Office of Chief Counsel
Internal Revenue Service

memorandum

CC:TEGE:EOEG:EO1:MLSchäffer
PRENO-120831-07

date: July 31, 2007

to: David L. Fish
Acting Manager, SE:T:EO:RA:G

from: Michael B. Blumenfeld
Senior Technician Reviewer, CC:TEGE:EOEG:EO2

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subject: [redacted] - Final Denial Letter

By memorandum dated 05-01-07, you requested this office's concurrence in the issuance of a final adverse ruling to the subject organization. As discussed in the [redacted]

BACKGROUND

The subject organization [redacted] was formed [redacted] essentially by [redacted]

- to keep and maintain donated [redacted] from the time of donation to [redacted] to the time of sale ([redacted]%);
- to lease donated vessels to outside parties to generate income for [redacted] ([redacted]%); and
- to operate donated [redacted] to conduct educational and research activities for [redacted] ([redacted]%).

On [redacted] accepted the donation of [redacted] from [redacted] related individuals (directly and through [redacted] corporations owned by these individuals). The donation of the donors' direct and indirect interests was effected on [redacted] and [redacted] A condition of the donation, stipulated in a separate letter agreement between [redacted] and the donors, was that the [redacted] not be sold for [redacted] years. During [redacted] ownership, the [redacted] were kept mostly at [redacted] and maintained at no cost to [redacted] In addition, the donors agreed to indemnify [redacted] for any losses it might incur during this period.

The donors purchased the [redacted] at auction in [redacted] for $[redacted]. In [redacted], the donors obtained 2 appraisals and used the lower valuation to claim charitable contribution deductions totaling $[redacted]. [redacted] did not solicit or participate in these appraisals but was aware of the valuations.

[redacted] made no effort to sell the [redacted] for [redacted] years after the donation, in accordance with the condition for the donation. It sold the [redacted] approximately [redacted] after the no-sale condition expired for $[redacted], less than [redacted]% of their appraised value upon donation. During its period of ownership, [redacted] used none of these [redacted] research or education, performed no maintenance on the [redacted] and solicited no new [redacted] donations.

Summary of [redacted] activities from [redacted] to [redacted]:

- [redacted] [redacted] received the donation of the [redacted] at issue.
- [redacted] [redacted] received the donation of [redacted] valued at $[redacted] and sold [redacted] for $[redacted]
- [redacted] [redacted] received cash contributions of $[redacted] and purchased [redacted] for research activities. It put the [redacted] at issue up for sale.
- [redacted] [redacted] received no contributions, but sold the [redacted] at issue for $[redacted]
- [redacted] [redacted] received no contributions, but sold its research [redacted]

[redacted] was created to support and assist [redacted] in it educational purposes, with its principal purpose being to raise funds for [redacted] and a secondary purpose being to use the donated [redacted] research and education. [redacted] has stated that it agreed to hold [redacted] for the agreed upon period to allow it to assess whether [redacted] or its related organizations would be able use the [redacted] for educational purposes.

EO issued a proposed adverse determination letter concluding that [redacted] failed to establish that it qualifies as an organization described in §501(c)(3) basically for two reasons. First, [redacted] is engaged in a commercial activity by keeping and maintaining donated [redacted] arranging for their sale, and transferring the sale proceeds to [redacted]. Second, [redacted] does not carry on a charitable program commensurate in scope with its financial resources.

In its protest, [redacted] claimed that it is organized and operated to receive donations of [redacted], which are risky assets (assets having a higher exposure to potential liability), without jeopardizing assets held by [redacted] or an associated entity. [redacted] also claimed that its activities are not commercial because it does not accumulate profits or even have a profit motive. In essence, [redacted] claimed that it merely receives [redacted] as contributions, maintains those [redacted] and then distributes the net proceeds to [redacted] when the [redacted] are sold. Furthermore, [redacted] claimed that because it distributed all of its net proceeds from the sale of its donated vessels to [redacted] its activities were commensurate with its financial resources.

The draft final adverse determination letter concludes that [redacted] failed to establish that it is organized and operated exclusively for exempt purposes within the meaning of § 501(c)(3) and § 1.501(c)(3)-1 of the Income Tax Regulations.

CODE & REGULATIONS

Section 501(a) provides that an organization described in § 501(c) shall be exempt from taxation under subtitle A.

Section 501(c)(3) provides that among the organizations exempt from taxation under subtitle A by virtue of § 501(a) are those organized and operated exclusively for charitable, religious or educational purposes.

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

Section 1.501(c)(3)-1(c)(1) provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of the exempt purposes specified in § 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Section 1.501(c)(3)-1(d)(1)(i) provides that an organization may be exempt as an organization described in § 501(c)(3) if it is organized and operated exclusively for charitable purposes, *inter alia*.

Section 1.501(c)(3)-1(d)(1)(ii) provides that an organization is not organized or operated exclusively for one or more of the purposes specified in § 1.501(c)(3)-1(d)(1)(i) unless it serves a public rather than a private interest. Thus, to meet the requirement of § 1.501(c)(3)-1(d)(1)(i), an organization must establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

Section 1.501(c)(3)-1(d)(2) provides that the term "charitable" is used in § 501(c)(3) in its generally accepted legal sense and is, therefore, not to be construed as limited by the separate enumeration in § 501(c)(3) of other tax-exempt purposes which may fall within the broad outlines of "charity" as developed by judicial decisions. Such term includes the advancement of education or science.

Section 1.501(c)(3)-1(e)(1) provides that an organization may meet the requirements of § 501(c)(3) although it operates a trade or business as a substantial part of its activities, if the operation of that trade or business furthers the organization's exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business, as defined in § 513. In determining the existence or nonexistence of such primary purpose, all the facts and circumstances must be considered, including the size and extent of the trade or business and the size and extent of the activities which further one or more exempt purposes.

HAZARDS OF LITIGATION

Under the rules of the Tax Court, the disposition of an action for declaratory judgment involving the initial qualification or classification of an exempt organization (see § 7428) ordinarily will be made on the basis of the administrative record.[1] Only with the permission of the court, upon good cause shown, will any party be permitted to introduce evidence other than that presented before the Service and contained in the administrative record. U.S. Tax Ct. R. 217(a). Therefore, unless squarely contradicted

[1] The term "administrative record" is defined to include the request for determination, all documents submitted to the Service by the applicant regarding the request for determination, all protests and related papers submitted to the Service, all written correspondence between the Service and the applicant regarding the request for determination or such protests, all pertinent returns filed with the Service, and the notice of determination by the Commissioner. U.S. Tax Ct. R. 210(b)(12).

by other statements or facts, [redacted] representations in the administrative record are presumed to be true. See Public Industries, Inc. v. Comm., T.C. Memo 1991-3; 61 TCM (CCH) 1626.

Underlying EO's adverse determination is the concern that [redacted] was organized and operated to accommodate what seems to be grossly excessive charitable contribution deductions. Considered together, certain facts of the case do suggest such a conclusion – for example, the donors' original purchase price for the [redacted] ([redacted]); the appraisals obtained by interested parties [redacted] years later indicating the [redacted] appreciation by a factor of more than [redacted] ([redacted]); and the size of the charitable contribution deductions claimed by the donors compared to the amount of the proceeds from the sale by [redacted] ([redacted]). [redacted] Congress addressed the problem of overvalued donations in 2004 by amending § 170 to provide more specifically for the deduction of contributions to charitable organizations of used motor vehicles, boats, and airplanes. Therefore, we believe it likely that a court would view the overvaluation problem as one having to do with the legitimacy of the donor's deduction rather than the tax-exempt status of the charity itself. See § 170(f)(12), added by the American Jobs Protection Act of 2004, P.L. 108-357, § 884(a).

[redacted]

Our first concern is with EO's characterization of [redacted] activities as commercial in nature. In its proposed denial letter of [redacted] EO accepted the taxpayer's statement that its principal function is to accept, maintain, and sell donated [redacted] and then to contribute the net proceeds to a tax-exempt entity. As [redacted] explained it, a separate entity was formed for this function so as to allow [redacted] to accept the donation of risky assets ([redacted]) without putting its other properties at risk. EO concluded, however, that [redacted] activities constitute the performance of common commercial services for [redacted] rather than services furthering a charitable purpose. Because its primary activities are commercial, [redacted] is organized and operated for the primary purpose of carrying on an unrelated trade or business, and so fails to meet the requirements of § 1.501(c)(3)-1(e)(1). [redacted]

Courts have identified factors that characterize a nonexempt commercial operation (sometimes referred to as the commerciality doctrine).[2] The factors include the commercial hue of the organization's activities; the existence of substantial profits; the substantial accumulation of capital surplus in comparison to direct expenditures for exempt purposes; competition with commercial firms organized for profit; the failure to solicit contributions, grants, or government funds, or the lack of plans to make such solicitations (lack of resemblance to the financing of the typical tax-exempt organization); funding solely by substantial fixed fees; the charging of fees not subject to downward adjustment to account for the ability of service recipients to pay; lack of coordination of activities with any government agencies; not limiting clientele to exempt organizations; operating a business of a type typically carried on for profit; and having a structure and operation similar to that of a commercial organization. These factors for identifying a commercial operation weigh heavily in favor of [redacted] qualification for tax exemption. From its funding to its structure and operation, [redacted] can be distinguished from the typical commercial enterprise. For example, [redacted] serves but one organization, and that a tax-exempt entity ([redacted]; it charges no fees to the organization it serves; it competes with no commercial ventures; it maintains and sells its own assets, and uses those assets for educational and research activities; and it makes no profit from its sales of donated [redacted] contributing the net proceeds to the tax-exempt entity. If [redacted] activities are not commercial activities, a court is highly unlikely to deny [redacted] application on the basis of § 1.501(c)(3)-1(e)(1). In addition, under § 502(b)(3) and § 513(a)(3), the selling of donated merchandise is not deemed to be an unrelated trade or business. These sections reflect a policy that charities should be able to receive like-kind gifts and turn them into cash with no tax consequences. These sections also indicate congressional intent that such activities not be considered commercial activities.

In concluding that [redacted] was engaged in a related trade or business, EO referred to Rev. Rul. 64-182, 1964-1 C.B. 186, stating that [redacted] did not carry on a charitable program commensurate in scope with its financial resources. We think that this doctrine, administrative in origin, is of limited relevance. First, Rev. Rul. 64-182, which introduced the commensurate-in-scope doctrine, involved a charitable organization that derived revenue from an unrelated rental real estate business. [redacted] awp

[2] See, for example, Easter House v. U.S., 12 Cl. Ct. 476 (1987), aff'd in unpub. opinion, 846 F.2d 78 (Fed. Cir.), cert. denied, 488 U.S. 907 (1988); Nonprofits' Insurance Alliance of Calif. v. U.S., 32 Fed. Cl. 277 (1994); B.S.W. Group v. Comm., 70 T.C. 352, 359 (1978); American Institute for Economic Research v. U.S., 157 Ct. Cl. 548, 555; 302 F.2d 934, 937-38 (1962), cert. denied, 372 U.S. 976 (1963); Airlie Foundation v. I.R.S., 283 F. Supp. 2d 258 (D.D.C. 2003.

Second, and more to the point, any relevance the commensurate-in-scope doctrine might have had in determining whether an organization qualified as tax-exempt was severely compromised by the Tax Reform Act of 1969, P.L. 91-172 (the "Act"), which added § 4942 to the Code. In the Act, Congress singled out private foundations as special objects of their concern that the financial resources of charitable organizations be used in a manner consistent with the reason for their tax-exemption (i.e., that a foundation's income and assets be used for public rather than private benefit). Congress noted that then-current law allowed many private foundations to delay indefinitely current distributions of income or principal for charitable purposes while providing benefits of tax exemption and deductions to the foundations and their donors. Section 4942 was intended to end this practice by requiring a private foundation to distribute its income currently, but not less than 5 percent of its investment assets. See. H.R. Report No. 91-413 (Part 1), reprinted in 1969-3 C.B. 200, 217. If Congress saw fit to require private foundations to make distributions equal to just 5 percent of investment assets, we think it highly unlikely that a court would invoke a subjective administrative rule that imposes a potentially harsher requirement on a public charity's use of its financial resources.

Of course, it is not the nature of an organization's activities but the purpose toward which those activities is directed that ultimately is dispositive of an organization's claim for tax exemption. See B.S.W. Group v. Comm., 70 T.C. 352, 356-357 (1978). This issue leads to another concern we have with EO's determination. In its supplemental proposed denial letter of 03-13-06, EO concluded that [redacted] principal purpose was to accommodate the contribution of the [redacted] based on questionable valuation, in violation of §§ 1.501(c)(3)-1(a)(1) and 1.501(c)(3)-1(c)(1), and that by doing so, it provided the donors with more than incidental private benefits, in violation of § 1.501(c)(3)-1(d)(1)(ii).

[redacted] was created to support and assist [redacted] in it educational purposes, with its principal purpose being to raise funds for [redacted] Making grants to other tax-exempt entities is a valid exempt purpose under the operational test. See National Foundation, Inc. v. U.S., 13 Cl. Ct. 486 (1987). The administrative record shows that the formation of a separate foundation to accept the donation of [redacted] thus shielding [redacted] from the higher potential liability associated with such assets, was under consideration by the [redacted] board before the school was approached by the donors. Though [redacted] efforts at soliciting donations and at selling its properties might seem insufficiently aggressive, the record shows that it has had cash receipts, either from direct donations or from sales, in each of its fiscal years, beginning [redacted] (it was formed at the end of [redacted]. Presumably, the net receipts were contributed to [redacted] for the support of its educational programs.

The question remains, of course, whether [redacted] had the substantial non-exempt purpose of accommodating the contribution of the [redacted] based on questionable valuation, thus conferring a more-than-incidental benefit on private parties. [redacted]

[redacted] did not participate in obtaining the appraisals, and it represents that it had no reason to believe that they were not prepared by competent and qualified appraisers. As part of its due diligence, [redacted] had the [redacted] inspected and evaluated for their potential use and value. [redacted] determined that it was in its best interests to accept the donation, even subject to the [redacted] year no-sale condition, because it would provide a significant net benefit. There is no requirement that a donee or potential donee do more than this, such as trying to ascertain the *bona fides* of the donor, or determining whether any appraisals obtained by the donor are reasonable. Even the active acceptance by a charitable organization of obviously overvalued properties is not proscribed by the Code. If Congress has not seen fit to place on donees the burden of donor oversight, then we think that, as matter of law and of policy, a court will not impose that burden on a charity in a declaratory judgment action.

Further, [redacted] persuasively argues that it provided no benefits to the donors, at least by way of the charitable contribution deductions they claimed on the donation of the [redacted] Though we recognize that an actual donation to an actual charitable donee is a necessary condition for a charitable contribution deduction, it is not a sufficient condition, because the ability to take the deduction is governed by § 170 and not by any act of the donee. [redacted] did not participate in the preparation of the donors' tax returns, did not provide any tax advice to the donors, and had no actual knowledge of the deductions claimed by the donors. We find no authority, and EO cites none, by which we might characterize the donors' charitable contribution deductions as benefits conferred by [redacted]

Nor does it appear that [redacted] violated any provisions that would implicate it in donors' potential tax avoidance. For example, the administrative file lacks evidence to sustain liability for the penalty under § 6701 for aiding and abetting the understatement of the donors' tax liability. For a taxpayer to be so liable, it must have aided in preparing or presenting some document that it knew, or had reason to believe, would be used in determining another person's tax liability and would result in an understatement of that's person's tax. The only documents in this case that bear directly on the donors' tax liability are the appraisals. Because [redacted] did not assist in obtaining or preparing these appraisals, it cannot be held liable under § 6701 with respect to them.[3]

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[3] Section 6701(a) provides that any person (1) who aids or assists in, procures, or advises with respect to, the preparation or presentation of any portion of a return, affidavit, claim, or other document, (2) who knows (or has reason to believe) that such portion will be used in connection with any material matter

[redacted] awp

Contact Martin Schäffer at 2-3905 or Michael Blumenfeld at 2-7103 if you have any questions.

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arising under the internal revenue laws, and (3) who knows that such portion (if so used) would result in an understatement of the liability for tax of another person, shall pay a penalty with respect to each such document in the amount determined under § 6701(b).