



Department of the Treasury
Internal Revenue Service
Tax Exempt and Government Entities

Date: February 23, 2023

Taxpayer ID number (last 4 digits):

Form:

Tax periods ended:

Release Number: 202321005

Release Date: 5/26/2023

UIL Code: 501.03-00

Person to contact:

Name:

ID number:

Telephone:

Fax:

Last day to file petition with United States
Tax Court:

May 24, 2023

CERTIFIED MAIL - Return Receipt Requested

Dear _____ :

Why we are sending you this letter

This is a final determination that you don't qualify for exemption from federal income tax under Internal Revenue Code (IRC) Section 501(a) as an organization described in IRC Section 501(c)(3), effective _____ . Your determination letter dated _____ , is revoked.

Our adverse determination as to your exempt status was made for the following reasons: You are not operated exclusively for one or more exempt purposes as required by IRC Section 501(c)(3). You operate a for-profit coffee shop and restaurant for non-exempt commercial purposes. The income from the sale proceeds from the operation of the coffee shop are not exclusively and primarily dedicated to an exempt purpose.

Organizations that are not exempt under IRC Section 501 generally are required to file federal income tax returns and pay tax, where applicable. For further instructions, forms and information please visit [IRS.gov](https://www.irs.gov).

Contributions to your organization are no longer deductible under IRC Section 170.

What you must do if you disagree with this determination

If you want to contest our final determination, you have 90 days from the date this determination letter was mailed to you to file a petition or complaint in one of the three federal courts listed below.

How to file your action for declaratory judgment

If you decide to contest this determination, you can file an action for declaratory judgment under the provisions of Section 7428 of the Code in either:

- The United States Tax Court,
- The United States Court of Federal Claims, or
- The United States District Court for the District of Columbia

You must file a petition or complaint in one of these three courts within 90 days from the date we mailed this determination letter to you. You can download a fillable petition or complaint form and get information about filing at each respective court's website listed below or by contacting the Office of the Clerk of the Court at one of the addresses below. Be sure to include a copy of this letter and any attachments and the applicable filing fee with the petition or complaint.

You can eFile your completed U.S. Tax Court petition by following the instructions and user guides available on the Tax Court website at ustaxcourt.gov/dawson.html. You will need to register for a DAWSON account to do so. You may also file your petition at the address below:

United States Tax Court
400 Second Street, NW
Washington, DC 20217
ustaxcourt.gov

The websites of the U.S. Court of Federal Claims and the U.S. District Court for the District of Columbia contain instructions about how to file your completed complaint electronically. You may also file your complaint at one of the addresses below:

US Court of Federal Claims
717 Madison Place, NW
Washington, DC 20439
uscfc.uscourts.gov

US District Court for the District of Columbia
333 Constitution Avenue, NW
Washington, DC 20001
dcd.uscourts.gov

Processing of income tax returns and assessments of any taxes due will not be delayed if you file a petition for declaratory judgment under IRC Section 7428.

Information about the IRS Taxpayer Advocate Service

The IRS office whose phone number appears at the top of the notice can best address and access your tax information and help get you answers. However, you may be eligible for free help from the Taxpayer Advocate Service (TAS) if you can't resolve your tax problem with the IRS, or you believe an IRS procedure just isn't working as it should. TAS is an independent organization within the IRS that helps taxpayers and protects taxpayer rights. Contact your local Taxpayer Advocate Office at:

Internal Revenue Service

Or call TAS at 877-777-4778. For more information about TAS and your rights under the Taxpayer Bill of Rights, go to taxpayeradvocate.irs.gov. Do not send your federal court pleading to the TAS address listed above. Use the applicable federal court address provided earlier in the letter. Contacting TAS does not extend the time to file an action for declaratory judgment.

Where you can find more information

Enclosed are Publication 1, Your Rights as a Taxpayer, and Publication 594, The IRS Collection Process, for more comprehensive information.

Find tax forms or publications by visiting IRS.gov/forms or calling 800-TAX-FORM (800-829-3676). If you have questions, you can call the person shown at the top of this letter.

If you prefer to write, use the address shown at the top of this letter. Include your telephone number, the best time to call, and a copy of this letter.

You may fax your documents to the fax number shown above, using either a fax machine or online fax service. Protect yourself when sending digital data by understanding the fax service's privacy and security policies.

Keep the original letter for your records.

Sincerely,



Lynn A. Brinkley

Director, Exempt Organizations Examinations

Enclosures:

Publication 1

Publication 594

Publication 892

cc:



**Department of the Treasury
Internal Revenue Service
Tax Exempt and Government Entities
Exempt Organizations Examinations**

Date:
9/16/2022
Taxpayer ID number:

Form:

Tax periods ended:

Person to contact:
Name:
ID number:
Telephone:
Fax:
Address:

Manager's contact information:
Name:
ID number:
Telephone:
Response due date:
10/17/2022

CERTIFIED MAIL – Return Receipt Requested

Dear _____ :

Why you're receiving this letter

We enclosed a copy of our audit report, Form 886-A, Explanation of Items, explaining that we propose to revoke your tax-exempt status as an organization described in Internal Revenue Code (IRC) Section 501(c)(3).

If you agree

If you haven't already, please sign the enclosed Form 6018, Consent to Proposed Action, and return it to the contact person shown at the top of this letter. We'll issue a final adverse letter determining that you aren't an organization described in IRC Section 501(c)(3) for the periods above.

After we issue the final adverse determination letter, we'll announce that your organization is no longer eligible to receive tax deductible contributions under IRC Section 170.

If you disagree

1. Request a meeting or telephone conference with the manager shown at the top of this letter.
2. Send any information you want us to consider.
3. File a protest with the IRS Appeals Office. If you request a meeting with the manager or send additional information as stated in 1 and 2, above, you'll still be able to file a protest with IRS Appeals Office after the meeting or after we consider the information.

The IRS Appeals Office is independent of the Exempt Organizations division and resolves most disputes informally. If you file a protest, the auditing agent may ask you to sign a consent to extend the period of limitations for assessing tax. This is to allow the IRS Appeals Office enough time to consider your case. For your protest to be valid, it must contain certain specific information, including a statement of the facts, applicable law, and arguments in support of your position. For specific information needed for a valid protest, refer to Publication 892, How to Appeal an IRS Determination on Tax-Exempt Status.

Fast Track Mediation (FTM) referred to in Publication 3498, The Examination Process, generally doesn't apply now that we've issued this letter.

4. Request technical advice from the Office of Associate Chief Counsel (Tax Exempt Government Entities) if you feel the issue hasn't been addressed in published precedent or has been treated inconsistently by the IRS.

If you're considering requesting technical advice, contact the person shown at the top of this letter. If you disagree with the technical advice decision, you will be able to appeal to the IRS Appeals Office, as explained above. A decision made in a technical advice memorandum, however, generally is final and binding on Appeals.

If we don't hear from you

If you don't respond to this proposal within 30 calendar days from the date of this letter, we'll issue a final adverse determination letter.

Contacting the Taxpayer Advocate Office is a taxpayer right

The Taxpayer Advocate Service (TAS) is an independent organization within the IRS that can help protect your taxpayer rights. TAS can offer you help if your tax problem is causing a hardship, or you've tried but haven't been able to resolve your problem with the IRS. If you qualify for TAS assistance, which is always free, TAS will do everything possible to help you. Visit www.taxpayeradvocate.irs.gov or call 877-777-4778.

For additional information

You can get any of the forms and publications mentioned in this letter by visiting our website at www.irs.gov/forms-pubs or by calling 800-TAX-FORM (800-829-3676).

If you have questions, you can contact the person shown at the top of this letter.

Michelle Henson

Michelle Henson signing for
Lynn A. Brinkley
Acting Director, Exempt Organizations
Examinations

Enclosures:
Form 886-A
Exhibit 1 to 8
Form 6018
Form 4621-A
Form 4549
Publication 892
Publication 3498

Form 886-A (Rev. May 2017)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
Name of taxpayer	Tax Identification Number (Last 4 digits)	Year/Period ended

Issue:

Whether [redacted] exempt status under IRC section 501(c)(3) should be revoked on the grounds that it is operating for a substantial non-exempt purpose, operating a for-profit

Facts:

The exempt organization, [redacted] was founded on [redacted], in the [redacted]. [redacted] is a corporation under the laws of the [redacted]. The organization was recognized as an exempt organization under Internal Revenue Code Section 501(c)(3) on [redacted] with effective date of [redacted], as per Internal Revenue Service's records. The current address of the organization is [redacted].

According to the organization's Articles of Incorporation, the organization is organized exclusively for the charitable purposes, more specifically to [redacted].

Exempt Organization's Activities:

The Summary of Narrative Description of Activities on Form 1023 Application for Recognition of Exemption Under Section 501(c)(3) of Internal Revenue Code. (See Exhibit 1 and 2 for detail)

•

The organization's activities described by the founder/executive director during the field examination on [redacted]:

- As stated by the executive director during the initial interview, the organization operates with a centralized purpose of organizing awareness events and presentations for local businesses, schools, and other facilities about [redacted].
- The organization also provide training for [redacted] to assist with the [redacted]. The training is provided via a [redacted].
- The organization partners with other organizations to provide funds for food and shelter.
- The organization educates the general public including youth to [redacted].

Form 886-A (Rev. May 2017)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
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- The organization rents out a portion of the facility to other organizations and local businesses to host awareness events.
- Operates _____ in which some of the proceeds from the sale are donated to exempt organizations.
- Sales of merchandizes made by _____

The main activities identified during the field examination was the sales of _____ from _____ and other vendors. There was also income from the rental of the space by other organizations for events.

The _____ is open to the general public to sell _____ days a week, _____ (_____), and _____ similar to a for-profit _____.

The exempt organization's hours of operation are stated below:

- Monday to Friday: _____ AM – _____ PM
- Sunday: _____ AM – _____ PM

The employees of the _____ in _____ and _____ were not _____ per the founder/executive director. Therefore, the organization was not providing employment opportunities for _____ as stated on the organization's Form 1023.

The hours of operation of the _____ annually are _____ hours, in which _____ hours in _____, and _____ hours were spent related to the exempt activities. It was stated that most of the exempt activities were moved to virtual due to COVID-19 in _____ but there were no supporting documents provided to verify that. (See Exhibit 3 and 4).

The tour of the facility revealed the organization is operating as a _____ similar to a for-profit _____. The exempt activities appear not to be the main focus of the organization. The activities that are in furtherance of the exempt purpose are not conducted as regularly as the _____ sales and other profit producing activities, and the proceeds from the profit producing activities are put back into the budget of the _____ to pay expenses for operation of the facility.

Analysis of the exempt organization's books and records reveals that the majority of the organization's income is from the _____ sales, apart from the donations from individuals and corporations.

The proceed from the _____ goes to purchasing _____ supplies. The exempt organization's fund goes to paying the salaries and other benefits to the employees that are not _____.

Form 886-A (Rev. May 2017)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
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The minutes of Board of Directors reviewed for the years under examination also revealed the main objectives of the organization, is to increase the sales of the merchandize, salaries, benefits of the founder/executive director, other employees, and to reduce cost in order to make profit. (See Exhibit 5).

The organization was granted an exemption on the fact that the organization will provide in-house training programs and employment opportunities for . It will provide support to enable to them to reintegrate back into society. These programs include counseling, childcare for employees, tutoring, group therapy sessions, job training, GED classes, resume writing and financial mentoring. It will operate a in which it will provide in-house training programs and employment opportunities for . The examination of the organization revealed that:

- The organization appears to have a small percentage of actual assistance to victim of , the emphasis is on operating the and obtaining profits from the sales.
- The program is the main method of exempt purpose activity and is not the full-time focus of the organization. The organization did not provide any documentation or records to support that they are operating a program to during the year and .
- Also, the organization had no records of assisting , no programs to re-introduce them into society as stated in the application in any form. The only assistance was donations to other assistors.
- The newsletters and the seminars assist the knowledge and awareness, but more help needs to be provided to the actual victims since the purpose is to assist the victims.
- Per the organization's minutes of meetings, the menu of the was enhanced with to increase the profit of the organization.
- The internal controls of the organization are not adequate, founder/executive director was in charge of opening the organization's mail, making deposits, writes and signs the checks.

Law:

Internal Revenue Code (IRC) Section 501(c)(3) exempts from Federal income tax 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 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 and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.

Form 886-A (Rev. May 2017)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
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Treasury. Regulation Section 1.501(c)(3)-1(d)(i) states that an organization may be exempt as an organization described in 501(c)(3) if it is organized and operated exclusively for one or more of the following purposes: religious, charitable, scientific, testing for public safety, literary, educational, or prevention of cruelty to children or animals.

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

Treas. Reg. 1.501(c)(3)-1(c)(1) of the regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3).

IRC Section 501(c)(3), an organization which is organized and operated exclusively for an exempt purpose (and meets the other requirements of the provision) qualifies as a tax-exempt organization. In order for an organization to be exempt from Federal income taxes under Section 501(a) and (c)(3), it must satisfy both the organizational and operational tests of Section 1.501(c)(3)-1(b) and 1.501(c)(3)-1(c), Income Tax Regs.

In *Better Business Bureau of Washington, D.C., Inc. v. United States*, 326 U. S. 279 (1945), the Supreme Court of the United States interpreted the requirement in Section 501(c)(3) that an organization be "operated exclusively" by indicating that an organization must be devoted to exempt purposes exclusively. This plainly means that the presence of a single non-exempt purpose, if substantial in nature, will destroy the exemption regardless of the number and importance of truly exempt purposes.

In *Fides Publishers Assoc. v. United States*, 263 F. Supp. 924 (1967), the government retroactively revoked the taxpayer's exempt status, concluding that, for the previous five years, the taxpayer was engaged primarily, if not solely, in publishing activities. The court noted that, to qualify for Section 501(c)(3) exemption, the taxpayer must be "organized and operated exclusively for" an exempt purpose. The court rejected the taxpayer's argument that, rather than its primary activity, the court should focus on the end to which that activity was taken, namely, religious education. The court pointed out that the taxpayer's sole activity and purpose was the carrying on of the publishing trade and held that the taxpayer's purpose, rather than its goals, were the focus of Section 501(c)(3).

In *Living Faith Inc. v. Commissioner*, T.C. Memo 1990-484, *aff'd* 950 F. 2d 365 (7th Cir. 1991), the court said that the activities were conducted as a business and the organization was in direct competition with other restaurants and health food stores; thus, it did not qualify for exemption under Section 501(c)(3). The appellate court stated the factors that the court relied upon to find commerciality and thus offered the best contemporary explanation of the commerciality doctrine. These factors include:

Form 886-A (Rev. May 2017)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
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1. The organization sold goods and services to the public.
2. The organization was in direct competition with for profit businesses.
3. The prices set by the organization were based upon pricing formulas common in retail food businesses.
4. The organization utilized promotional material and "commercial catch phrases" to enhance sales.
5. The organization advertised its services and food.
6. The organization did not receive any charitable contributions.

In *Airlie Found. v. IRS*, 283 F. Supp. 2d 58 (D.D.C. 2003), the court laid out the factors for determining whether an organization's activity is of a commercial nature. It said:

"Among 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 . . . whether the organization uses commercial promotional methods (e.g., advertising) and the extent to which the organization receives charitable donations."

The court also decreed that the organization derived substantial income from business entities that rented the facility, but that the center did not provide services at substantially below cost to other Section 501(c)(3) organizations nor did it show that the facility was used by organizations to promote educations with the meaning of Section 501(c)(3).

In *Federation Pharmacy Services, Inc. v. Commissioner*, 625 F.2d 804 (8th Cir. 1980) affg 72 T.C. 687 (1979), the appellate court held that a pharmacy was not exempt as a charitable organization because it was operated for the substantial commercial purpose of selling prescription drugs to the public. Although it provided special discounts for handicapped and senior citizens, it did not provide any drugs below cost or free to indigent persons. Therefore, although its services did improve health in the area, it was primarily a commercial venture operated in competition with other area pharmacies.

TAXPAYER'S POSITION:

The taxpayer's position on the issue is unknown at this time.

Governments Position:

IRC 501(c)(3) requires an organization to be both "organized" and "operated" exclusively for one or more IRC 501(c)(3) purposes. If the organization fails either the organizational test or the operational test, it doesn't qualify for exemption under IRC section 501(c)(3) (See Treas. Reg.

Form 886-A (Rev. May 2017)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
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1.501(c)(3)-1(a)(1)). The operational test applies to the organization's activities and how it furthers exempt purposes.

An organization will be regarded as operated exclusively for exempt purposes only if it engages primarily in activities which accomplish one or more of the following exempt purposes: religious, charitable, scientific, testing for public safety, literary, educational, fostering national or international sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), prevention of cruelty to children or animals (See Treas. Reg. 1.501(c)(3)-1(d)).

An organization won't meet the operational test if:

- More than an insubstantial part of its activities isn't in furtherance of an exempt purpose. See Treas. Reg. 1.501(c)(3)-1(c)(1).
- Its net earnings inure in whole or in part to the benefit of private shareholders or individuals, furthering private (rather than public) interests. See Treas. Reg. 1.501(c)(3)-1(c)(2).
- A substantial part of an organization's activities is attempting to influence legislation by its direct contact, or in urging the public to contact members or employees of a legislative body to propose, advocate and support for the adoption or the rejection of legislation and it is regarded as an "action" organization. See Treas. Reg. 1.501(c)(3)-1(c)(3). For more detail, see Special Rules Related to Lobbying Activities.

Treas. Reg. Section 1.501(c)(3)-1(e)(1) provides that an organization may meet the requirements of Section 501(c)(3) even though it operates a trade or business as a substantial part of its activities unless its primary purpose is carrying on of a trade or business that does not further charitable purposes. Based on the tables listed below, primary purpose was carrying on a trade or business which does not further charitable purposes, because it was operated for the substantial commercial purpose of selling to the public. The time spent on the activities unrelated to the exempt purpose was substantial, the income generated from activities unrelated to the exempt purpose was substantial and the expenses related to the activities unrelated to the exempt purpose was substantial.

Tax Year Ending	Time Spent on Exempt Activities	Time Spent on Activities unrelated to the exempt purpose (operating the)	Percentage of time spent on activities unrelated to the exempt purpose
	hours	hours	%
	hours	hours	%

Tax Year Ending	Income from Exempt Activities	Income from Activities unrelated to the exempt purpose (operating the)	Percentage of income from activities unrelated to the exempt purpose
	\$	\$	%
	\$	\$	%

Form 886-A (Rev. May 2017)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
Name of taxpayer	Tax Identification Number (Last 4 digits)	Year/Period ended

Tax Year Ending	Expenses related to Exempt Activities	Expenses related to Activities unrelated to the exempt purpose (operating the)	Percentage of expenses related to activities unrelated to the exempt purpose
	\$	\$	%
	\$	\$	%

The tour of the facility during the examination shows that the exempt organization was not just selling to the public as stated on the organization Form 1023 but also selling to the public just like for profit organizations. The menu of the was enhanced with to increase the profit of the organization per the meeting minutes. The paid employees of the exempt organization in the years under examinations are not survivors of as stated on the Form 1023 during the determination process. The organization is not operating as a charitable organization because it was operated for the substantial commercial purposes of selling to the public, see *Federation Pharmacy Services, Inc. v. Commissioner*, 625 F.2d 804 (8th Cir. 1980) aff'g 72 T.C. 687 (1979),

The was in direct competition with other for-profit and operated primarily as a commercial business, therefore it does not qualify for exemption under IRC Section 501(c)(3). See *In Living Faith Inc. v. Commissioner*, T.C. Memo 1990-484, aff'd 950 F. 2d 365 (7th Cir. 1991).

Conclusion:

You are not operated exclusively for charitable, religious, or educational purposes consistent with Section 501(c)(3) of the Code and Treas. Reg. Section 1.501(c)(3)-1(d)(1)(i) and therefore fail to meet the operational test under Treas. Reg. Section 1.501(c)(3)-1(b)(4). Specifically, the facts above indicate that you are not operated for exempt purposes but that you are operated in a commercial manner.

Per Treas. Reg. Section 1.501(c)(3)-1(c)(1), you are not operated exclusively for one or more exempt purposes because you do not engage primarily in activities that accomplish one or more of such exempt purposes specified in Section 501(c)(3). Under this Treasury Regulation, an organization will not be regarded as exempt if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

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Alternative Position, if the proposed revocation is not sustained

Unrelated Business Income (UBI)

Issue:

1. Whether the Exempt Organization (EO) is subject to IRC section 511 tax on Unrelated Business Income from the income it received from the activities.
2. Whether Failure to File IRC 6651(a)(1) and Failure to Pay IRC Section 6651(a)(2) applies to the unrelated business income.

Facts:

The Facts of the case remain the same as stated above.

Law:

IRC Section 512(a)(1) defines the term “unrelated business taxable income” as gross income derived by any organization from any unrelated trade or business regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business, both computed with certain modifications.

Section 1.513-1(a) of the Federal Tax Regulations provides that unless one of the specific exceptions of section 512 or 513 is applicable, gross income of an exempt organization subject to the tax imposed by section 511 is includible in the computation of unrelated business taxable income if (1) it is income from trade or business, (2) such trade or business is regularly carried on by the organization, and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions.

Treas. Reg. 1.512(a)-1(a) provides that in general, except as otherwise provided in Section 1.512(a)-3, Section 1.512(a)-4, or paragraph (f) of this section, Code Section 512(a)(1) defines “unrelated business taxable income” as the gross income derived from any unrelated trade or business regularly carried on, less those deductions allowed by chapter 1 of the Code which are directly connected with the carrying on of such trade or business, subject to certain modifications referred to in Treas. Reg. Section 1.512(b)-1. To be deductible in computing unrelated business taxable income, therefore, expenses, depreciation, and similar items not only must qualify as deductions allowed by chapter 1 of the Code, but also must be directly connected with the carrying on of unrelated trade or business. Except as provided in paragraph (d)(2) of this section, to be “directly connected with” the conduct of unrelated business for purposes of Code Section 512, an

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item of deduction must have proximate and primary relationship to the carrying on of that business.

Treas. Reg. Section 1.512(a)-1(b) provides that expenses, depreciation, and similar items attributable solely to the conduct of unrelated business activities are proximately and primarily related to that business activity, and therefore qualify for deduction to the extent that they meet the requirements of Code Section 162, Code Section 167, or other relevant provisions of the Code. Thus, for example, salaries of personnel employed full-time in carrying on unrelated business activities are directly connected with the conduct of that activity and are deductible in computing unrelated business taxable income if they otherwise qualify for deduction under the requirements of Code Section 162. Similarly, depreciation of a building used entirely in the conduct of unrelated business activities would be an allowable deduction to the extent otherwise permitted by Code Section 167.

Treas. Reg. 1.512(a)-1(c) discusses dual use of facilities or personnel. Where facilities are used both to carry on exempt activities and to conduct unrelated trade or business activities, expenses, depreciation, and similar items attributable to such facilities (as, for example, items of overhead) shall be allocated between the two uses on a reasonable basis. Similarly, where personnel are used both to carry on exempt activities and to conduct unrelated trade or business activities, expenses, and similar items attributable to such personnel (as, for example, items of salary) shall be allocated between the two uses on a reasonable basis. The portion of any such item so allocated to the unrelated trade or business activity is proximately and primarily related to that business activity and shall be allowable as a deduction in computing unrelated business taxable income in the manner and to the extent permitted by Code Section 162, Code Section 167 or other relevant provisions of the Code. Thus, for example, assume that X, an exempt organization subject to the provisions of Code Section 511, pays its president a salary of \$20,000 a year. X derives gross income from the conduct of unrelated trade or business activities. The president devotes approximately 10 percent of his time during the year to the unrelated business activity. For purposes of computing X's unrelated business taxable income, a deduction of \$2,000 (10 percent of \$20,000) would be allowable for the salary paid to its president.

IRC Section 162, trade or business expenses shall be allowed as a deduction all ordinary and necessary expense paid or incurred during the taxable year in carrying on any trade or business including.

IRC Section 162 (a)(1) a reasonable allowance for salaries or other compensation for personal services actually rendered.

In *Iowa State University of Science and Technology v. United States*, 500 F.2d 508 (Ct. Cl. 1974), the Court of Claims held that an educational institution could not offset expenses from a university's nonprofit radio station against the unrelated business income from a university's nonprofit radio station against the unrelated business income from its for-profit television station. In its opinion, the court stated that "a nonprofit endeavor, even if operated by a profit-making concern, does not constitute a trade or business for the purpose of deduction of expenses under Code Section 162," supra at 521.

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In *Portland Golf Club v. Commissioner*, *supra*, at 2787, the court held that deductions claimed by a Code Section 501(c)(7) club were allowable, if at all, only under Code Section 162. Since the court had previously ruled that a taxpayer's activities fall within the scope of Code Section 162 only if an intent to profit has been shown, the court found that expenses will be deductible only if the income producing the activity was performed with an intent to profit.

In *Rensselaer Polytechnic Institute v. Commissioner*, 732 F. 2d 1058 (2d Cir. 1984), the court held that whether or not a method of allocating expenses is a reasonable one is a factual determination.

Penalties:

Understatement Penalty

Internal Revenue Code Section 6651(a) Addition to The Tax

In case of failure

Internal Revenue Code Section 6651(a)(1)

Failure to file any return required under authority of subchapter A of chapter 61 (other than part III thereof), subchapter A of chapter 51 (relating to distilled spirits, wines, and beer), or of subchapter A of chapter 52 (relating to tobacco, cigars, cigarettes, and cigarette papers and tubes), or of subchapter A of chapter 53 (relating to machine guns and certain other firearms), on the date prescribed therefor (determined with regard to any extension of time for filing), unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be added to the amount required to be shown as tax on such return 5 percent of the amount of such tax if the failure is for not more than 1 month, with an additional 5 percent for each additional month or fraction thereof during which such failure continues, not exceeding 25 percent in the aggregate;

Internal Revenue Code Section 6651(a)(2)

To pay the amount shown as tax on any return specified in paragraph (1) on or before the date prescribed for payment of such tax (determined with regard to any extension of time for payment), unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be added to the amount shown as tax on such return 0.5 percent of the amount of such tax if the failure is for not more than 1 month, with an additional 0.5 percent for each additional month or fraction thereof during which such failure continues, not exceeding 25 percent in the aggregate; or

Internal Revenue Code Section 6651(a)(3)

To pay any amount in respect of any tax required to be shown on a return specified in paragraph (1) which is not so shown (including an assessment made pursuant to section 6213(b)) within 21 calendar days from the date of notice and demand therefor (10 business days if the amount for which such notice and demand is made equals or exceeds \$100,000), unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be added to the

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amount of tax stated in such notice and demand 0.5 percent of the amount of such tax if the failure is for not more than 1 month, with an additional 0.5 percent for each additional month or fraction thereof during which such failure continues, not exceeding 25 percent in the aggregate.

Internal Revenue Code Section 6662(a) of the Code provides that if this section applies to any portion of an underpayment of tax required to be shown on a return, there shall be added to the tax an amount equal to 20% of the portion of the underpayment to which this section applies.

Internal Revenue Code Section 6662(b) of the Code identifies the portion of underpayment to which the section applies as attributable to, among others, negligence or disregard of rules or regulations, and any substantial understatement of income tax.

Internal Revenue Code Section 6662(c) of the Code defines "negligence" as any failure to make a reasonable attempt to comply with the provisions of this title, and the term "disregard" as any careless, reckless, or intentional disregard.

Internal Revenue Code Section 6662(d) of the Code provides there is a substantial understatement of income tax for any taxable year when the amount of the tax understated exceeds the greater of 10 percent of the tax required to be shown on the return for taxable year, or \$5,000.

Internal Revenue Code Section 1.6662-2(c) of the Regulations provides the maximum accuracy-related penalty imposed on a portion of an underpayment may not exceed 20 percent of such portion (40 percent of the portion attributable to a gross valuation misstatement), notwithstanding that such portion is attributable to more than one of the types of misconduct described in paragraph (a) of this section. For example, if a portion of an underpayment of tax required to be shown on a return is attributable both to negligence and a substantial understatement of income tax, the maximum accuracy-related penalty is 20 percent of such portion. Similarly, the maximum accuracy-related penalty imposed on any portion of an underpayment that is attributable both to negligence and a gross valuation misstatement is 40 percent of such portion.

Internal Revenue Code Section 1.6662-3(b)(1) of the Regulations provides that the term "negligence" includes any failure to make a reasonable attempt to comply with the provisions of the internal revenue laws or to exercise ordinary and reasonable care in the preparation of a tax return. Negligence is strongly indicated where a taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit or exclusion on a return which would seem to a reasonable and prudent person to be "too good to be true" under the circumstances.

Internal Revenue Code Section 1.6662-3(b)(2) of the Regulations provides that the term "disregard of the rules or regulations" includes any careless, reckless, or intentional disregard of the provisions of the Internal Revenue Code, temporary or final Treasury regulations issued under the Code, and revenue rulings or notices issued by the IRS and published in the Internal Revenue Bulletin. A disregard of rules or regulations is "careless" if the taxpayer does not exercise reasonable diligence to determine the correctness of a return position that is contrary to the rule or regulation. A disregard is "reckless" if the taxpayer makes little or no effort to determine whether a rule or regulation exists, under circumstances that demonstrate a substantial deviation from the

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standard of conduct that a reasonable person would observe. A disregard is “intentional” if the taxpayer knows of the rule or regulation that is disregarded. Nevertheless, a taxpayer who takes a position contrary to a revenue ruling or a notice has not disregarded the ruling or notice if the contrary position has a realistic possibility of being sustained on its merits.

Treasury Reg. 1.6664-4 provides for Reasonable cause and good faith exception to section 6662 penalties.

Governments Position:

Section 513(a) of the Code defines the term ‘unrelated trade or business’ as any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of the purpose or function constituting the basis for its exemption under section 501 of the Code.

Organizations exempt from Federal income taxes under Section 501(c)(3) may operate trades or businesses which further their exempt purpose, but organizations are not operated for their exempt purposes if their primary activity is carrying on a business with the general public in a manner similar to organizations operated for profit. If they operate trades or businesses which are unrelated to their exempt purposes aside from the need for the profits therefrom, they are subject to tax on income on their unrelated taxable income from such unrelated trades or business under Section 511

The operation of the _____ without any victims of _____ as employees only serves as a source of income for the organization. Also, the organization sold items created by _____ vendors and non-_____ vendors, with no emphasis on the _____ vendors as a selling point.

“Unrelated business taxable income” is “the gross income derived by any organization from any unrelated trade or business... regularly carried on by it,” subject to certain allowable deductions. Section 512(a)(1).

Exempt Organizations are subject to the unrelated business income tax, and must submit the Form 990-T, Exempt Organization Business Income Tax Return, for each taxable year they have gross unrelated taxable income of \$1000 or more.

Allocation of Expenses:

According to Treasury Regulations Section 1.512(a)-1(a), only expenses directly connected with the carrying on of the unrelated trade or business and which is attributable solely to the conduct of unrelated business activities that are proximately and primarily related to that business activity,

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qualify as a deduction. Operation of for-profit and are separate activities from the organization's exempt activities and are an unrelated business subject to unrelated business income tax. The expenses that are related to both activities (i.e., rent of the facility, utilities, etc.) must be allocated between the two using a reasonable allocation method, per Treasury Regulations Section 1.512(a)-1(c).

According to Treasury Regulation Section 1.512(a)-1(f)(6)(i), the time allocation method accurately reflects the salaries, wages, and contract labor expenses, however, the time allocation method is not a reasonable method for allocating the rent, utilities, maintenance and repair, and other expenses. The gross receipts method reasonably reflects each activity use of the space. Therefore, the gross receipts allocation method is a reasonable method to allocate the rent, utilities, maintenance and repair, and other expenses.

We have used the gross-to-gross receipt method to allocate the expenses that are related to both exempt activities and . We have determined that the gross-to-gross receipt allocation method was reasonable in this situation for the years ended , and . The method was used to compute the ordinary and necessary expenses by dividing the total gross receipts by the total receipts (total contributions and receipts), which produced the ratio of % for the tax year ended , and % for the tax year . The expenses were allocated to the exempt activities and the operation of the . Please see Exhibit 6,7, and 8 for the allocation of expenses between the exempt activities and the expenses.

Conclusion:

If the revocation is not sustained, we have the alternative position to assess unrelated business income tax on the income from the sale of .

The Unrelated Business Taxable Income is subject to IRC 511 at the tax rate stated in IRC 11 as %.

conducted activities subject to UBI and the taxes and penalties for calendar year and are stated below:

Summary of taxes, penalties, and interest

Balance Due/Taxes	\$	\$
Failure to File – IRC 6651(a)(1)	\$	\$
Failure to Pay – IRC 6651(a)(2)	\$	\$
Interest	TBD	TBD
Tax Deficiency and Penalties Subject to Adjusted Interest Rate	\$	\$

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We have prepared Form 4945 and exhibits to provide detailed deductions in assessing the unrelated business income tax for the periods - , and other penalties:

Interest to be calculated at the date of payment by Service Center.