Internal Revenue Service
Appeals Office

Department of the Treasury

Taxpayer Identification Number:

Person to Contact:

Tax Period(s) Ended:

UIL: 501.33-00
501.32-00

Release Number: 201309029
Release Date: 3/1/2013
Date: Dec-4 2012

The Organization

Certified Mail

Dear,

We considered your appeal of the adverse action proposed by the Director, Exempt Organizations, Rulings and Agreements. This is our final determination that you do not qualify for exemption from Federal income tax under Internal Revenue Code (the "Code") section 501(a) as an organization described in section 501(c)(3) of the Code.

Our adverse determination was made for the following reason(s):

- Since your incorporation, you mainly provided training to employees of a for-profit automotive entity during the initial years of your operation; you then sold your assets to a related for-profit entity; you provided only two grants to charities after the sale of assets; and you conducted no other activities afterwards.
- The sale of your assets to a related for-profit entity served to the inurement of its owners, who represent the majority of your governing body, because the terms of the agreement favored the buyer.
- Your continuation of monthly payments to a related for-profit entity for its administrative services fee while you carry no activity to further the purposes of section 501(c)(3) of the Code serves non-exempt purposes.
- Because a lack of charitable or educational program(s) within the meaning of section 501(c)(3) and a substantial amount of your assets are used for private interest, you are not operated exclusively for exempt purposes described in section 501(c)(3) of the Code.

You are required to file Federal income tax returns on Forms 1120 for the tax periods stated in the heading of this letter and for all tax years thereafter. File your return with the appropriate Internal Revenue Service Center per the instructions of the return. For further instructions, forms, and information please visit www.irs.gov.

Please show your employer identification number on all returns you file and in all correspondence with Internal Revenue Service.

You have waived your right to contest this determination under the declaratory judgment provisions of Section 7428 of the Code.

You also 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 matters that may not have been resolved through normal channels get prompt and proper handling. If you want that may not have been resolved through normal channels get prompt and proper handling. If you want Taxpayer Advocate assistance, please contact the Taxpayer Advocate for the IRS office that issued this letter. You may call toll-free, 1-877-777-4778, for the Taxpayer Advocate or visit www.irs.gov/advocate for more information.

If you have any questions about this letter, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely Yours,

Appeals Team Manager

Enclosure:

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

Date: June 30, 2011

Contact Person:

Identification Number:

Contact Number:

FAX Number:

Employer Identification Number:

LEGEND:

UIL:
501.33-00
501.32-00

M=Name of Organization
B=Name of For-profit
C=Name of Exempt Organization
D=Original Name of M
E=Name of M after first amendment
F=Name of M after second amendment
G=Name of company
H=Name of company
c=Number of shares
d=$amount
j =$amount
x=Name of state
y=Name of state
Date 1=Date
Date 2=Date
Date 3=Date
Date 4=Date
Date 5=Date
Date 6=Date
Date 8=Date

Dear Applicant:

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

Issues

1. Does M qualify for exemption under Section 501(c)(3) of the Internal Revenue Code? No, for the reasons outlined below.

2. If upon appeal M is granted exemption under 501(c)(3) should exemption be granted retroactively to M's formation date? No, for the reasons stated below.

Facts

C was formed in x on Date 1. C's purposes as stated in the Articles of Incorporation include:

1. To develop and deliver educational courses and programs to public and private organizations to enhance the competitiveness of the automotive service workforce
2. To establish and maintain world class standards in education and training for the automotive service industry and to engage in research and development activities that will benefit automotive service education.
3. To act as a liaison between public education and private industry and thereby benefit the motoring public.

C applied for and received exempt status under Section 501(c)(3) of the Code on Date 2.

C formed D (M's prior name) as a corporation in y on Date 3.

C merged into D on Date 4 with D being the surviving corporation. C then ceased to exist.

D's[M's] purposes are similar to C's and include:

A. To develop and deliver training and instruction to individuals to maintain and improve their skills and abilities as automotive service technicians.

B. To establish and maintain world class standards in the instruction and training of automotive service technicians and to engage in research and development to further that end.

C. To promote economic development and employment opportunities by providing instruction and training programs, thereby helping automotive service technicians better themselves and society.

D. To provide facilities, equipment, and a faculty of qualified trainers and instructors, to carry on the training and instruction of automotive service technicians.

E. To engage in such other activities in the interest of education as may be possible, and do every act appropriate or necessary to carry out any of the foregoing objectives.

F. To seek and accept gifts, grants and other support from individuals, organizations, foundations, and others, and to charge fees and tuition, for carrying out the purposes of the Corporation as described herein.

D did not apply for a new Employer Identification Number (EIN) nor did D apply for exemption. D continued to use the EIN # of C. D filed amended articles of incorporation in y to change its name to E on Date 5. Subsequently name change amendments were filed to change the name from E to F and then to M, your current name, on Date 8. Applications for Certificates of Authority of a Foreign Corporation to transact business in x were also filed at different periods.

During M's first two years of operation as C, D, E and F, revenue was funding under an educational service contract with G, a for profit automotive company. M subsequently launched a development program for an online Associate degree program for automotive technician instructors and technicians. This was licensed by the x Department of Education. However only a few students enrolled in the program and the program was closed. Later G decided to provide training in house and hired M's employees which then ended M's contract with G. Subsequently M sought to expand training in fleets under a contract with H, another for profit automotive company. Since course enrollment in this was low this contract was also cancelled. The ensuing economic decline resulted in a financial crisis and M was to discontinue operations unless a different business model was found. A little more than two years after you were formed M turned to the internet as a training tool because there was no nationally recognized internet training for automotive service technicians. M realized this could not be pursued without significant capital infusion, grants would typically be not available for these purposes and the activity could be unrelated to M's exempt purpose and would need to be conducted by a for-profit entity.

B was incorporated as a for-profit corporation in state y on Date 6 approximately two and one-half years after M's formation to pursue development of Internet based training modules for training technicians. B the for-profit and M shared personnel pursuant to a management services agreement and B made payments to M under this agreement in cash and B's stock. The value of B's stock was valued by the officers of B at a value of between $ and $ per share. Approximately four years after formation, M which

was then known as F entered into an Asset Purchase Agreement. Pursuant to this Asset purchase Agreement M transferred all its assets including contracts and other automotive related businesses and accounts receivable in exchange for c shares of B's common stock. The common stock of B was valued by B's owners at $ er share. Accounts receivable were transferred at book value and fixed assets were transferred at book value + %. A majority of the stockholders of B were the officers and directors of M and received % of the shares of stock of B.

Approximately two years after B's formation a Stock Redemption Agreement was entered into whereby B agreed to purchase all its shares held by M, then known as F for a total sum of $d. The Agreement provided for 6,000 shares to be purchased by B each month at a price of $ /share. The stock redemption agreement included provisions to allow B to stop buying back its shares if it did not have sufficient cash flow to do so.

Approximately five years after the stock redemption, a service contract with G ,which was B's major source of income, expired and B was unable to meet its obligations. The stock redemption agreement was amended to cease payments until such time as B would have sufficient cash flow to continue payments. B had paid approximately % of $d. The Stock Redemption Agreement re-commenced two years later at a lower rate of 2,000 shares per month.

Following the sale of assets M had no activities for the next five years. M's only activity during this five year period was to hold the cash and stock received from B.

M states its current activity consists of using the cash proceeds generated by the asset sale and future investment income to make grants to select tax-exempt entities with an educational emphasis primarily in the automotive technical education area. At the end of the five year period two distributions were made to charitable organizations. No other charitable distributions have been made.

M also has an Administrative Services Agreement with B by which M pays the sum of $j per month for services provided to it by B. The most recent copy of the agreement which is signed on behalf of M by its officers, who are also stockholders of B, indicates B provides accounting and financial services, grant management services, maintenance and security of historical and official business etc, collectively known as administrative services.

Financial data provided by M indicates all of revenue for the three years prior to filing for exemption was from Investment income. All expenses were for administrative, accounting and other services provided by B under the Administrative Services Agreement.

Law

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

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

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

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

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

Section 1.501(c)(3)-1(d)(ii) of the regulations states that an organization is not operated exclusively for one or more exempt purpose unless it serves a public rather than a private interest. It must not be operated for the benefit of designated individuals or the persons who created it.

A disqualified person is defined in Treas. Reg. § 53.4958-3 as a person in a position to exercise substantial influence over the affairs of the organization at anytime during the five-year period before the benefit transaction in question occurred. Family members and entities controlled by the disqualified person are also considered disqualified persons.

Revenue Ruling 67-5, 1967-1 C.B. 123, 1967 A foundation controlled by the creator's family operated to enable the creator and his family to engage in financial activities which are beneficial to them, but detrimental to the foundation, resulted in the foundation's ownership of non-income-producing assets which prevent its carrying on a charitable program commensurate in scope with its financial resources. It was Held that,

the foundation is operated for a substantial non-exempt purpose and serves the private interests of the creator and his family, and therefore is not entitled to exemption from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954.

Rev. Rul. 67-390, 1967-2 CB 179 states that an exempt organization incorporated under the laws of one state and then reincorporated under the laws of another state with no change in its purposes has created a new legal entity and that each new entity must establish its exemption in accordance with Section 1.501(a)-1(a)(2) of the Income Tax Regulations.

Rev. Rul. 76-91, 1976-1 C.B. 150, held that the purchase, in a transaction not at arm's length, of all of the assets of a profit-making hospital by a nonprofit hospital corporation at a price that includes the value of intangible assets, determined by the capitalization of excess earnings formula, does not result in the inurement of the hospital's net earnings to the benefit of any private shareholder or individual or serve a private interest precluding exemption under section 501(c)(3) of the Code.

Rev. Rul. 76-441, 1976-2 C.B. 147, held that an otherwise qualifying nonprofit organization that purchases or leases at fair market value the assets of a former for - profit school and employs the former owners, who are not related to the current directors, at salaries commensurate with their responsibilities is operated exclusively for educational and charitable purposes. An organization that takes over a school's assets and its liabilities, which exceed the value of the assets and include notes owed to the former owners and current directors of the school, is serving the directors' private interests and is not operated exclusively for educational and charitable purposes.

For an organization claiming the benefits of §501(c)(3), "exemption is a privilege, a matter of grace rather than right." Christian Echoes National Ministry, Inc. v. United States, 470 F.2d 849, 857 (10th Cir. 1972), cert. denied, 414 U.S. 864 (1973). The applicant for tax exempt status under section 501(c)(3) has the burden of showing it "comes squarely within the terms of the law conferring the benefit sought." Nelson v. Commissioner, 30 T.C. 1151, 1154 (1958).

The petitioner in est of Hawaii, 71 T.C. 1067 (1979), conducted training, seminars and lectures in the area of intrapersonal awareness. Such activities were conducted under licensing arrangements with various for-profit corporations. The licensing agreements were conditioned on the petitioner maintaining tax exempt status. The petitioner argued that it had no commercial purpose of its own and that its payments to the for-profits were just ordinary and necessary business expenses. The Court did not agree. The question for the court was not whether the payments made to the for-profit were excessive, but whether it benefited substantially from the operation of the applicant. The court determined that there was a substantial private benefit because the applicant "was simply the instrument to subsidize the for-profit corporations and not vice versa and had

no life independent of those corporations."

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

In Church by Mail, Inc. v. Commissioner, 765 F.2d 1387,(1985) the Court in affirming a Tax Court decision stated as follows. The critical inquiry is not whether particular contractual payments to a related for-profit organization are reasonable or excessive, but instead whether the entire enterprise is carried on in such a manner that the for-profit organization benefits substantially from the operation of the Church. In short, the purpose and objective to which the income of the Church is devoted is the ultimate test in determining whether it is operated exclusively for an exempt purpose.

Housing Pioneers, Inc. v. Commissioner, 58 F.3d 401 (9th Cir. 1995). The organization's purpose was to provide affordable housing for low income and handicapped persons. The organization entered into an agreement with a for-profit partnership to participate in a project whereby the for-profit's property would be exempt from property tax. As part of the agreement, the for-profit loaned money to the exempt organization to buy an interest in and become a general partner. Part of the property tax savings was to go to the general partnership to keep rents low and part to the exempt organization for its charitable purposes. The court ruled that even though the tax reductions were to be used exclusively to make rents affordable, private inurement was present. Federal income tax advantages and property tax reductions resulted in inurement at least indirectly to the benefit of the non-exempt partners (two of whom were insiders with respect to the exempt entity) because their partnerships were relieved of maintaining rents at a level sufficient to cover operating expenses that would otherwise have to be paid out of partnership capital.

Application of Law

M is not described in section 501(c)(3) because M is not operated exclusively for section 501(c)(3) exempt purposes. Specifically the facts indicate that M's operations included the sale of all its assets to a for-profit entity in which the directors of M were majority stockholders. This resulted in inurement to them. In addition M's initial operations were focused primarily on providing training to employees of G and H for-profit organizations based on contracts entered into with them for services. This

arrangement resulted in private benefit to G and H. Finally, your current operations consist primarily of making monthly payments to B for administrative services and those payments result directly in private benefit to B and indirectly as inurement to your common board members. Thus far, your charitable operations have been insignificant and limited to a mere two distributions over 6+ years of operation.

M is not described in Section 1.501(c)(3)-1(a)(1) of the regulations because M fails the operational test. M's activities further the private interests of G, H and B and also result in inurement to M's directors.

M is not as described in section 1.501(c)(3)-1(c)(1) of the Regulations because more than an insubstantial part of your activities further the private interests of G, H, and B.

M is not as described in section 1.501(c)(3)-1(c)(2) of the Regulations because by selling all of M's assets and employees and contracts to B, a for-profit in which M's directors were majority stockholders earnings inured to the benefit of M's directors.

M is also not as described in section 1.501(c)(3)-1(d)(ii) of the Regulations because your activities further the private interests of G & H and also the private interests of the directors of M who are also the stockholders of B.

Like the organization in Revenue Ruling 67-390 M's incorporation created a new entity. The merger of C into M then known as D with D being the survivor resulted in C ceasing to exist. More than ten years later M applied for a new EIN and for exemption. M's application for exemption was therefore, not filed timely.

M is like the organization in Revenue Ruling 67-5. After selling its assets to the for-profit B and receiving cash and B stock in return, the funds were kept unused for approximately five years. Payments were received at regular intervals under the stock redemption agreement from B. These funds were accumulated and not used for any charitable purpose. At the end of the five year period, two disbursements were made. The value of the stock of B was determined by the directors. The directors also valued the assets sold at book value plus %. No attempt was made to secure an independent appraisal of fair market value. M's activities were detrimental to itself. M owned assets that produced little or no income and did not carry on a charitable program .

Like the organization in est Hawaii, M's initial operations were aimed exclusively at providing training for employees of G and H per service contracts entered into with them resulting in private benefit to these for-profit organizations. No other educational activities were conducted and therefore M had no life independent of G and H.

As in John Marshall Law School and John Marshall University v. United States, supra the issue is not if the insider provides goods and services of commensurate value to the organization but the fact they are in position to exercise control over the organization and use the assets as if they were their own by using them at will rather than in a fiduciary capacity. The transfer of assets was enabled in part because the owners of B were current and or past board members of M. The owners of B are disqualified persons of M per Treas. Reg. § 53.4948.3 by virtue of being past and current members of M's board. These individuals were able to exercise control over M by taking M's assets for their own purposes. More evidence of control occurred when the Stock Redemption Agreement was suspended by B and approved by M's board members. When the agreement restarted after two years a lesser amount was accepted and further benefitted B. By transferring the assets, employees and contracts to B and freely using these assets for the benefit of B, inurement occurred.

Similar to the organization in Church by Mail, Inc. v. Commissioner, the dual control enables the directors as stockholders of B to profit from the use of the assets of M.

You are not like the organization in Revenue Ruling 76-91 because you too are the party to transactions which were not arms length, where the value of assets were arbitrarily determined by the board of directors with no appraisal and those transactions resulted in inurement.

The creation of B by M's directors is similar to the second scenario of Rev. Rul. 76-441, supra, because M's transactions serve directors private interests and M is not operated exclusively for exempt purposes.

After incorporating M simply merged with C used its EIN number and continued the same operations. No application for exemption was submitted for more than ten years operations were continued by M. M's activities were conducted under the EIN # of an entity that had ceased to exist. In addition M conducted no activities for several years. The assets were sold and stock and cash received were held by M during this period. M made two charitable distributions in only one of those years and subsequently you have not shown that you are operating exclusively for a 501(c)(3) purposes. Therefore, M is like the organizations in Christian Echoes National Ministry, Inc. v. United States, and Nelson v. Commissioner, supra because M has failed to show it meets the requirements of exemption.

You are like Housing Pioneers, Inc. v. Commissioner, because B was relieved of the time and expense of procuring its own service contracts and employees. B received fixed assets, service contracts, and a regular source of funds from M.

Applicant's Position

M's position included the following in pertinent part:

- M was a commercial training organization with focus on a single customer G who provided substantially all of the revenue. It was due to the inability to raise capital as an exempt organization that the decision to convert to a for-profit corporation was made with the officers and directors being the majority shareholders and the transfer/sale of the assets were effected. After a pre-submission conference M learned a favorable ruling would not be issued on converting M to a for-profit.
- The asset transfer between M and B did not serve private interests of the board members and owners of B because the assets were exchanged for shares of common stock of equal or greater than fair market value and therefore the sale of assets should not jeopardize the organization's exempt status.
- It is not uncommon for a tax exempt organization to sell assets related to a program activity because the organization no longer wishes to engage in that activity and that sometimes those assets are sold to one or more individuals who are officers or to a for profit entity. Revenue Ruling 76-441, TAM 9130002 and Revenue Ruling 67-5 were cited. M concluded the assets were exchanged for shares of common stock of equal or greater fair market value at the time of the exchange. The asset transfer did not serve the private interests of the board of directors and owners of B Based on the foregoing the sale of assets should not jeopardize M's exempt status.

Service Response to Applicant's Position

As noted in M's response M originally intended to convert what it believed was an existing 501(c)(3) organization to a for profit corporation. In doing so M sold its assets to a related for profit corporation B. The board members of M were also the shareholders of B. The decision to sell M's assets to B was therefore not an arms length transaction. The value of the stock was determined by the same individuals. The value of the assets was also determined by the same individual. No independent appraisal was made. As shareholders of B the individuals were in a position to use the assets for personal gain. In addition, the payments under the stock redemption agreement were restructured to benefit B based on its revenue stream. In fact no payments were made after the first few years and when payments resumed payments were at a much lower rate. M's structuring of transactions resulted in private benefit to B and inurement to M's board members who are also majority shareholders of B.

The benefits received by B were substantial. B received assets in exchange for stock. The question is not whether the amount was fair or excessive but whether B benefitted substantially from the transaction. B received fixed assets, service contracts, and

accounts receivables along with employees from M. The benefits received by B were more than incidental and M was the instrument to subsidize B.

Conclusion

Based on the above facts and law we conclude:

1. M does not qualify for exemption under section 501(c)(3) of the Code because M fails the operational test for three reasons, any one of which standing alone precludes exemption. One, M's operations as initially conducted served the private benefit of G and H. Two, M's operations served the private benefit of B and additionally resulted in inurement to M's directors who are also majority shareholders of B stock. And, three M's charitable operations have been insubstantial and limited to only two charitable distributions during the last six plus years.

2. If upon appeal M is granted exemption, the facts clearly show M's past operations provided benefit to private interests and inurement to its directors. Therefore, M should not be granted exemption retroactive to its formation date. Exemption, if granted upon appeal, should only be prospectively.

You have the right to file a protest if you believe this determination is incorrect. To protest, you must submit a statement of your views and fully explain your reasoning. You must submit the statement, signed by one of your officers, within 30 days from the date of this letter. We will consider your statement and decide if the information affects our determination. If your statement does not provide a basis to reconsider our determination, we will forward your case to our Appeals Office. You can find more information about the role of the Appeals Office in Publication 892, Exempt Organization Appeal Procedures for Unagreed Issues.

Types of information that should be included in your appeal can be found on page 2 of Publication 892, under the heading "Regional Office Appeal". The statement of facts (item 4) must be accompanied by the following declaration:

"Under penalties of perjury, I declare that I have examined the statement of facts presented in this appeal and in any accompanying schedules and statements and, to the best of my knowledge and belief, they are true, correct, and complete."

The declaration must be signed by an officer or trustee of the organization who has personal knowledge of the facts.

Your appeal will be considered incomplete without this statement.

If an organization's representative submits the appeal, a substitute declaration must be

included stating that the representative prepared the appeal and accompanying documents; and whether the representative knows personally that the statements of facts contained in the appeal and accompanying documents are true and correct.

An attorney, certified public accountant, or an individual enrolled to practice before the Internal Revenue Service may represent you during the appeal process. If you want representation during the appeal process, you must file a proper power of attorney, Form 2848, Power of Attorney and Declaration of Representative, if you have not already done so. You can find more information about representation in Publication 947, Practice Before the IRS and Power of Attorney. All forms and publications mentioned in this letter can be found at www.irs.gov, Forms and Publications.

If you do not file a protest within 30 days, you will not be able to file a suit for declaratory judgment in court because the Internal Revenue Service (IRS) will consider the failure to appeal as a failure to exhaust available administrative remedies. Code section 7428(b)(2) provides, in part, that a declaratory judgment or decree shall not be issued in any proceeding unless the Tax Court, the United States Court of Federal Claims, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted all of the administrative remedies available to it within the IRS.

If you do not intend to protest this determination, you do not need to take any further action. If we do not hear from you within 30 days, we will issue a final adverse determination letter. That letter will provide information about filing tax returns and other matters.

Please send your protest statement, Form 2848, and any supporting documents to the applicable address:

Mail to:

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

Deliver to:

Internal Revenue Service
EO Determinations Quality Assurance
550 Main Street, Room 7-008
Cincinnati, OH 45202

You may fax your statement using the fax number shown in the heading of this letter. If you fax your statement, please call the person identified in the heading of this letter to confirm that he or she received your fax.

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Lois G. Lerner
Director, Exempt Organizations

Enclosure, Publication 892