



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
1100 Commerce Street
Dallas, TX 75242

501-03.00

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Date: April 1, 2013

Release Number: 201327019

Release Date: 7/5/2013

LEGEND

ORG - Organization name

XX - Date Address - address

Person to Contact:

Badge Number:

Contact Telephone Number:

Contact Address:

Employer Identification Number:

ORG

ADDRESS

CERTIFIED MAIL

Dear _____ :

This is a final notice of adverse determination that your exempt status under section 501(c) (3) of the Internal Revenue Code is revoked. Recognition of your exemption under Internal Revenue Code section 501(c)(3) is revoked effective January 1, 20XX for the following reason(s):

You are not operated exclusively for an exempt purpose as required by Internal Revenue Code section 501(c)(3). You are not and have not been engaged primarily in activities which accomplish one or more exempt purposes. You are not a charitable organization within the meaning of Treasury Regulation 1.501(c)(3)-1(d); rather, your activities further a substantial nonexempt commercial purpose and serve private rather than public interests.

Because you did not protest the proposed modification of your non-private foundation status and have indicated your agreement by signing the Form 6018 on January 16, 20XX, it is further determined that you have not exhausted your available remedies for purposes of declaratory judgment under section 7428 of the Code.

Contributions to your organization are no longer deductible.

You are required to file Federal income tax returns on Form 1120. These returns should be filed with the appropriate Service Center for the year ending December 31, 20XX and for all the tax years thereafter in accordance with instructions of the return.

It is further determined that your failure to file a written appeal constitutes a failure to exhaust your available administrative remedies. However, if you decide to contest this determination in court, you must initiate a suit for declaratory judgment in the United States Tax Court, the United States Claims Court, or the district court of the United States for the District of Columbia

before the (ninety-first) 91st day after the date that this determination was mailed to you. Contact the clerk of the appropriate court for rules for initiating suits for declaratory judgment. To secure a petition form, write to the following address: United States Tax Court, 400 Second Street, NW, Washington, DC 20217.

Please understand that filing a petition for a declaratory judgment under IRC section 7428 will not delay the processing of subsequent income tax returns and assessment of any taxes due.

You also have the right to contact the Office of the Taxpayer Advocate. However, you should first contact the person whose name and telephone number are shown above since this person can access your tax information and can help you get answers. You can call 1-877-777-4778, and ask for the Taxpayer Advocate assistance or you can contact the Advocate from the site where this issue was determined by writing to:

Taxpayer Advocate assistance cannot be used as substitute for established IRS procedures, formal appeals processes, etc. The Taxpayer Advocate is not able to reverse legal or technically correct tax determination, nor extend the time fixed by law that you have to file a petition in 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.

This letter should be kept within your permanent records.

If you have any questions, please contact the person whose name and telephone number are shown above.

Sincerely,

Nanette M. Downing
Director, EO Examinations

Enclosures:
Publication 892

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer ORG	Tax Identification Number EIN		Year/Period ended Dec 31, 20XX – Dec. 31, 20XX

LEGEND

ORG - Organization name EIN - ein XX - Date State - state County -
county motto - motto Founder - founder Secretary - secretary CO-1
through CO-10 - 1st through 10th COMPANIES

ISSUES

Whether the organization's tax exempt status under Code §501(c)(3) should be revoked due to the following issues:

1. ORG ("Organization") failed to operate exclusively for exempt purposes as required by Internal Revenue Code ("Code") §501(c)(3) during the years under examination.
2. The Organization operated primarily for private benefit of CO-1, a for-profit motto, owned by Founder, the founder of the Organization.

FACTS

Background of Organization

The Organization was incorporated as a State non-profit public benefit corporation on May 5, 20XX by Founder. The Organization was recognized as exempt from Federal income tax under section 501(a) of the Internal Revenue Code and described in section 501(c)(3) on October 30, 20XX. When the Organization was approved as an exempt organization it agreed that it would operate for exempt purposes.

Description of Activities

Form 1023 - Initial Description of Activities

The initial *Detailed Description of Activities* was provided with the Form 1023, *Application for Recognition of Exemption under Section 501(c)(3) of the Code*.

The Organization submitted one initial and two revised *Detailed Description of Activities* statements before receiving approval for exemption from Federal income tax.

On May 18, 20XX, the Organization filed Form 1023 applying for tax exempt status under Code Section 501 (c)(3). An attachment to Form 1023 was included that described The Organization's activities.

The initial *Detailed Description of Activities* statement that was attached to Form 1023 is shown below in its entirety:

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
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Activity 1: Acquiring of book donations

Most charities, such as thrift stores and Friends of the Library, are unable to procure much needed inventory for their fundraising sales, for multiple reasons: they do not market their need for donations effectively, and they do not have the means and labor to pick up book donations, especially larger ones of more than a few boxes. The organization ORG will assist in this by providing marketing and free book donation pick-ups for the public – to be re-donated to partner non-profits.

This will begin as soon as ORG receives 501(c)(3) status, so it can provide tax receipts to donors. Pick-ups will be provided initially for the County area, expanding to the rest of southern State and beyond as demand and ability grows. Employees, supplemented by volunteers and interns, will pick-up donations in cargo vans or small trucks, and drop them off at nearby thrift stores, libraries, or other partner charities.

Companies and the general public will become aware of the free pick-ups through internet marketing, direct mail, and billboard & print advertising, as the organization's funding allows. Donors will be able to schedule a pick-up over the phone or by the website <http://www.booksforpeople.org>.

Funding will come primarily from the organization's 2nd activity.

ACTIVITY 2: Internet sale of qualifying book donations consigned to ORG by other non-profits.

Most charities do not have the technological know-how needed to determine the internet value of their book donations, or the skilled workers needed to sell higher-valued books. ORG will market its services to charities that wish to increase their fundraising efforts by selling donated books online.

It will contact non-profits by phone, through direct mail, and in person. This will be the same area as the book donation pick-ups, as above. With these partners, ORG will help sort out higher-valued books from the donations. Then it will remove those consigned books to its own facilities, where trained employees and volunteers will list, store, and ship books as they are sold. Books will be sold primarily on websites such as CO-4 and CO-5, but also other book-selling sites as needed.

ORG will retain no more than % of net revenue from consignment sales as its primary funding source. This will be agreed upon contractually with partner non-profits. The % should be enough to cover all of the organization's expenses, including pick-up services. Any additional revenue will be re-distributed to partner non-profits as applicable.

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Name of taxpayer ORG	Tax Identification Number EIN	Year/Period ended Dec 31, 20XX – Dec. 31, 20XX	

It should be noted that initial funding before consignment services begin will be provided by personal donors to CO-2.

Supplemental Information on Form 1023

The Form 1023 disclosed that Founder, the President and founder of the Organization, was also the owner of a profit motto known as CO-1.

Part V of the Form 1023 stated that the Organization would not have business with any officers, directors, etc. The Organization also stated that it would be publicly supported by grants or contributions.

The relationship between the Organization and CO-1 was outlined in correspondence between the Service and the Organization as part of the process of determination for exempt status.

Dialogue Between the Service and the Organization Regarding Its Activities

The Service sent out an inquiry dated August 11, 20XX, to the Organization for additional information. This inquiry was necessary to make a determination on its Form 1023. The Service also had questions about the initial *Detailed Description of Activities* statement that was attached to Form 1023.

On August 31, 20XX, the Service received correspondence from the Organization in reply to the Service's request for additional information.

Questions shown below were asked by the Service in correspondence dated August 11, 20XX. Answers shown below were given by the Organization in its written reply dated August 31, 20XX.

The Service received the following reply regarding question numbers 7) c, d, e, and f.

The questions and the Organization's answers are shown below in their entirety.

Question: 7): Provide the following for "CO-3" and its relationship to you:"

Question 7) c): The relationship among your board members and its owners. Also, identify the ownership of CO-3.

In answer to Question 7C of the Service's inquiry The Organization stated the following:

Founder, President of the Board of ORG is founder and owner of CO-1. We recognize that this could lead to a conflict of interest between ORG and CO-1 and therefore will maintain no relationship professionally or otherwise between ORG and CO-1. It is the knowledge and experience Founder gained over the years with CO-1

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that will give ORG the systems and guidance needed to perform its functions effectively and efficiently.

Question 7) d): What will this company provide to you and what will you provide to this company? Explain in detail (when, how, where, etc)

In answer to Question 7D of the Service's inquiry the Organization stated the following:

D) There will be nothing provided to ORG from CO-1 nor anything provided for CO-1 from the ORG. The two companies will operate separately and have no relationship.

Question 7) e): If your organization did, does, or will do any business with this company, provide detailed business transactions (past, current and future) between your organization and this company along with the contract agreement. (For us to process your application, you will need to provide a draft, at least.)

In answer to Question 7E of the Service's inquiry the Organization stated the following:

E) ORG has not and will not do any business with or for CO-1.

Question 7) f): Explain the relationships between your organization and this company including the information of personnel who works for both organizations.

In answer to Question 7F of the Service's inquiry The Organization stated the following:

F) Additional Relationships: Founder as the President of ORG and owner of CO-1 is the only relationship existing between the two entities. No employee or independent contractor of ORG will be working for CO-1 and vice versa. The two entities are completely independent and will maintain their own personnel in perpetuity.

The initial *Detailed Description of Activities* statement that was submitted with Form 1023 was not accepted by the Service because the Organization would be engaged in commercial activities.

The consignment store for donors or 501 (c)(3) organizations was considered commercial because percent fees would be charged. The Service also disagreed with intermingling of the Organization with the for-profit business, CO-1. The Service determined that if the Organization just raised funds to give to 501(c)(3) organizations that this would be acceptable.

The Service discussed the above adverse situation in detail with Founder on September 21, 20XX, by telephone. Founder stated he would get rid of the negative issues.

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As a result of this telephone call, Founder faxed a second version of the Organization's *Detailed Description of Activities* statement and the Service received this fax on October 3, 20XX.

The second *Detailed Description of Activities* statement showed significant changes to Activity 2. The changes eliminated the consignment sales activity and stated that the Organization would sell a portion of its books online to fund its operations and donate the rest to charity. Activity 1 stayed basically the same as initially presented, except that the revision placed more emphasis on the public benefit of the Organization's activities.

The revised *Detailed Description of Activities* received on October 3, 20XX, is shown below in its entirety, except that revisions to Activity 1 are underlined. Other than the underlined sentences, Activity 1 is the same as it was presented with the initial Form 1023.

ACTIVITY 1: Free donation pick-ups.

Most charities, such as thrift stores and Friends of the Library, are unable to procure much needed inventory for their fundraising sales, for several reasons: they do not market their need for donations effectively, and they do not have the means and labor to pick up book donations, especially larger ones of more than a few boxes. Consequently, many donors without the means to bring donations to the charities are forced to simply throw away their books, creating a burden on landfills. The organization ORG will address this problem by providing free book donation pick-ups for the public – to be re-donated to local non-profits.

This will begin as soon as ORG receives 501(c)(3) status, so it can provide tax receipts to donors. Pick-ups will be provided initially for the County area, expanding to the rest of southern State and beyond as demand and ability grows. Employees, supplemented by volunteers and interns, will pick-up donations in cargo vans or small trucks. After sorting for Activity 2 (below), they will drop them off at nearby thrift stores, libraries, or other partner charities as needed.

Organizations and the general public will become aware of the free pick-ups through internet marketing, direct mail, and billboard & print advertising, as the organization's funding allows. Donors will be able to schedule a pick-up over the phone or by the website. Also, ORG will place donation bins in locations such as businesses, schools, churches, and non-profits, where people can conveniently deposit donations.

Funding will come primarily from the organization's 2nd activity.

ACTIVITY 2: Internet sale of a small portion of book donations.

ORG will fund its free donation pick-ups and redistributions by selling a portion of donated books online. Trained employees will sort out, list, shelve, and ship books higher in value than \$. Books will be sold primarily on websites like CO-4 and CO-5, but also other book selling sites as needed.

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ORG will retain only enough of the sales to cover expenses. Any net revenue greater than ORG's overhead will be distributed to local not-for-profits. It should be noted that initial funding before activities begin will be provided by board members.

The Service's Rejection of the Second Draft Concerning Activities

The second *Detailed Description of Activities* statement was rejected by the Service due to the lack of clarity concerning fundraising. Also, the Organization did not include a statement that there would be complete separation from the non-profit. The Service discussed this situation with Founder on October 16, 20XX, by telephone.

Third Submission of Activities Statement

As a result of this telephone conversation, Founder stated that he would clarify new activities again, collaborate the separation between the two organizations, and resign from the Organization's Board.

Founder faxed his third and final version of the Organization's *Detailed Description of Activities* statement. It was received by the Service via fax on October 19, 20XX.

The third *Detailed Description of Activities* statement received on October 19, 20XX, is shown below in its entirety. There was essentially no change to Activity 1 as previous presented in the first and second revised activity statements. However, Activity 2 was significantly changed as shown below.

ACTIVITY 1: Free donation pick-ups.

ORG will offer a free pickup service for donations of books by the public.

This will begin as soon as ORG receives 501(c)(3) status, so it can provide tax receipts to donors. Pick-ups will be provided initially for the County area, expanding to the rest of southern State and beyond as demand and ability grows. Employees, supplemented by volunteers and interns, will pick-up donations in cargo vans or small trucks.

Donors will become aware of the free pick-ups through internet marketing, direct mail, and billboard & print advertising, as the organization's funding allows. Donors will be able to schedule a pick-up over the phone or by the website booksforpeople.org. Also, ORG will place donation bins in locations such as businesses, schools, and churches, where individuals can conveniently deposit donations.

Funding will come primarily from the organization's 2nd activity.

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ACTIVITY 2: Internet sale of a small portion of book donations.

ORG will fund its free donation pick-ups by selling a portion of donated books online. Trained employees will sort out, list, shelve, and ship books higher in value than \$. Books will be sold primarily on websites like CO-4 and CO-5, but also other book-selling sites as needed.

ORG will retain only enough of the sales to cover expenses. Any net revenue greater than its overhead costs will be donated to local non-profits. ORG will choose the organizations to receive the funds, and will donate the funds to them. ORG will not sell books as the agent of any other organization, nor will it carry out any activities in direct relationship with or at the request of any other organization.

Note: Initial funding before activities begin will be provided by board members. Board president Founder will resign his position with ORG once it is up and running to avoid any potential conflict of interest. Furthermore, no employee of his business CO-1 will be simultaneously employed by ORG.

Activity 2 Statement Accepted By The Service

The third *Detailed Description of Activities* was accepted by the Service. The Letter 947 dated October 30, 20XX was sent to the Organization to show that it was approved for exemption from Federal Income Tax under Code section 501(c)(3).

Current Organizational Activities

Tax Year 20XX

The 20XX Form 990 return reported that the Organization's primary purpose is to assist the members of the community in donating books and media by scheduling and fulfilling donation pick-up and delivery from the donor's place of holding to the best fit local charity.

The Service initiated an examination of the Organization's 20XX Form 990-EZ. A summary of the interview, that was titled, *Statement of Activities* was agreed to by the agent and the Executive Director/Board Secretary/Treasurer, Secretary. Secretary has signed this *Statement of Activities* and edited it to make minor changes to show agreement with the facts.

In 20XX, the assigned agent ("agent") determined that the Organization's activities corresponded to the *Detailed Description of Activities* statement that was presented to the Service to obtain exemption from Federal Income Tax.

The activities that the Organization engaged in during 20XX are listed below.

Organization Activities for 20XX

EXPLANATIONS OF ITEMS

Name of taxpayer

Tax Identification Number

Year/Period ended

ORG

EIN

Dec 31, 20XX –
Dec. 31, 20XX

1. Solicited book donations on its website, booksforpeople.org. The Organization's van is wrapped with the Organization's Logo. (Donors see the van and call for donation pick ups.)
2. Picked up book donations and sorted books 3-4 days per week using their own employees and volunteers.
3. Sold its individual book donations directly on CO-4.com and other websites.
4. Did not have a consignment contract with CO-1 in 20XX.
5. Books that could not be used were recycled.
6. Fulfilled all shipping orders and shipped books to purchasers.
7. Employed drivers and paid transportation fees.
8. CO-1 was the Organization's only charitable contributor in the amount of \$.
9. The Organization paid \$ in rent to a third party as part of a sublease with CO-1 in what was determined to be an arm's length transaction by the agent.
10. The organization donated eight (8) boxes of books to CO-6. Normally, there are 15 books per box. This repurpose of books is in contrast to the number of books sold. No other books were donated.

20XX Revenue and Expenses

Description	Amounts
	Per Audit
REVENUE	
Direct online net book sales	
The Organization's bank deposits	
Difference	
EXPENSES	
Grant to CO-7 - 501(c) (3)	
Salary expense	
Shipping and supplies	
Rent	
Transportation	
Other Expenses:	
TOTAL EXPENSES	
Excess for the year:	

During the examination of the 20XX return, the agent discussed the 20XX activities with the Organization's officers. According to the Organization's officers, the Organization made substantial changes to its operations as follows:

Organization Activities for 20XX

1. Employees from CO-1 sort most of the donated books because they are skilled at it and have special scanners to do it quickly. Books are sorted into the following categories:

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- Sales on internet through consignment agreement with CO-1
- Sales for a warehouse sale
- Sales to CO-1 for banker's boxes
- Donations to charities
- Recycling

2. On January 31, 20XX, the Organization entered into a written consignment agreement with CO-1.
 - a. This agreement allowed CO-1 to hold the Organization's books in a Trust by CO-1 as a charitable organization (i.e. the Organization retained ownership of unsold items).
 - b. This agreement allowed CO-1 to list books on the internet, sell and ship books on behalf of the Organization. It also allowed CO-1 to sell the Organization's items at special event sales.
 - c. The agreement stated that CO-1 would retain % of the net proceeds and the other % would go to the Organization.
 - d. The Organization's drivers picked up the books.
 - e. CO-1 employees sorted and shipped the books with minimal help from the Organization. See the chart below that shows the charges for CO-1 services, including employee services.
3. In 20XX, the Organization began selling a banker's box of books to CO-1 in addition to the consignment agreement. Each box contained an average of 15 books. These books were valued at \$ to \$ each. Each banker's box was sold to CO-1 for \$ per box, and this is the common rate that CO-1 buys books from the public.
4. The Organization donated at least 12-14 boxes of books to CO-8 and dictionaries to a classroom at CO-9. Boxes have varying amounts of books. Normally, there are approximately 15 books per box. No other book donations were verified in 20XX.
5. The organization donated \$ to CO-7 – which is a 501(c)(3) organization.

In 20XX, the Organization and CO-1 conducted special event sales. This included a warehouse sale and a parking lot sale. These sales were staffed by the Organization and CO-1 employees and volunteers. The amounts of gross receipts from these sales and expense details have not been disclosed by the Organization to the Service. Based on the financial records, the net amount received by the Organization was approximately \$.

Consignment Revenue

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Organization books that are sold on CO-4.com are advertised by CO-1. CO-1 sets the selling price. CO-4 deducted merchant fees and remitted net amounts to CO-1. CO-1 deducts fees and splits the net amount with the Organization as shown below.

Consignment Revenue - 20XX

Description	Amounts
CONSIGNMENT REVENUE	
Gross Sales Proceeds - Online sales of donated books	
Total gross proceeds after merchant fees	
EXPENSES	
Rent – for CO-1 rented warehouse	
Transportation - CO-1's van with the Organization logo	
Employees - CO-1 employees for 2,734.43 hours	
TOTAL EXPENSES	
Net Proceeds to split 50/50	
CO-1 received % of net proceeds	
The Organization received % of net proceeds	
Total amount of proceeds paid to CO-1 = %	
Total amount of proceeds paid to the Organization = %	

Form 990 Revenue and Expenses - 20XX

Description	Amounts
	Per Audit
REVENUE	
% of consignment proceeds paid by CO-1	
CO-4.com direct sales	
Other Consignment - CO-1	
Banker's Box sales 51 boxes x 15 books = 765 books	
CO-1 charitable contribution	
Total Revenue	
EXPENSES	
Grant to CO-7 - 501(c) (3)	
The Organization's Salary expense	
Auto – to CO-1	
Outside Contract expense to CO-1	
Rent - to CO-1	
Sales Tax and travel - paid to CO-1	
Other Expenses - The Organization	
TOTAL EXPENSES	

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Total expenses paid to CO-1 = %	
Excess for the year:	

Organization Activities for 20XX

In 20XX, the Organization entered into a second consignment agreement with CO-1 in addition to the first one. Otherwise, it operated as it did in 20XX.

1. On June 12, 20XX, the Organization entered into a second consignment agreement with CO-1.
 - a. This agreement stated that CO-1 has constructed a 6,100 sq. ft. mezzanine space called "CO-10 CO-1" for the purpose of selling donations on behalf of itself and the Consignee (the Organization).
 - b. Books are sold in "CO-10" at thrift store prices of \$ each.
 - c. Approximately half of the books sold in the "CO-10" are owned by the Organization. The other half are procured by CO-1.
 - d. The agreement is that % of the net proceeds would be paid to the Organization.

2. The Organization substantiated a donation of approximately 150 boxes of books to various charitable organizations, such as hospitals, schools, etc. between April and August 20XX. That is approximately 2,000 books.

3. A written statement titled *Statement of Accomplishments and Activities Year to Date 20XX* was provided by Secretary, the Organization's Executive Director/Board Secretary and Treasurer that showed the following changes in 20XX:
 - a. After February 21, 20XX, the Organization began requiring donation pick ups to consist of more than 60 items because of driving difficulties and low quality donations. Prior to this the Organization accepted a minimum of 60 items. The Organization did not accept donations of lesser amounts for donation pick up.
 - b. New procedures were implemented by CO-1 to reduce employee hours to sort books that resulted in reduced labor costs.
 - c. The Organization plans to advertise CO-10 venue to increase awareness of where some of the Organization donations go, and to increase traffic and sales.

Consignment Revenue – 20XX (January – July 20XX)

20XX

Description	Amounts
CONSIGNMENT REVENUE	
Gross Sales Proceeds - Online sales of donated books 1/1 - 7/31	
Gross sales from CO-10 Above CO-1 6/12 - 7/29 - approximately 20,389 books at \$ each	

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Total Revenue	
EXPENSES	
Van Repairs - CO-1's van	
Transportation - CO-1's van	
Employees - CO-1 employees for 1,118.3 hours	
Rent - For CO-10 Last Motto(\$ per month)	
Security for CO-10 (331 hours)	
\$ Sales not donated - CO-10	
TOTAL EXPENSES	
Net Proceeds to split 50/50	
CO-1 received % of net proceeds	
The Organization received % of net proceeds	
Total amount of proceeds paid to CO-1 = %	
Total amount of proceeds paid to the Organization = %	

Other Revenue

The Organization sold 122 banker's boxes of books to CO-1 for \$ between January and July 20XX. This is approximately 1,830 books valued at \$ to \$ each.

The Organization has two employees, i.e. one driver and the Executive Director. The driver works 3-4 days per week, and 100% of his time is spent scheduling and retrieving book pick-ups, delivering them to the warehouse and assisting with sorting.

The Executive Director works part-time dispatching pick-up requests, answering questions about organizational, administrative and accounting duties.

LAW

Tax Exemption

Generally, an organization that is described in Code §501(c)(3), is exempt from income tax. These organizations include corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or

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distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

In order to be exempt as an organization described in Code §501(c)(3), an organization must be both organized and operated exclusively for one or more of the purposes specified in such section.

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 Code §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. The existence of a substantial nonexempt purpose, regardless of the number or importance of exempt purposes, will cause failure of the operational test.

An organization is not organized or operated exclusively for one or more exempt purposes unless it serves a public rather than private interest. Thus, an organization must establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or creator’s family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

Operating for the benefit of private parties who are not members of a charitable class constitutes a substantial nonexempt purpose.

Code §501(c)(3) exempts from Federal income tax organizations organized and operated exclusively for charitable, educational, and other exempt purposes, provided that no part of the organization’s net earnings inures to the benefit of any private shareholder or individual.

Federal Tax Regulations (“Regulations”)

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

Regulations §1.501(c)(3)-1(c)(1) 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 Code §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.

Regulations §1.501(c)(3)-1(c)(2) provides that the operational test is not satisfied where any part of the organization’s earnings inure to the benefit of private shareholders or individuals, and where the organization serves a private benefit rather than public interests.

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Regulations §1.501(c)(3)-1(d)(ii) provides that an organization is not organized or operated exclusively for one or more exempt purposes unless it serves a public rather than private interest. Thus, it is necessary for an organization to establish that 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.

Regulations §1.501(c)(3)-1(d)(iii) Example 2

Example 2 shows an art museum's principle activity is to exhibit art created by unknown artists. Each artist whose work is exhibited has a consignment arrangement with the art museum. Under this arrangement, when art is sold, the museum retains 10 percent of the selling price to cover the costs of operating the museum and gives the artist 90 percent.

The court determined that because the art museum gives 90 percent of the proceeds from its sole activity to the individual artists, the direct benefits to the artists are substantial and the art museum's provision of these benefits to the artists is more than incidental to its other purposes and activities. The art museum is not operated exclusively for exempt purposes and, therefore, is not described in section 501(c)(3).

Revenue Ruling 64-175 illustrates that incidental private benefit will not destroy the qualification of an otherwise educational organization; however, where an organization is serving both public and private interests the private benefit must be clearly incidental to the overriding public interest. A contrary finding will indicate that the organization is serving a private interest.

In *American Campaign Academy v. Commissioner*, 92 T.C. 1053, the organization operated for the benefit of private interests, a nonexempt purpose. Because more than an insubstantial part of the organization's activities furthered this nonexempt purpose, the organization failed to establish that it operated exclusively for exempt purposes within the meaning of section 501(c)(3).

This case clarified that not all organizations which incidentally enhance the public good will be classified as "public" organizations within the meaning of Code §501(c)(3). There are examples of "nonpublic" organizations which often do much to enhance the public good, such as private clubs, fraternal societies, veterans' organizations, and labor organizations, but they are not public organizations.

This case also clarified that the operational test probes to ascertain the purpose towards which an organization's activities are directed and not the nature of the activities themselves.

When an organization operates for the benefit of private interests, such as designated individuals, the creator or his family, or persons directly or indirectly controlled by such private interests, the organization by definition does not operate exclusively for exempt purposes.

The presence of a single substantial nonexempt purpose can destroy the exemption regardless of the number or importance of exempt purposes. Better Bus. Bureau v. United States, 326 U.S. 279, 238, 90 L. Ed. 67, 66 S. Ct. 112 (1945); Am. Campaign Acad. V. Commissioner, 92 T.C.

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1053, 1065 (1989); see also Old Dominion Box Co., Inc. v. United States, 477 F.2d 340 (4th Cir. 1973), cert. denied, 413 US 910 (1973) ("operating for the benefit of private parties who are not members of a charitable class constitutes a substantial nonexempt purpose".) When an organization operates for the benefit of private interests, such as designated individuals, the creator or his family, or persons directly or indirectly controlled by such private interests, the organization by definition does not operate exclusively for exempt purposes. Am. Campaign Acad. V. Commissioner, supra at 1065-1066.

In Hawaii v. Commissioner, 71 T.C. 1067 (1979), the tax court found that the denial of tax-exempt status was proper because the corporation had a substantial commercial purpose that served private rather than public interests. The court noted that the corporation paid substantial royalties for trainers, materials, and management services provided by an outside organization and that the organization exerted considerable control over the corporation.

The court held that the corporation was not exempt from income tax because its income-producing activities were not incidental to its educational activities. Additionally, the court determined that regardless of whether the payments made by the organization to commercial organizations was excessive, the determining factor was that commercial organizations benefited substantially from the operation of non-profit.

In Church by Mail, Inc. v. Commissioner, 765 F.2d 1387, 1391-1392 (9th Cir. 1985) the tax court found that the church was operated for the substantial non-exempt purpose of providing a market for Twentieth's services. (Twentieth Century Advertising Agency provided the printing and mailing services for the church's mass mailings. Twentieth was owned and controlled by the ministers. The church and Twentieth share office space in Beverly Hills, State.)

The employees of Twentieth spend two-thirds of their time working on the services provided to the church. The majority of the church's income is paid to Twentieth to cover repayments on loan principal, interest, and commissions. Finally, the potential for abuse created by the ministers' control of the church requires open and candid disclosure of facts bearing upon the exemption application. Bubbling Well, 670 F.2d at 105.

The court found the church exaggerated the importance of the contracts. The critical inquiry was not whether particular contractual payments to a related for-profit organization are reasonable or excessive, but instead whether the entire enterprise is carried on in such a manner that the for-profit organization benefits substantially from the operation of the church.

The tax court determined that the church was operated for the substantial non-exempt purpose of providing a market for Twentieth's services.

ANALYSIS

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ISSUE 1 - Whether the organization's tax exempt status under Code §501(c)(3) should be revoked because ORG ("Organization") failed to operate exclusively for exempt purposes as required by Internal Revenue Code ("Code") §501(c)(3) during the years under examination.

Taxpayer Position

A closing teleconference was held with the Organization on November 29, 20XX. The Organization was notified of the opportunity to appeal the Draft Form 886-A Revenue Agent Report. The Organization provided a written response to the draft Form 886-A, and it was received by the Service on December 28, 20XX. The Organization will not appeal.

It is the Organization's position to agree with the findings, but wishes that an opportunity to re-structure their processes and procedures would have been offered. The Organization believes their efforts provide a much needed service to the citizens of County and over-burdened landfills.

Government Position

It is the Government's position that the Organization failed to operate exclusively for exempt purposes as required by Code §501(c)(3) during the years under examination. An organization is not organized or operated exclusively for one or more exempt purposes unless it serves a public rather than private interest.

After the Organization's initial full year in operation, the Organization entered into two consignment contracts with CO-1. The Organization also entered into a separate agreement to sell banker's boxes of books to CO-1. These commercial contracts were entered into despite the Organization's earlier discussions with the Service that clarified that exempt activity excluded doing business with CO-1.

During the process for determination of exempt status the Organization was given three opportunities to re-structure their processes and procedures. In fact, the Organization did restructure its processes and procedures during this process. The Organization was prohibited from transactions with percentage consignment fees because they are commercial and not exempt activities. The Organization was also prohibited from business with CO-1 because this presented a conflict of interest.

However, when the Organization began its second year of operation, the Organization began to engage in business with CO-1 for percentage consignment fees.

The Organization has entered into three business agreements that allow its book donations to substantially benefit CO-1 more than the public. Therefore, the Organization's free book donation pick up service for which it is issuing tax donation receipts is serving a private rather than a public interest.

In *Church by Mail, Inc. v. Commissioner*, the tax court determined that the organization operated for the substantial non-exempt purpose of providing a market for an advertising service. A

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majority of the organization's income in Church by Mail was paid to a for-profit organization as a majority of your income is paid to CO-1. Whether the contractual payments were reasonable or excessive was not the critical point in this case. Instead, whether the entire enterprise was carried on in a manner that the for-profit organization benefited substantially from was critical in determining the organization operated for substantial non-exempt purposes.

As in Church by Mail, the Organization carried on its entire enterprise in a manner that the for-profit benefited substantially from. This is shown through the second consignment agreement that was entered into on June 12, 20XX with CO-1. CO-1 specifically created a commercial space in its store to sell books donated to the Organization. Books sold in this space are those donated to the Organization and those procured by CO-1. The consignment agreement made with CO-1 in 20XX substantially benefits CO-1 by obtaining zero cost inventories to help fill the bookshelves of its used motto. As well, the Organization's gross revenue substantially benefits CO-1 through fees and a percentage of the consignment net profit.

The operational test outlined in Regulations §1.501(c)(3) is not satisfied when an organization serves private benefit rather than public interests. The Organization has failed the operational tests for two of the three full years it has been in operation because it is not operating exclusively for exempt purposes.

As shown in *Better Bus. Bureau v. United States*, the presence of a single non-exempt purpose can destroy the exemption, regardless of the number or importance of exempt purposes.

Thus, it is our position that the Organization no longer qualifies for exemption under Code §501(c)(3) and the regulations because it failed to operate exclusively for exempt purposes and its exempt status should be revoked.

ISSUE 2 - Whether the organization's tax exempt status under Code §501(c)(3) should be revoked because the Organization operated primarily for private benefit of CO-1, a for-profit motto, owned by Founder, the founder of the Organization.

Taxpayer Position

A closing teleconference was held with the Organization on November 29, 20XX. The Organization was notified of the opportunity to appeal the Draft Form 886-A Revenue Agent Report. The Organization provided a written response to the draft Form 886-A, and it was received by the Service on December 28, 20XX. The Organization will not appeal.

It is the Organization's position to agree with the findings, but wishes that an opportunity to re-structure their processes and procedures would have been offered. The Organization believes their efforts provide a much needed service to the citizens of County and over-burdened landfills.

Government Position

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It is the Government's position that the Organization is operating for the private benefit of its founder, Founder's for-profit business, CO-1. The Organization is picking up thousands of donated books from the public; however, only a small percentage of those books are re-donated to other charities. Likewise, most of these donated books were sold to or through CO-1. Thus, the Organization's book donations provide significant zero cost inventories for CO-1 to sell in it's used for profit book store.

Additionally, sales through CO-1 were made at the expense of the Organization through consignment agreements. Through consignment agreements the Organization paid a significant amount of its gross revenue to CO-1 in the form of fees. After this the Organization splits the remaining net profit with CO-1 equally.

During 20XX, none of the revenue was paid in fees or expenses to CO-1. However, in 20XX, % of the consignment revenue was paid in fees and expenses to CO-1. The gross amount of revenue received from the special event warehouse and parking lot sales was not disclosed to the Service.

In 20XX, % of the consignment revenue obtained through July 31, 20XX, was paid in fees and expenses to CO-1. The total amount of fees and expenses for 20XX is not known as of the date of this report.

In Regulations §1.501(c)(3)-1(d)(iii) Example 2, the art museum had a consignment arrangement to display and sell works by unknown individual artists. The art museum retained 10 percent of its proceeds for operations and gave 90 percent of the proceeds from its activity to the individual artists. The arrangement gave substantial benefit to the artists and caused the art museum to be operated for the benefit of private interests and not exclusively for exempt purposes.

Likewise, the Organization's arrangements with CO-1 are giving substantial benefit to the for-profit. CO-1 is substantially benefiting from the Organization's activity to pick up donated books at no charge to donees. A substantial percentage of the proceeds from selling books donated to the Organization are given to CO-1. Thus, as in Regulations §1.501(c)(3)-1(d)(iii) Example 2, the consignment arrangements between the Organization and CO-1 cause the Organization to be operated for the benefit of private interests and not exclusively for exempt purposes.

In *Hawaii v. Commissioner*, the court determined that when a corporation allows a commercial business to benefit substantially from its operations, that this is a considerable factor in determining the corporation is not exempt.

To establish that it is operated exclusively for exempt purposes, an organization must prove that it is operated for a public purpose rather than for the benefit of private interests, such as those of the creator or his family, shareholders, or designated individuals. Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii).

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As shown in *Am. Campaign Acad. V. Commissioner*, when an organization operates for the benefit of private interests, such as the creator or his family, the organization by definition does not operate exclusively for exempt purposes.

It is the Government's position that the Organization is operating for the private interests of its creator's for profit business, CO-1. As a result, the majority of the Organization's efforts and activities exist to benefit CO-1 more than the public. As shown above, the Organization's activities exist to promote, market, and profit CO-1, and are not operated for public purposes.

It is the Government's position that the Organization's tax exempt status under Code §501(c)(3) should be revoked because the Organization operated primarily for private benefit of CO-1, a for-profit motto, owned by Founder, the founder of the Organization.

Conclusion:

Issue 1 – It is the Government's position that the Organization was operated for commercial purposes rather than exclusively for exempt purposes as required by Code §501(c)(3) during the years under examination because its activities primarily benefit its founder's for-profit business, CO-1. As a result, the Organization's tax exempt status should be revoked because it has failed to operate exclusively for exempt purposes as required by Code §501(c)(3) during the years under examination.

Issue 2 – It is the Government's position that the Organization operated primarily for private benefit during the years under examination through its three business agreements with CO-1. These agreements allowed the book donations to benefit the private interests of the founder more than the public. The Organization should be revoked because it serves a private rather than a public purpose. As a result, it has failed to operate exclusively for exempt purposes as required by Code §501(c)(3) during the years under examination.

The tax exemption status should be revoked effective January 1, 20XX.