefit insiders it does not qualify for exemption.

### **Conclusion**

Based on the facts and information submitted, you are not operated exclusively for exempt purposes. You are indistinguishable from a commercial gallery that sells artworks to the public. You serve the private interests of your members in more than an insubstantial degree. In addition, you have not established that your net earnings will not inure to the benefit of private shareholders or individuals. Thus, you do not qualify for exemption as an organization described in section 501(c)(3) of the 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. If your statement does not provide a basis to reconsider our determination, we will forward your case to our Appeals Office. You can find more information about the role of the Appeals Office in Publication 892, *Exempt Organization Appeal Procedures for Unagreed Issues*.

*Types of information that should be included in your appeal can be found on page 2 of Publication 892, under the heading "Regional Office Appeal". The statement of facts (item 4) must be accompanied by the following declaration:*

*"Under penalties of perjury, I declare that I have examined the statement of facts presented in this appeal and in any accompanying schedules and statements and, to the best of my knowledge and belief, they are true, correct, and complete."*

*The declaration must be signed by an officer or trustee of the organization who has personal knowledge of the facts.*

*Your appeal will be considered incomplete without this statement.*

*If an organization's representative submits the appeal, a substitute declaration must be included stating that the representative prepared the appeal and accompanying documents; and whether the representative knows personally that the statements of facts contained in the appeal and accompanying documents are true and correct.*

An attorney, certified public accountant, or an individual enrolled to practice before the Internal Revenue Service may represent you during the appeal process. If you want representation during the appeal process, you must file a proper power of attorney, Form 2848, *Power of Attorney and Declaration of Representative*, if you have not already done so. You can find more information about representation in 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](http://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 appeal 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 the applicable address:

Mail to:

Internal Revenue Service  
EO Determinations Quality Assurance  
Room 7-008  
P.O. Box 2508  
Cincinnati, OH 45201

Deliver to:

Internal Revenue Service  
EO Determinations Quality Assurance  
550 Main Street, Room 7-008  
Cincinnati, OH 45202

You may 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

Enclosure, Publication 892