

Issue Podcast Script – Proposing Denial for an IRC 501(c)(3) Organization, Part 1

Text version for assistive readers who prefer a text version of this course

Page 1 – Welcome

Hello everyone! Welcome to our issue podcast on Proposing Denial. Before we get started, we have a few announcements.

The information contained in this presentation is current as of the day it was presented, and should not be considered official guidance.

Any stories, names, characters, and incidents portrayed in this production are fictitious. No identification with actual persons (living or deceased), places, buildings, and products is intended or should be inferred.

This recording will be maintained in accordance with federal record keeping laws.

So with that, let's get started.

We must make the correct determination when reviewing an application for exemption whether it is approving or proposing denial of an application. But how do we know when proposing denial on an application for tax exemption under Code section 501(c)(3) is the right thing to do?

In this podcast, we're going to be discussing a suggested 5-step roadmap to help us figure out when proposing denial is appropriate.

Page 2 – Do I Have a Denial?

Do I have a denial? It's not always clear if the case we're developing is a potential denial.

Here's a quick 5-step roadmap that can help us figure out if we're dealing with a potential denial. Please feel free to use the roadmap if it's helpful to you.

I just want to add that although the scenarios and steps are written from a determination perspective, the same steps could also apply to an examination and revocation case.

We'll discuss and illustrate each of the 5 steps through a scenario.

Page 3 – Scenario

So, let's take a look at the scenario we have here. We gathered the following facts from our review of a Form 1023 application and attachments:

- The organization has operated a public garden and park for the past two years
- A majority of the income of the organization is from gifts, grants and contributions
- The board members are comprised of a husband and wife couple and two unrelated individuals

- The organization said on the attachment to the Form 1023 that it has a gardening and landscaping contract with Madison Landscaping, which is owned by the organization's husband and wife board members

Page 4 – Are There Potential Disqualifying Issues?

Given the information gathered from the Form 1023 application, do we need to develop this case?

Well, let's take a look at what the IRM says.

IRM 7.20.2.3 tells us that:

For initial and reinstatement exemption requests, limit activity development to cases that indicate activities and or purposes potentially contrary to the requirements for recognition of tax exemption. However, the organization must describe its activities in sufficient detail to permit you to conclude that it'll meet the requirements of its requested subsection (Rev. Proc. 2015-9, updated annually).

So, let's assume we have a complete application with no foundation classification, effective date, automatic revocation or administrative issues. If an organization described its activities in sufficient detail to permit us to conclude that it met the requirements of its requested subsection, and if there are no indicators of activities and or purposes that are potentially contrary to the requirements for tax exemption, we will recommend the application for approval.

However, if there are any indicators of potentially disqualifying issues, we must develop these issues.

A list of the potentially disqualifying issues for organizations seeking recognition of exempt status under Code section 501(c)(3) that we may encounter in our cases is on this slide. Note that this list is not all inclusive.

Page 5 – Identify Potential Disqualifying Issues

Let's get back to our scenario of an organization operating a public garden and park.

Does this case need development?

- Did the organization describe its activities in sufficient detail to permit us to conclude that it'll meet the requirements of its requested subsection in accordance with Rev. Proc. 2017-5, updated annually?
- Are there any indicators of activities and/or purposes that are contrary to the requirements of tax exemption?

What do you all think?

The organization has provided sufficient description of its public garden and park activities. But I think that this case requires development because there is a potential disqualifying issues in this application:

Here are some of my thoughts:

We need more information about the service contract Madison Landscaping has with the organization:

- Did the organization get bids from other gardening and landscaping contractors besides Madison Landscaping?
- Were the terms of the contract negotiated at arm's length?
- Does Madison Landscaping benefit substantially from its contract with the organization?

The issue from our list of potentially disqualifying issues I see is:

- If Madison Landscaping substantially benefits from its contract with the organization, the organization may be operating for a substantial nonexempt purpose.

So, I think there is potential disqualification issue in this scenario that requires development.

Page 6 – Get the Facts

Rev. Proc. 2017-5, Section 3.05, tells us that a determination letter on exempt status is issued based solely upon the facts, attestations, and representations contained in the administrative record.

Therefore, we need to properly develop the case to obtain an agreed upon set of facts in the administrative record.

To do this, we follow the procedures in IRM 7.20.2.

When requesting additional information, use the appropriate approved streamline questions, Letter 1312 pre-written questions, and/or individually composed questions.

The approved streamline questions and Letter 1312 pre-written questions are available on the EO SharePoint site and on the IRS.gov web address shown on this slide.

When warranted, be sure to work with your manager to ensure that the development questions are appropriate and necessary for your case.

Page 7 – Get the Facts

Getting back to our scenario, we properly developed the case and here are the additional facts we received from case development:

- The organization received bids from various gardening and landscaping service providers
- Madison Landscaping was selected as the service provider because it provided the lowest bid and was established as a quality service contractor in the community
- Madison Landscaping was selected as the service provider by the organization's board members unrelated to Madison Landscaping

What would we do in this situation?

Looking at this set of facts, it appears that the landscaping service contract was the result of an arm's length transaction. It looks like the potentially disqualifying issue of substantial nonexempt purpose is resolved. And if there are no other non-qualification issues, I would recommend the application for approval.

Page 8 – Get the Facts

Let's say we have a change in the facts we got from case development. Here are the new facts:

- Madison Landscaping has an exclusive 10-year contract to provide gardening and landscaping services to the applicant organization
- No other bids were obtained from any other garden and landscaping service contractors
- The husband and wife board members controlled the daily operations of the organization and the unrelated board members deferred to the husband and wife to select the landscaping contractor because of their knowledge and experience
- 80% of the organization's income was to pay Madison Landscaping
- Looking at this set of facts, it doesn't appear that the potentially disqualifying issue of substantial nonexempt purpose is resolved. But how do these facts impact the determination of the case? Let's find the laws that are relevant to situations like this.

Page 9 – Find Relevant Law

What do we do now that we've developed the facts, attestations and representations in the case? What laws or authorities are there that will help us make the correct determination?

What do the statutes, tax treaties, Internal Revenue Code, Treasury Regulations, revenue rulings, revenue procedures and court cases say about these issues and fact pattern you've identified?

If the case involves an issue that you are not familiar with, use the resources (including your co-workers and manager) that are available to you to find and identify the most relevant law. The TEGE Knowledge Management libraries are also a great place to start.

Plus, don't forget, EO Determinations Quality Assurance is available help you find relevant law, as well as possibly direct you to past denials that are similar to your case.

When identifying law to use in your case, look for law that addresses the potential disqualifying issues and share a similar or comparable (usually slightly different) fact pattern to your case.

Page 10 – Find Relevant Law

One of the activities of the organization is to operate a public park and garden.

From our research, we found Revenue Ruling 78-85 which provides that an organization formed by residents of a city to help preserve, beautify, and maintain a public park and whose support

is derived from membership dues and contributions from the general public is operated exclusively for charitable purposes.

The fact pattern in Rev. Rul. 78-85 is similar to the organization described in our scenario and the Revenue Ruling also addresses a qualification issue in our scenario. So, this Rev. Rul. seems to be right on point in addressing our first exemption qualification issue in our scenario.

Page 11 – Find Relevant Law

There are various authorities that address our potentially disqualifying issue of substantially nonexempt purpose we identified earlier.

From our research, an example of a court case that addresses the disqualifying issue and shares a similar fact pattern to our case is *International Postgraduate Medical Foundation v. Commissioner*.

The court case shares a similar fact pattern to the organization in our scenario.

- The organization's stated purpose is to provide continuing medical education to physicians by sponsoring seminars
- One of the three board members controlled the organization and exercised that control for the benefit of the for-profit touring business that he owned
- The organization did not solicit competitive bids from any travel agency other than from the related for-profit touring business
- The organization spent about 90 percent of its total revenue on production and distribution of brochures. The purpose for the production and distribution of the brochures was to solicit customers for tours arranged by the related for-profit touring business
- The administrative record supports the finding that the controlling board member formed the organization to obtain customers for his tour business
- The Tax Court found that a substantial purpose of the organization's operations was to increase the income of the related for-profit entity

This court case addresses the potentially disqualifying issue of substantial nonexempt purpose and serving a private rather than a public interest.

- The Tax Court stated in this case that when a for-profit organization benefits substantially from the manner in which the activities of a related organization are carried on, the latter organization is not operated exclusively for exempt purposes within the meaning of section 501(c)(3), even if it furthers other exempt purposes.
- In addition, the Tax Court agreed with the Service that the organization served a private interest rather than a public interest.

Page 12 – Apply the Law

When applying the facts to the law, we must weigh the totality of the facts with the law. We must take all of the facts in the case into consideration.

Compare and contrast the legal reasoning in the law with the facts and issues in your case.

Page 13 – Apply the Law

So, let's compare and contrast the law with the facts and issues in our scenario.

When applying the facts to the law, we know that we must weigh the totality of the facts with the law.

In our scenario:

- On the one hand, operating and maintaining a public park open to the public is a charitable activity based on Revenue Ruling 78-85.
- However, based on *International Postgraduate Medical Foundation v. Commissioner*, when Madison Landscaping benefits substantially from the manner in which the activities of the organization are carried out, the organization is not operated exclusively for exempt purposes under Code section 501(c)(3), even if it furthers other exempt purposes.
- The organization appears to serve the private interests of Madison Landscaping more than incidentally.

Page 14 – Make Your Initial Determination

Now that we have identified any potentially disqualifying issues, received the facts, found the relevant law and applied the law to the facts in our scenario, it's time to make our initial determination.

In applying the relevant law to the facts, do the law and authorities support approval or proposing denial?

Based on a review of the facts and the applicable law in this scenario, it looks like we may have a potential denial. Madison Landscaping substantially benefits from the manner in which the activities of the organization are carried out.

The organization appears to be operated for a substantial nonexempt purpose. Similar to the organization described in *International Postgraduate Medical Foundation v. Commissioner*, the organization serves the private interests of a related for-profit entity more than incidentally.

Stay tuned for our 2nd podcast in this series on Proposing Denial.

Now that we know we have a potential denial, in Part 2 of this podcast series, we'll talk about the next steps in the denial process including obtaining managerial concurrence on proposing denial and engaging the organization in a discussion on the issues found in the case.

We'll also demonstrate the actual writing of the proposed denial letter. Thank you for your participation!