

Internal Revenue Service
Appeals Office

Department of the Treasury

Date: April 30, 2008

Number: **201428021**

Release Date: 7/11/2014

A
B
C

Person to Contact:

Employee ID Number:

Tel:

Fax:

Refer Reply to:

In Re:

Form Required to be Filed:

Tax Period(s) Ended:

**Last Day to File a Petition with the
United States Tax Court:**

UIL: 501.03-05

LEGEND:

A =

B =

C =

Certified Mail

Dear _____

This is a final adverse determination as to your exempt status under section 501(c)(3) of the Internal Revenue Code (IRC). It is determined that you do not qualify as exempt from Federal income tax under IRC Section 501(c)(3) effective November 1, 1995.

Our adverse determination was made for the following reason(s): A substantial part of your activities consists of providing down payment assistance to home buyers. To finance the assistance, you rely on home sellers and other real-estate related businesses that stand to benefit from these down payment assistance transactions. Your receipt of a payment from the home seller corresponds to the amount of the down payment assistance provided in substantially all of your down payment assistance

transactions. The manner in which you operate demonstrates you are operated primarily to further your insiders' business interests. Therefore, you are operated for a substantial nonexempt purpose. In addition, your operations further the private interests of the persons that finance your activities. Accordingly, you are not operated exclusively for exempt purposes described in section 501(c)(3).

Contributions to your organization are not deductible under Code section 170.

You are required to file Federal income tax returns on the form indicated above. You should file these returns within 30 days from the date of this letter, unless a request for an extension of time is granted. File the returns in accordance with their instructions, and do not send them to this office. Processing of income tax returns and assessment of any taxes due will not be delayed because you have filed a petition for declaratory judgment under Code section 7428.

If you decide to contest this determination under the declaratory judgment provisions of Code section 7428, a petition to the United States Tax Court, the United States Court of Claims, or the district court of the United States for the District of Columbia must be filed within 90 days from the date this determination was mailed to you. Contact the clerk of the appropriate court for rules for filing petitions for declaratory judgment. To secure a petition form from the United States Tax Court, write to the United States Tax Court, 400 Second Street, N.W., Washington, D.C. 20217.

We will notify the appropriate State officials of this action, as required by Code section 6104(c). 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, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

TEAM MANAGER

Cc:



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY

Internal Revenue Service
TEGE, Exempt Organizations
1100 Commerce Street
Dallas, TX 75242

February 21, 2006

ORG
ADDRESS

Taxpayer Identification Number:

Form:

Tax Year(s) Ended:

Person to Contact/ID Number:

Contact Numbers:

Telephone:

Fax:

Certified Mail - Return Receipt Requested

Dear _____ ;

We have enclosed a copy of our report of examination explaining why we believe revocation of your exempt status under section 501(c)(3) of the Internal Revenue Code (Code) is necessary.

If you accept our findings, take no further action. We will issue a final revocation letter.

If you do not agree with our proposed revocation, you must submit to us a written request for Appeals Office consideration within 30 days from the date of this letter to protest our decision. Your protest should include a statement of the facts, the applicable law, and arguments in support of your position.

An Appeals officer will review your case. The Appeals office is independent of the Director, EO Examinations. The Appeals Office resolves most disputes informally and promptly. The enclosed Publication 3498, *The Examination Process*, and Publication 892, *Exempt Organizations Appeal Procedures for Unagreed Issues*, explain how to appeal an Internal Revenue Service (IRS) decision. Publication 3498 also includes information on your rights as a taxpayer and the IRS collection process.

You may also request that we refer this matter for technical advice as explained in Publication 892. If we issue a determination letter to you based on technical advice, no further administrative appeal is available to you within the IRS regarding the issue that was the subject of the technical advice.

If we do not hear from you within 30 days from the date of this letter, we will process your case based on the recommendations shown in the report of examination. If you do not protest this proposed determination within 30 days from the date of this letter, the IRS will consider it to be a failure to exhaust your available administrative remedies. Section 7428(b)(2) of the Code provides, in part: "A declaratory judgment or decree under this section shall not be issued in any proceeding unless the Tax Court, the Claims Court, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted its administrative remedies within the Internal Revenue Service." We will then issue a final revocation letter. We will also notify the appropriate state officials of the revocation in accordance with section 6104(c) of the Code.

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

If you have any questions, please call the contact person at the telephone number shown in the heading of this letter. If you write, please provide a telephone number and the most convenient time to call if we need to contact you.

Thank you for your cooperation.

Sincerely,

Marsha Rameriz,
Director, Exempt Organizations

Enclosures:
Publication 892
Publication 3498
Report of Examination

Form 886A	Department of the Treasury - Internal Revenue Service Explanation of Items	Schedule No. or Exhibit
Name of Taxpayer ORG		Year/Period Ended 20XX12/20XX12

LEGEND

ORG = Organization name XX = Date XYZ = State City = city
motto = motto Founder-1 = 1st founder Founder-2 = 2nd founder CO-1,
CO-2, CO-3 & CO-4 = 1st, 2nd, 3rd & 4th companies

ISSUE

Is ORG (ORG) operated exclusively for an exempt purpose within the meaning of section 501(c)(3) of the Internal Revenue Code (the "Code")?

FACTS

Background

ORG, (ORG) was incorporated under XYZ law on November 1, 19XX, and was recognized as exempt from federal income tax as an organization described in section 501(c)(3) of the Internal Revenue Code by letter dated February 22, 19XX, issued by the District Director of Internal Revenue Service in City, XYZ. According to its By-Laws, ORG was organized to perform activities that are exclusively charitable within the meaning of section 501(c)(3) of the Internal Revenue Code.

ORG's Articles of Incorporation state that ORG would accomplish its charitable mission by providing housing to low-median income families through programs sponsored by the United States Department of Housing and Urban Development (HUD). HUD programs allow non-profit organizations to purchase HUD owned properties at a discount of up to 30 percent in revitalization areas and up to 15 percent in non-revitalization areas. HUD intended that the discounted sales price would allow non-profit agencies to rehabilitate the properties if necessary and then to resell them to low and moderate-income homebuyers at a reduced, affordable price.

In its Application for Recognition of Exemption, Form 1023, dated November 2, 19XX, ORG stated its purpose as follows:

Homes will be purchased by the Corporation from the United States Department of Housing and Urban Development, repaired, then sold or leased with the option to purchase to low-median income families.

The Corporation will clean-up credit of these people during the Lease period so that they can purchase the homes. Any profit made from the sale of homes will go for expenses and to purchase more homes, and to repair homes. A portion of the Lease payments will be applied to the down payment of the homes.

By letter dated May 23, 20XX, ORG requested that HUD remove ORG from HUD's list of approved non-profit organizations. ORG no longer participates in the HUD property revitalization program.

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Down Payment Assistance Transactions

In 19XX, ORG began a seller funded motto (“Motto”) in addition to the HUD property revitalization program. After ORG requested that it be removed from the HUD property revitalization program in May 20XX, it conducted the Motto as its primary activity..

Promotional material published by ORG states that ORG, as a section 501(c)(3) non-profit company, is allowed, under FHA guidelines, to gift down payments to anyone purchasing a home with a FHA loan. ORG’s promotional material is available at ORG’s website at. (Also reference Exhibits 1, attached)

Under the Motto, ORG gifts 3 percent, or more, of the final contract price of the home to the buyer as a down payment and wires these funds to the closing agent 24 hours prior to closing. TO participate in ORG’s Motto, the seller/builder must pay ORG a Service Fee consisting of a current processing fee, or 1 percent of the final sales price, whichever is less, plus an amount equal to the down payment of the seller/builder’s home. Form 106 Revision 2/17/20XX “SELLERS/BUILDERS PARTICIPATING HOME SERVICE FEE AGREEMENT”, for the years at issue, states that the processing fee is \$ for new construction and \$, for resale property. (Exhibit 2 attached, sanitized copy) The closing agent must wire this Service Fee (the processing fee plus the down payment amount) to ORG immediately after the closing. The payment of the fee is conditioned on the successful sale of the seller’s home.

Material published by ORG states that it is the seller/builder’s responsibility to insure that the subdivision/home meets FHA guidelines and must be approved for an FHA loan. Participating sellers and builders must sign the ORG “Sellers/Builder’s Participating Home Service Agreement”, Form 106. In addition, the material states, “A service fee will be deducted from the seller’s funds at closing and wired to ORG. The service fee is the flat processing fee plus the gift requested and wired to the closing agent. The service fee is not part of the FHA allowable 6% seller contribution to the buyer for closing and other costs.” The material states that the builders must use a lender that has been approved by ORG.

Material published by ORG states that sellers and listing agents will receive the following advantages from participating in ORG’s Motto:

First, the seller will receive top appraised price for the property with little or no negotiations in the sales price.

The property will sell faster, usually within 30 days, because the pool of prospective buyers is larger since there is no money coming from the buyer. This means that the seller is not saddled with additional, unnecessary monthly notes to pay. Every time a seller pays a payment on the house that is money the seller will never get back from the sale of the property. That money is

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gone forever. After all, the price of the house will not go up because the seller is making payments on the house.

Last, but not least, the seller can make more bottom line money from the sale of the property by using the

The material illustrates how the seller can make extra money from the sale of the property by participating in ORG's Motto in the following example:

EXAMPLE:

Asking Price/Appraised value of house is \$ 3% gift with a \$ processing fee

Program	Normal Real Estate	ORG
Transaction		
Contract Sales Price	\$	\$
Closing Costs	\$	\$
Real Estate Commission	\$	\$
FHPP Service Fee	\$0	\$
Net to Seller	\$	\$

Material published by ORG further states that if the house appraises for more than the asking price, the seller could benefit even more by raising the price of the house to the appraised price. ORG's promotional material directed at home builders advises them that they will benefit from participating in ORG's Motto by getting access to a wider pool of potential buyers, selling the property more quickly and obtaining a better price for the property. ORG's promotional material sums up the benefits from ORG's Motto to all its participants as follows: "This program is a Win for the seller, a Win for the builder and a Win for the real estate agent, and a family will be able to realize the American Dream of Homeownership." In addition, ORG has recently begun offering free processing software to lenders and other real estate professionals to facilitate their participation in ORG's Motto.

Material published by ORG states that its down payment assistance is available to anyone, regardless of income, who qualifies for an FHA loan. The material states that ORG's "goal is to make homes available to every family that would like to have one." Participation in the program is not limited to specific types of property or geographic areas. Participation in the program is not limited to first time buyers. The material states the following Buyer's Responsibilities

The Buyer must qualify for an FHA or a conventional loan through a certified mortgage company and loan officer and meet all FHA guidelines.

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The Buyer must purchase a home from a seller or builder who agrees to participate in the ORG Down Payment Gift Program. The seller must meet all requirements that make a home a Participating Home.

Material published by ORG states the following Lender's Responsibilities:

The Lender must insure that the mortgage company is an approved FHA lender. The lender may use ORG's Down Payment Gift Program with any loan as long as the wholesaler/investor allows a down payment to be paid by a non-profit organization.

The Lender must also insure that the required documents are Faxed or processed on-line to ORG on a timely basis.

The Lender must submit ORG's "Request For Down Payment Gift Funds" Form 113, if not using on-line processing.

The Lender must submit a signed ORG "Sellers/Buyers Participation Home Service Fee Agreement" Form 106. The Lender must Fax the closing agents wiring instructions, for the wiring of gift funds, if not using the on-line processing.

The Lender must Fax a memo or call ORG confirming that the loan has been approved and is ready to close. The Lender must have a gift letter signed by ORG. This letter will be faxed to the Lender by ORG within one hour of receipt of request.

Material published by ORG also states that a Participating Home must be insurable and pass all FHA inspection requirements. A Participating Home must appraise for the contract price, or higher. The November 20XX report from the United States Government Accountability Office "Mortgage Financing – Additional Action Needed to Manage Risk of FHA-Insured Loans with Down Payment Assistance" states on page 1 of that report that "FHA-insured homes with seller-funded non-profit assistance sold for 2 to 3 percent more than homes without such assistance."

ORG's website contains some general "home buying tips" for buyers. ORG also claims to offer homebuyer education workshops. Material published by ORG, however, expressly states that ORG does not require homebuyer education as a prerequisite for participating in its Motto.

On ORG's website there is posted the following statement concerning the deductibility of the service fees paid by the sellers to ORG: "Never has ORG or the Internal Revenue Service recognized the ORG' service fee paid by the seller to be a charitable contribution. If you have any questions on this matter please seek advice from your certified accountant or the Internal Revenue Service."

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Marketing Agreement

ORG entered into an "Exclusive Marketing Agreement" (Agreement) with CO-1 (CO-3), a CO-2, on January 2, 20XX (Exhibit 3, attached). CO-3 is a Limited Liability Corporation filing as a partnership tax return. Founder-1 is the founder and a partner in CO-3, he receives 95% of it's Profits, Losses and Ownership of Capital. Founder-2 (Founder-1's wife) is a partner in CO-3 and receives 5% of it's Profits, Losses and Ownership of Capital. Together, they own 100% of CO-3. CO-3 was formed, in 20XX for a singular purpose, to process the Motto for ORG. ORG employed a marketing company controlled by its insiders to provide all of its Motto marketing services. The marketing company devoted 100% of its time to the work for ORG. The marketing agency had no other clients. The only Gross Receipts received by CO-3 originated from ORG's Motto. The net income, net loss, and ownership capital flowed through CO-3 to insiders, Founder-1 and his wife, Founder-2.

The Agreement states the following:

Beginning immediately, CO-3 agrees to provide ORG with all the marketing services ORG reasonably deems necessary for the marketing of ORG's programs and services. Such services shall include the following: presenting the ORG programs to mortgage brokers, mortgage bankers, banks, real estate agents, and others as directed by ORG; educating and training all the above via seminars and work sessions; and operating all conventions and show booths designated by ORG."

The Agreement further states the following:

ORG shall pay to CO-3 a per loan fee per month based upon the schedule set forth herein. CO-3 shall earn a fee for each loan processed by ORG. ORG shall pay CO-3 on a monthly basis by the 10th of the month following the month in which the loan is processed.

Following is the remuneration schedule:

- a) Up to 100 loans - \$ per loan
- b) 101 to 200 loans - \$ per loan
- c) 201 to 400 loans - \$ per loan
- d) 401 and up - \$ per loan

ORG will give CO-3 a forecast for the number of gifts expected for the coming each year. If CO-3 meets or exceeds the forecast for that year, CO-3 will receive a bonus of \$ per loan for the total of all gifts for that year. If CO-3 does not reach the forecast for the year, CO-3 will receive no bonus.

In 20XX, ORG paid total marketing fees in the amount of \$ to CO-3. This amount included marketing fees in the amount of \$, plus a \$ Bonus paid on each of 2,330 loans processed for a

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total bonus amount of \$. ORG filed information with its Protest that states that 2,255 closures were forecast.

In 20XX, ORG paid total marketing fees in the amount of \$ to CO-3. According to information filed with ORG's Protest to the examination report, the total number of loans processed was 3,885, and there were 6,875 closures forecast.

In the Protest to the Revenue Agents Report, ORG provided additional Exclusive Marketing Agreements dated March 1, 20XX and January 1, 20XX. The March 1, 20XX Exclusive Marketing Agreement can be found at ORG's Protest Exhibit K. The January 1, 20XX Exclusive Marketing Agreement can be found at ORG's Protest Exhibit N. No mention of these Exclusive Marketing Agreements were made during the examination of ORG. In fact in response to Information Document Request #3 where the agent requested "3. In order to determine the qualifications of the families/Individuals involved in the Motto, Please provide the following: Management contract and or other contracts for Marketing Fees paid to CO-4 for 20XX." In ORG's response to this request, only the Exclusive Marketing Agreement dated January 1, 20XX was provided. ORG never mentioned any other Exclusive Marketing Agreements. In addition, ORG contracted with a Certified Public Accountant to perform a Compilation Report for its financial position at the end of various periods. In ORG's ACCOUNTANTS COMPILATION REPORT for the period December 31, 20XX and 20XX, Notes to Financial Statements, Note 2. Related Party Transactions, it is stated "Effective January 1, 20XX, the Organization [ORG] contracted for marketing materials and services with a company owned by the Organization's [ORG] founder, who remains a member of the board of directors..." In ORG's ACCOUNTANTS COMPILATION REPORT for the period December 31, 20XX and 20XX, Notes to Financial Statements, Note 2. Related Party Transactions, it is stated "Effective January 1, 20XX, the Organization [ORG] contracted for marketing materials and services with a company owned by the Organization's [ORG] founder, who remains a member of the board of directors..." No mention is made of Exclusive Marketing Agreements dated March 1, 20XX or January 1, 20XX.

The General Ledger and Form 990 for ORG for 20XX and 20XX reported activity from ORG's Motto, i.e., service fee (the processing fee plus the down payment gift given to the buyer) from the sellers, down payment gifts to the buyers and the marketing fees to CO-3, as follows:

	<u>20XX</u>	<u>20XX</u>
SERVICE FEES		
DOWN PAYMENT GIFTS		
NET SERVICING FEES		
MARKETING FEES		
FUNDS AVAILABLE FOR OTHER EXPENSES		

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ORG paid Marketing Fees to CO-3 that represented 95% (\$/\$) of the Net Servicing Fees for 20XX and 53.48% (\$/\$) of the Net Servicing Fees for 20XX. Beginning with October 20XX, ORG paid a flat fee for the last three months of 20XX to CO-3 of \$ each month. The marketing agreement ended at the end of 20XX. The Marketing Fees paid by ORG to CO-3 represented 100% of the Gross Revenues received by CO-3 for 20XX and 20XX.

ORG December 31, 20XX and 20XX Accountants Compilation Report "Notes To Financial Statements" number two (2) Related Party Transactions, states the following:

Previously the Organization [ORG] contracted for marketing materials and services with a company owned by the Organization's [ORG] founder, who remains a member of the board of directors. Because of the external market conditions of the Organization's [ORG] industry, as of 20XX this contract was terminated and all marketing and related services are now provided by the Organization's [ORG] employees. As of December 31, 20XX, the accounts payable related party balance of \$ represents accrued but unpaid fees. The fees paid under this contract represent the costs of marketing the Organization's [ORG] motto to realtors and mortgage bankers nationwide."

LAW

ISSUE: FAILURE TO OPERATE EXCLUSIVELY FOR EXEMPT PURPOSES

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. *Treasury Regulations Section 1.501(c)(3)-1(c)(1)* provides that an organization operates exclusively for exempt purposes only if it engages primarily in activities that accomplish exempt purposes specified in *section 501(c)(3) of the Code*. An organization must not engage in substantial activities that fail to further an exempt purpose. In *Better Business Bureau of Washington, D.C. v. U.S.*, 326 U.S. 279, 283 (1945), the Supreme Court held that the "presence of a single . . . [nonexempt] purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly . . . [exempt] purposes." *Treasury Regulations Section 1.501(c)(3)-1(d)(1)(ii)* provides that an organization is not organized or operated exclusively for exempt purposes unless it serves a public rather than a private interest. To meet this requirement it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests.

Treasury Regulations Section 1.501(c)(3)-1(d)(2) defines the term "charitable" as used in *501(c)(3) of the Code* as including the relief of the poor and distressed or of the underprivileged and the promotion of social welfare by organizations designed to lessen neighborhood tensions, to eliminate prejudice and discrimination, or to combat community deterioration. The term "charitable" also includes the advancement of education. Id.

Treasury Regulations Section 1.501(c)(3)-1(e) provides that an organization that operates a trade or business as a substantial part of its activities may meet the requirements of *section 501(c)(3) of*

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the Code if the trade or business furthers an exempt purpose, and provided the organization's primary purpose does not consist of carrying on an unrelated trade or business.

Operating a Trade or Business for a Substantial Nonexempt Purpose

In Easter House v. United States, 12 Cl. Ct. 476, 486 (1987), aff'd, 846 F.2d 78 (Fed. Cir.) cert. denied, 488 U.S. 907 (1988), the court held that an organization that operated an adoption agency was not exempt as an organization described in section 501(c)(3) of the Code because a substantial purpose of the agency was a nonexempt commercial purpose. The court concluded that the organization did not operate exclusively for an exempt purpose because its primary activity was placing children for adoption in a manner indistinguishable from that of a commercial adoption agency. The court rejected the organization's argument that the adoption services merely complemented the health related services to unwed mothers and their children. Rather, the court found that the health-related services were merely incident to the organization's operation of an adoption service, which, in and of itself, did not serve an exempt purpose. The court also found that the organization competed with for-profit adoption agencies, engaged in substantial advertising, and accumulated substantial profits. The organization's sole source of support was the fees it charged adoptive parents, rather than contributions from the public. Accordingly, the court found that the "business purpose, and not the advancement of educational and charitable activities purpose, of plaintiff's adoption service is its primary goal" and held that the organization was not operated exclusively for purposes described in section 501(c)(3). Easter House, 12 Cl. Ct. at 485-486.

In Airlie Foundation v. Commissioner, 283 F. Supp. 2d 58 (D.D.C., 2003), the court relied on the "commerciality" doctrine in applying the operational test to an organization that operated a conference center as its primary activity and derived most of its revenues from user fees. Because of the commercial manner in which this organization conducted its activities, the court found that it was operated for a non-exempt commercial purpose, rather than for a tax-exempt purpose. In reaching this conclusion, the court stated that "[a]mong the major factors courts have considered in assessing commerciality are competition with for profit commercial entities; extent and degree of below cost services provided; pricing policies; and reasonableness of financial reserves. Additional factors include, *inter alia*, whether the organization uses commercial promotional methods (e.g. advertising) and to the extent to which the organization receives charitable donations." Id. At 63

Private Benefit

In American Campaign Academy v. Commissioner, 92 T.C. 1053 (1989), the court held that an organization that operated a school to train individuals for careers as political campaign professionals and could not establish that it operated on a nonpartisan basis, did not exclusively serve purposes described in section 501(c)(3) of the Code because it also served private interests more than incidentally. The court found that the organization was created and funded by persons affiliated with particular party entities and that most of the organization's graduates worked in campaigns for that party's candidates. Consequently, the court concluded that the organization

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conducted its educational activities with the objective of benefiting one party's candidates and entities. Although the candidates and entities benefited were not organization "insiders," the court stated that the conferral of benefits on disinterested persons who are not members of a charitable class may cause an organization to serve a private interest within the meaning of section 1.501(c)(3)-1(d)(1)(ii) of the regulations. The court concluded by stating that even if the party's candidates and entities did "comprise a charitable class, [the organization] would bear the burden of proving that its activities benefited members of the class in a non-select manner." In *Aid to Artisans, Inc. v. Commissioner*, 71 T.C. 202 (1978), the court held an organization that marketed handicrafts made by disadvantaged artisans through museums and other nonprofit organizations and shops was operated exclusively for charitable purposes within the meaning of section 501(c)(3) of the Code. The organization, in cooperation with national craft agencies, selected the handicrafts it would market from craft cooperatives in communities identified as disadvantaged based on objective evidence the Bureau of Indian Affairs or other government agencies. The organization marketed only handicrafts it purchased in bulk from these communities of craftsmen. It did not market the kinds of products produced by studio craftsmen. It did not select individual craftsmen based on the needs of the purchasers. The court concluded that the overall purpose of the activity was to benefit disadvantaged communities. The organization's commercial activity was not an end in itself but merely the means through which the organization pursued its charitable purposes. The method it used to achieve its purpose did not cause it to serve primarily private interests because the disadvantaged artisans directly benefited by the activity constituted a charitable class and the organization showed no selectivity with regard to benefiting specific artisans. Therefore, the court held that the organization operated exclusively for exempt purposes.

Revenue Ruling 67-138, 1967-1 C.B. 129, held that helping low income persons obtain adequate and affordable housing is a "charitable" activity because it relieves the poor and distressed or underprivileged. The organization described in the ruling carried on several activities directed to assisting low-income families obtain improved housing, including (1) coordinating and supervising joint construction projects, (2) purchasing building sites for resale at cost, and (3) lending aid in obtaining home construction loans.

Revenue Ruling 70-585, 1970-2 C.B. 115, discussed four examples of organizations providing housing and whether each qualified as charitable within the meaning of section 501(c)(3) of the Code. Situation 1 described an organization formed to construct new homes and renovate existing homes for sale to low-income families who could not obtain financing through conventional channels. The organization also provides financial aid to eligible families who do not have the necessary down payment. When possible, the organization recovered the cost of the homes through very small periodic payments, but its operating funds were obtained from federal loans and contributions from the general public. The revenue ruling held that by providing homes for low-income families who otherwise could not afford them, the organization relieved the poor and distressed.

Situation 2 described an organization formed to ameliorate the housing needs of minority groups by building housing units for sale to persons of low and moderate income on an open-occupancy basis. The housing was made available to members of minority groups who are unable to obtain

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adequate housing because of local discrimination. The housing units are located to help reduce racial and ethnic imbalances in the community. Since the activities were designed to eliminate prejudice and discrimination and to lessen neighborhood tensions, the revenue ruling held that the organization was engaged in charitable activities within the meaning of *section 501(c)(3) of the Code*.

Situation 3 described an organization formed to develop plans for the renewal and rehabilitation of a particular area in a city as a residential community. The median income level in the area was lower than in other sections of the city, and the housing in the area was generally old and badly deteriorated. The organization developed an overall plan for the rehabilitation of the area; it sponsored a renewal project; and involved residents in the area renewal plan. The organization also purchased apartment buildings that it rehabilitated and rented at cost to low and moderate income families with a preference given to residents of the area. The revenue ruling held that the organization is described in *section 501(c)(3) of the Code* because its activities combated community deterioration.

Situation 4 described an organization formed to alleviate a shortage of housing for moderate-income families in a particular community. The organization planned to build housing to be rented at cost to moderate-income families. The Service held that the organization failed to qualify for exemption under *section 501(c)(3) of the Code* because the organization's program did not provide relief to the poor or further any other charitable purpose within the meaning of *section 501(c)(3)* and the regulations.

Even if an organization's activities serve a charitable class or are otherwise charitable within the meaning of *section 501(c)(3)*, to qualify for exemption by reason of being described in *section 501(c)(3)*, the organization must demonstrate that its activities serve a public rather than a private interest within the meaning of Reg. Section 1.501(c)(3)-1(d)(1).

Revenue Ruling 72-147, 1972-1 C.B. 147, held that an organization that provided housing to low income families did not qualify for exemption under *section 501(c)(3) of the Code* because it gave preference to employees of business operated by the individual who also controlled the organization. The service reasoned that although providing housing for low income families furthers charitable purposes, doing so in a manner that gives preference to employees of the founder's business primarily serves the private interest of the founder rather than a public interest. In *Church Mail, Inc. v Commissioner*, 765 F. 2d 1387 (9th Cir. 1985), the Ninth Circuit held that a church that conducted its activities by mail did not qualify for exemption under *section 501(c)(3)* because a substantial purpose of its activities was to benefit a for-profit corporation controlled by the church's insiders. The church employed an advertising agency controlled by its insiders to provide all of the printing and mailing services for the church's mass mailings. The advertising agency devoted approximately two-thirds of its time to the work for the church. The majority of the church's income was paid to the advertising agency. Although the advertising agency claimed to have clients unrelated to the church, it did not advertise its services and refused to identify its other clients. The Ninth Circuit held that the church was operated for the substantial non-exempt purpose of "providing a market for [the advertising agency's] services" and, thus, primarily served the interests of the advertising agency and its owners rather than a public interest. 765 F. 2d at 1391

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In KJ's Fund Raiser v. Commissioner, T.C. Memo 19XX-424 (19XX), aff'd, 19XX U.S. App. LEXIS 27982 (2d Cir. 19XX), the Tax Court held that an organization formed to raise funds for distribution to charitable causes did not qualify for exemption under section 501(c)(3) because the primary purpose of its activity was to attract customers to its founders' private business. The founders served as officers of the organization and, at times, also controlled the organization's board. The Tax Court found that the founders exercised substantial influence over the affairs of the organization. The organization's business consisted of selling "Lucky 7" or similar instant win lottery tickets exclusively to patrons of KJ's Place. The lottery tickets were sold during regular business hours by the owners of the lounge and their employees. The organization derived most of its funds from the lottery ticket sales. The organization solicited no public donations. From the proceeds of the sales of the lottery tickets, the organization made grants to a variety of charitable organizations. Although supporting charitable organizations may be a charitable ACTIVITY, THE Tax Court nevertheless upheld the Commissioner's denial of exemption to the organization on the ground that the organization's operation resulted in more than incidental private benefit to KJ's Place and, indirectly, its owners. The Second Circuit affirmed.

Inurement

An organization serves a private rather than a public interest within the meaning of Treasury Regulations 1.501(c)(3)-1(d)(1) if any of its assets or earnings inure to the benefit of any insiders or other disqualified persons. See Treasury Regulations 1.501(c)(3)-1(d)(1)(ii). Treasury Regulation section 1.501(a)-1(c) states that "[t]he words 'private shareholder or individual' in section 501 refer to persons having a personal and private interest in the activities of the organization." Any unjust enrichment out of gross or net earnings, may constitute inurement. See People of God Community v. Commissioner, 75 T.C. 127 (1980). Excessive compensation for services is a form of inurement. For example, in Mabee Petroleum Corp. v U.S., 203 F.2d 872, 875 (5th Cir. 1953), payment of a full-time salary for part-time work was held to constitute inurement.

The provision of inurement can be direct or indirect. In Church of Scientology, 823 F.2d at 1315, the organization transferred in excess of \$3.5 million to a for-profit corporation by the organization's founder and his wife. The directors of the corporation were high-ranking members of the Church of Scientology. The directors approved the founder's decision to transfer \$2 million from the corporation's account to the ship *Apollo*, aboard which the founder and his family lived. The Ninth Circuit held that the funds funneled through the for-profit corporation constituted inurement to the founder and his family. Id. At 1318.

In Anclote Psychiatric Ctr. V Commissioner, T.C. Memo 19XX-273 (19XX). An organization's board of directors caused the organization to sell its largest asset – a hospital – to a for-profit entity formed by the directors. The Tax Court determined that the purchase price received by the

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organization on the sale of the hospital was below market. Accordingly, the Tax Court held that the sale transaction resulted in inurement within the meaning of section 501(c)(3). Although the for-profit corporation was the direct beneficiary of the below-market sale transaction, the Tax Court held that the transaction resulted in "an advantage" to the shareholders of the for-profit corporation and that this "advantage" constituted inurement of the organization's charitable assets to the shareholders.

Even a small amount of inurement is fatal to exempt status. In Spokane Motorcycle Club v. United States, 222 F. Supp. 151 (E.D. Wash. 1963), net profits were found to inure to private individuals where refreshments, goods and services in the amount of \$825.00 (representing some 8% of gross revenues) were furnished to members.

GOVERNMENT'S POSITION

Based on the supporting documentation reviewed during this examination, it is concluded that ORG is not operated for exempt purposes.) The documentation provided with respect to ORG indicates that the organization's primary purpose is to operate a motto that does not exclusively serve a purpose described in *section 501(c)(3)*.

Charitable purposes include relief of the poor and distressed. See Treas. Reg. *section 1.501(c)(3)-1(d)(2)*. ORG did not conduct its motto in a manner that establishes that its primary purpose is to address the housing needs of low-income persons. See *Rev. Rul. 70-585*, Sit. 1. ORG's motto does not serve exclusively low-income persons. Instead, ORG's program is open to anyone, with no income limitations. Furthermore, ORG did not review the financial health of applicants or suitability of the properties in order to ensure that the grantee will be able to afford to maintain the house over time and that the houses were habitable. See *Rev. Rul. 67-138, 1967-1 C.B. 129*. ORG has not demonstrated that its motto exclusively serves any other exempt purpose described in Treas. Reg. *1.501(c)(3)-1(d)(2)*. ORG has not shown that its program is designed to attract a mixed-income or mixed-race group of homeowners to a specifically defined geographical area that has a history of neighbor tensions or racial problems. See *Rev. Rul. 70-585*, Situations 2 and 3. Thus, ORG's activities do not serve the purpose of lessening neighbor tensions or eliminating prejudice and discrimination within the meaning of section 501(c)(3). ORG's program does not limit assistance to certain geographic areas or target those areas experiencing deterioration. See *Rev. Rul. 70-585*, Situation 4. Down payment assistance is available for any property that is otherwise able to qualify for a mortgage, regardless of the location of the property. Arranging the purchase of homes in a broadly defined metropolitan area does not combat community deterioration within the meaning of section 501(c)(3) of the Code. Thus, ORG's activities do not serve the purpose of combating community deterioration.

Although ORG has posted a few home buying tips on its website and claims to offer homebuyer education workshops, it does not require homebuyer education as a prerequisite for participation in its program. Moreover, ORG's educational activities are dwarfed in size and scope by its down payment assistance activities. Thus, ORG's activities do not serve an educational purpose within the meaning of section 501(c)(3).

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Only an insubstantial portion of the activity of an exempt organization may further a nonexempt purpose. As the Supreme Court held in Better Business Bureau 326 U.S. at 283, the “presence of a single [non-exempt] purpose, if substantial in nature, will destroy the exemption, regardless of the number or importance of truly [exempt] purposes”. Even if ORG directed its program exclusively to low-income individuals or disadvantaged communities, its total reliance on sellers for financing its Motto would establish that ORG has been operating for the substantial purpose of benefiting private interests of the seller/builders that benefited from ORG brokered down payment assistance transactions.

Like the organization considered in American Campaign Academy, *supra*, ORG is structured and operated to assist the private parties who pay for its services and give it business. Sellers who participate in ORG’s Motto benefit from achieving access to a wider pool of buyers and from being able to get a higher prices for their homes. This fact was documented in the GAO-06-24 report issued in November 20XX (Exhibit 4, printed in part, attached). The private benefit flowing to home sellers from the down payment assistance transactions facilitated or brokered by ORG, even in the case of transactions with low-income homebuyers, is substantial. Real estate professionals who participate in ORG’s Motto, from real estate brokers to escrow companies, benefit from increased sales volume and the attendant increase in their compensation.

The manner in which ORG operated its Motto shows that the private benefit to the various participants in ORG’s activities was the intended outcome of activities and not a mere incident of such activities. ORG’s down payment assistance procedures are designed to channel funds in a circular manner from the sellers to the buyers and back to the sellers in the form of proceeds from the sale of their homes that may have been sold at artificially inflated prices. To finance its activities, ORG relies exclusively on sellers and other real-estate related businesses that benefit from the transactions ORG facilitates. In virtually every ORG brokered transaction, payments from seller/builders to ORG correspond to the amount of the down payment assistance on the seller/builder’s home. ORG neither solicits nor receives funds from sources other than sellers of homes. ORG’s grant making procedures indicate that gift funds are only provided if seller has paid the Service Fee to ORG. The seller’s obligation to pay the Service Fee arises only if there is a closing on their home. In this respect, ORG is like *Easter House*, *supra*, which provided health care to indigent pregnant women, but only when a family willing to adopt a woman’s child sponsored the care financially.

ORG conducted its operations in a manner that is consistent with a commercial firm seeking to maximize sales of services, rather than in a manner that would be consistent with a charitable or educational organization seeking to serve a charitable class or the public at large. Facts show that ORG is in the business of facilitating sales of homes as its primary activity. Facilitating home sales is not an inherently charitable activity. Unlike the trade or business considered in *Aid to Artisans*, *supra*, ORG’s trade or business is not a mere instrument of furthering charitable purposes but is an end in itself. ORG provides services to home sellers for which it charges a market rate fee. The fees are tied to the success of a specific transaction. The fees are designed to make a profit and, thus, are not incidental to the organization’s exempt purpose. Virtually all of ORG’s revenue comes from the sellers. ORG markets and provides its services to a wide variety of individuals and entities. Most of these individuals and entities are not within a

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charitable class. ORG does not solicit funds from any parties that do not have interest in its down payment transactions. Although ORG has characterized the funds it receives from seller/builders as "gifts", these funds are more appropriately characterized as fees received in exchange for the sale of a service. These payments are not contributions which are deductible under section 170 of the Code. These payments also do not qualify as gifts under section 102 because they do not "proceed from detached and disinterested generosity". See Commissioner v. Duberstein, 363 U.S. 278, 285 (1960). ORG's reliance on seller financing and a lack of public support are indicative of a commercial purpose. Like the organization in *Easter House* and *Airlie Foundation*, the manner in which ORG operated is inconsistent with the requirements of section 501(c)(3).

Furthermore, ORG structured its Motto to provide a substantial private benefit to its insiders. ORG and CO-3, a for-profit LLC wholly-owned by Founder-1, had an exclusive marketing agreement whereby ORG carried out its Motto through CO-3. For the years at issue, ORG paid most of its net revenues to CO-3 and was the source of all of CO-3's gross revenues. Like the organizations in Church by Mail, *supra*, 765 F.2d 1387 and KJ's Fund Raiser v. Commissioner, *supra*, T.C. Memo 1997-424, ORG existed for the substantial nonexempt purpose of creating business for CO-3. Thus, like the organization in Church by Mail, *supra*, 765 F.2d 1387 and KJ's Fund Raiser v. Commissioner, *supra*, ORG's operations resulted in a substantial private benefit to ORG's insiders CO-3 and its owner, Founder-1.

ORG's operations also resulted in inurement of its charitable assets to its insiders, including its founder Founder-1. The government takes the position that the fees from ORG to CO-3 constituting 95% of ORG's net revenues in 20XX and 53% of ORG's net revenue in 20XX were excessive. Payment of excessive compensation is a form of inurement. See Mabee Petroleum Corp. v. U.S., 203 F.2d 872, 875 (5th Cir. 1953). Accordingly, ORG's marketing contract with CO-3 resulted in inurement of ORG's charitable assets to CO-3. Furthermore, where a party to a transaction giving rise to inurement is a for-profit entity in which the organization's insiders are shareholders or members, the "advantage" accruing to such shareholders or members from the transaction constitutes inurement. See Anclote Psychiatric Ctr. V. Commissioner, T.C. Memo 1998-273 (1998). Accordingly, ORG's marketing contract with CO-3 resulted in inurement of ORG's charitable assets to Founder-1 as the sole member of CO-3.

Accordingly, it is determined that ORG is not operated exclusively for an exempt purpose and is not described in section 501(c)(3) if the Internal Revenue Code.

Taxpayers Position

ORG's position with respect to the issues, facts, applicable law and government's position as discussed in this report is shown in the attached bound AUDIT EXAMINATION APPEALS REQUEST. ORG disagrees with the agents examination findings and has requested its right to Appeals. Reference Protest at Exhibit 5

Conclusion

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In 19XX, ORG began its Motto. On May 23, 20XX, ORG wrote a letter to HUD requesting its removal from the HUD's list of approved non-profit organizations. ORG's Motto was not identified in its "Application for Recognition of Exemption" Form 1023 filed with the Internal Revenue Service on November 2, 19XX. Facts show that ORG is in the business of facilitating sales of homes as its primary activity. Facilitating home sales is not an inherently charitable activity. Therefore, ORG has not operated exclusively for an exempt purpose within the meaning of section 501(c)(3). Accordingly, ORG is not described in section 501(c)(3) of the Code. Revocation of the exempt status of ORG is proposed back to 19XX, the year in which ORG started its motto.

In the Protest, ORG provides information that there were three Exclusive Marketing Agreements that were negotiated and approved between ORG and the CO-4. This fact does nothing to disqualify the conclusion that there was private benefit to the disqualified person, the founder of ORG and also to private persons, the home sellers.