



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

Release Number: **201315029**
Release Date: 4/12/2013
Date: 1/15/13
UIL Code: 501.32-00
501.32-01
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.

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.

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

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,

Holly O. Paz
Director, Exempt Organizations
Rulings and Agreements

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: September 25, 2012

Contact Person:

Identification Number:

Contact Number:

FAX Number:

Employer Identification Number:

LEGEND:

**UIL: 501.32-00, 501.32-01,
501.33-00**

B =
C =
D =
E =
F =
x =
y =

Dear

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

Issues

- Have you failed to meet the organizational test under section 1.501(c)(3)-1(b)(4) of the regulations? Yes for the reasons stated below.
- Have you failed to demonstrate that you meet the operational test by operating exclusively for an exempt purpose under section 501(c)(3) of the Code? Yes for the reasons stated below.
- Do you benefit private interests, which could preclude exemption under section 501(c)(3) of the Code? Yes for the reasons stated below.

Letter 4036 (CG) (11-2005)
Catalog Number 47630W

Facts

You incorporated in the State of B on date C. Article III of your articles states your purpose " ... is to focus on developing worldwide interactive video instruction." Your articles do not state what would happen to your assets should you dissolve. You later submitted amended articles that changed your purpose to exempt purposes under section 501(c)(3) of the Code.

Article II of your bylaws indicates that your membership consists solely of your board of directors.

Your board of directors consists of 4 individuals. D is your founder and president and receives compensation of y dollars per year. E is your vice president and was described as D's "mate" and "closest advisor." Your two remaining board members have worked with D on various projects with his for-profit business and other non-profit entities.

D previously formed a for-profit company, F, which had primarily produced programs for non-profit clients. Activities conducted by F included videotaping and editing. D customarily retained the edited masters and non-exclusive rights to distribute the programming.

In order "To receive support for editing and distributing a composite show, D realized it would be necessary to connect with a 501(c)(3) umbrella foundation to act as a fiscal agent or to become a 501(c)(3) non-profit." Shortly after this, you were formed.

You edit and distribute up to 20 video books (DVDs). You reflect D's evolving vision of how to best utilize his library of video productions to serve an emerging sustainable and compassionate global civilization.

Your activities consist of editing, finalizing and packaging the 20 previously recorded video books, detailing the route to sustainable development; developing interactivity participatory formats as an integral part of video-based seminar programs; targeting worldwide internet outreach for conducting screenings and focus groups; establishing a network of schools, libraries, think tanks, and civil society organizations to order and utilize videos and to schedule and staff interactive video seminars at learning centers.

You have an accessible digital database that can motivate people to action as well as provide models for innovative solutions. You will sell the video books up to x dollars for individuals, twice that for institutions and double that again for public performance rights.

You have a non-exclusive license to distribute D's public education video programming. D also owns all copyrights to the video books. You have agreed to pay D a modest portion of the receipts as royalties to him so that he is able to recoup his sizable costs, plus deferred payments as fair compensation for his unpaid creative work in recording, completing, packaging and arranging dissemination of the products.

Correspondence states D has assigned licensing rights to you and that D will not receive any royalties. A letter of agreement subsequently indicates D has donated a non-exclusive license

in perpetuity to you to utilize and distribute all video programming D produced. However, the agreement further states that maximum industry royalty rates of 10-12% may apply or "a more likely compensation figure is 5% of gross receipts." You again stated the small percentage is to recoup D's costs.

Your gross receipts for tax years 20 through 20 averaged nearly \$ per year. As stated above, D will also be compensated y dollars per year with the majority of the remaining expenses going to professional fees. Of the professional fees, up to \$ will be the fees to produce the DVDs. You will be providing funds to F to write checks to independent contractors to post-produce, package and make available on-line the entire series of videobooks (DVDs).

Distribution of the videobooks will be available through your website where a potential buyer can screen a two to six minute excerpt and then activate a shopping cart mechanism with a third party online payment service provider to purchase the DVDs. You hire interns to offer your titles and services on list serves, using sustainable development contact databases from organizations such as the United Nations and other civil society organizations.

You are open to partnering with producers consortia to disseminate their educational documentaries.

Subsequent correspondence indicates that E went dormant in 2001; and dissolved in 2011 as a sole proprietorship.

D is working with video editors remotely through an internet messaging service to have contracted facilities produce the DVDs. A copy of the professional services agreement indicates that the contractor has already produced 4 DVDs and is now authorized to produce 7 more DVDs.

Law

Section 501(c)(3) of the Code exempts corporations and any community chest, fund, or foundation, organized and operated exclusively for charitable, religious or educational purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(a)-1(c) of the regulations defines a private shareholder or individual as those persons having a personal and private interest in the activities of an organization. In general, a private shareholder or individual is considered an "insider" with respect to the exempt organization.

Section 1.501(c)(3)-1(a)(1) of the regulations states in order for an organization to be exempt under section 501(c)(3), it must be both organized and operated exclusively for one or more exempt purposes. If an organization does not meet either the organizational test or operational test, it is not exempt.

Section 1.501(c)(3)-1(b)(4) of the regulations provides that an organization will not qualify for exemption under section 501(c)(3) of the Code unless its organizing document contains a dissolution provision that permanently dedicates its assets to an exempt purpose.

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 that accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

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

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations states an organization is not organized or operated exclusively for one or more of the purposes unless it serves a public rather than a private interest. Thus, to meet the requirement of this subdivision, it is necessary for an organization to establish 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.

In Rev. Rul. 55-231, 1955-1 C.B. 72, an organization was formed for the purpose of making known to the world the contents and meanings of certain books written by one of the incorporators of the organization. The Service held that an organization whose primary purpose is to promote the circulation of books of one of its incorporators and whose activities consist of purchasing such works and making them available for public use is not organized and operated exclusively for educational purposes within the meaning of section 501(c)(3) of the Code.

In Rev. Rul. 76-91, 1976-1 C.B. 149, a proprietary hospital was acquired by a nonprofit corporation. The purchase of all of the assets at a price that included the value of intangible assets, determined by the capitalization of excess earnings formula, did not result in the inurement of the hospital's net earnings to the benefit of any private shareholder or individual or serve a private interest precluding exemption under section 501(c)(3) of the Code.

Rev. Rul. 76-441, 1976-2 C.B. 147, presented two situations concerning school operations. In the first scenario a nonprofit school succeeded to the assets of a for-profit school. While the former owners were employed in the new school, the board of directors was completely different. The ruling concludes that the transfer did not serve private interests. Part of that conclusion was based on the independence of the board. In the second scenario, the for-profit school converted to a nonprofit school. The former owners became the new school's directors. The former owners/new directors benefited financially from the conversion. The ruling concluded that private interests were served.

In Spokane Motorcycle Club v. U.S., 222 F. Supp. 151 (E.D. Wash. 1963), net profits were found to inure to private individuals where refreshments, goods and services amounting to \$825 (representing some 8% of gross revenues) were furnished to members.

Harding Hospital, Inc. v. United States, 505 F. 2d 1068 (1974), holds that an organization seeking a ruling as to recognition of its tax exempt status has the burden of proving that it

satisfies the requirements of the particular exemption statute. Whether an organization has satisfied the operational test is a question of fact.

In Church by Mail, Inc. v. Commissioner, 765 F.2d 1387 (9th Cir. 1985) the Court of Appeals affirmed a Tax Court decision. Church by Mail sent out sermons in numerous mailings. This required a great deal of printing services. A for-profit company, controlled by the same ministers, provided the printing and the mailing. This company also employed family members. The services were provided under two contracts. The contracts were signed by the two ministers for both the organization and the for-profit company. The organization's business comprised two-thirds of the overall business done by the for-profit company. The court determined that there was ample evidence in the record to support the finding that the organization was operated for the substantial non-exempt purpose of providing a market for the services of the for-profit company. The employees of the company spent two-thirds of their time working on the services provided to the church. The majority of the Church's income was paid to the for-profit company to cover repayments on loan principal, interest, and commissions. Finally, the potential for abuse created by the ministers' control of the Church required open and candid disclosure of facts bearing upon the exemption application. Moreover, the ministers' dual control of both the Church and the for-profit company enabled them to profit from the affiliation of the two entities through increased compensation.

In John Marshall Law School v. United States, 228 Ct. Cl. 902 (1981), the Court of Claims held that personal expenses paid on behalf of the family controlling a law school were not part of reasonable compensation. The plaintiff argued that if these payments had been included in salary, the salary still would be reasonable. However, the court said the expenses were not paid as additional salary or treated as compensation on the corporate books. Instead, they were paid at the insider's discretion. He was free to make personal use of the corporate funds for himself and family when and if he chose to do so. The court upheld the Commissioner in the revocation of the school's exempt status based on inurement.

In International Postgraduate Medical Foundation v. Commissioner, T.C. Memo. 1989-36, the Tax Court considered the qualification for exemption under section 501(c)(3) of the Code of a nonprofit corporation that conducted continuing medical education tours. The petitioner had three trustees. Mr. Helin, who was a shareholder and the president of H & C Tours, a for profit travel agency. Mr. Regan, an attorney, and a third director who was ill and did not participate. Mr. Helin served as executive director. The petitioner used H & C Tours exclusively for all travel arrangements. There is no evidence that the petitioner ever sought a competitive bid. The Court found that a substantial purpose of the petitioner was benefiting the for-profit travel agency. It concluded that: "When a for-profit organization benefits substantially from the manner in which the activities of a related organization are carried on, the latter organization is not operated exclusively for exempt purposes within the meaning of section 501(c)(3) even if it furthers other exempt purposes."

In Salvation Navy v. Commissioner, T.C. Memo. 2002-275, 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 Law

You do not meet the organizational test under section 1.501(c)(3)-1(b)(4) as your articles of incorporation do not permanently dedicate your assets to an exempt purpose.

You do not meet the operational test since you are not operated for exempt purposes consistent with Section 501(c)(3) of the Code. Your activities consist of producing video books (DVDs) in which intellectual property rights are owned by your president, D, as well as the selling of these DVDs to the general public at market rates. You are marketing these products through advertising and the direct marketing efforts of your board members. Therefore, you were formed for the benefit of your president and not operating exclusively for charitable purposes. These facts demonstrate a substantially non-exempt purpose inconsistent with Section 501(c)(3) of the Code.

Section 1.501(c)(3)-1(c)(2) of the regulations provides that an organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals. Your net earnings inure, in part, to the benefit of your president, D, who owns the intellectual property rights of these DVDs and who will continue to receive royalties for allowing you the use of his intellectual property.

You are similar to the organization in Rev. Rul. 55-231 in that you were formed to distribute the DVDs of your president. Although the organization in Rev. Rul. 55-231 distributed books authored by one of its incorporators, your activities of selling DVDs of your president is no different than that of the organization in the revenue ruling.

You are dissimilar to the organization described in Rev. Rul. 76-91. In that ruling, the nonprofit hospital purchased the assets of the for-profit hospital. The nonprofit obtained an independent appraisal of the assets and it was determined that the price resulting from the appraisal was at fair market value. The ruling stated that in situations where there is common control of or a close relationship between the buyer and seller and both tangible and intangible assets are being purchased, the value of the tangible assets must first be established by an independent appraisal. The purchaser must then establish the components of the intangible assets, indicate how these components will be used to further its exempt purposes, and establish the aggregate value of these intangibles. In contrast, you did not obtain any independent appraisal in establishing fair market value. You simply sold DVDs to individuals and organizations at market rates with the proceeds there from inuring to your president.

Generally, where an organization purchases assets from an independent third party, a presumption exists that the purchase price (arrived at through negotiations) represents fair market value. A common control existed amongst the buyer and seller for your conversion and thus the above presumption cannot be made because the elements of an arm's length transaction were not present. In determining the sales price of the DVDs, no arm's length transactions were present.

In reference to Rev. Rul. 76-441, you are similar to the second situation in the ruling in that your president benefits financially from your operation. E was a sole proprietorship of your president, D. You were formed because your president " ... realized it would be necessary to connect with

a 501(c)(3) umbrella foundation to act as a fiscal agent or to become a 501(c)(3) non-profit." (Emphasis added.)

You are similar to the organization in Spokane Motorcycle Club. In that case, an organization's primary purpose was the provision of refreshments and meals to its members. The organization argued that the amounts involved were de minimis. The court agreed with the Service and stated: "Refreshments, goods and services furnished to members of an exempt corporation from the net profits of the business enterprise are benefits inuring to the individual members." The court further stated that: "In this case, although the amounts are not large, (the court) must hold that the organization was not operated exclusively for recreation, pleasure, charitable and other nonprofit purposes and that part of the earnings of the organization did inure to the benefit of private individuals." Although you do not provide refreshments and meals to your members, your actions of selling copy-righted materials owned by your president and his receipt of royalties on the sale of such materials, results in prohibited inurement.

In Harding Hospital, the court determined that it was the organization's burden to show that it was operated exclusively for exempt purposes. You have not demonstrated that you are operating exclusively for exempt purposes and not for the private interests of private individuals since your president receives a royalty payment and retains ownership of the intellectual property.

You have not demonstrated that you are operating exclusively for exempt purposes and not for the private benefits of the individuals of the organization. Therefore, you are similar to the organization described in Church by Mail. In this case, the court determined that organization was operating for the interests of the individuals and related for-profit business which precluded them from exemption. In similar fashion, you were formed to sell reproduced DVDs created by your president which is not an exempt purpose under section 501(c)(3).

As stated in John Marshall Law School, the issue is not if the insider provides goods and services of commensurate value to the organization but the fact they are in position to exercise control over the organization and use the assets as if they were their own by using them at will rather than in a fiduciary capacity. Since D is the previous owner of E, and owns all licensing rights, D is has the authority to determine if you can reproduce the material.

You are similar to the organization described in International Postgraduate Medical Foundation v. Commissioner, in that you are not operating exclusively for exempt purposes but for the benefit of your president. In that court case, the organization was operated for the benefit of a related for-profit travel agency. The Tax Court stated in this opinion: "When a for-profit organization benefits substantially from the manner in which the activities of a related organization are carried on, the latter organization is not operated exclusively for exempt purposes within the meaning of section 501(c)(3) ... "

You are comparable to the organization in Salvation Navy in that have not proven you were not organized to serve the private interests of your president, D.

Conclusion

You do not meet the organizational test under section 1.501(c)(3)-1(b)(4) of the regulations as your assets are not permanently dedicated to an exempt purpose.

You do not meet the operational test under section 1.501(c)(3)-1(c) of the regulations as you are operated for a non-exempt purpose, the production and sale of the video books in a commercial manner. A substantial part of your activities is operating a trade or business to further a non-exempt purpose. Further, you do not meet the operational test under section 1.501(c)(3)-1(c)(2) of the regulations because your net earnings inure to your president.

You failed to establish that you are not organized or operated for the benefit of your creator, D thereby contravening section 1.501(c)(3)-1(d)(1)(ii) of the regulations.

Accordingly, we have determined you do not qualify for exemption as an organization described in section 501(c)(3).

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, 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:

Deliver to:

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

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,

Holly O. Paz
Director, Exempt Organizations
Rulings and Agreements

Enclosure, Publication 892