Internal Revenue Service

District Director

[redacted]

Department of the Treasury

P.O. Box 2508
Cincinnati, OH 45201

Person to Contact:
[redacted]

Telephone Number
[redacted]

Refer Reply to:
EP/EO

Employer Identification Number:
[redacted]

Date: APR 01 1996

Dear Sir or Madam:

We have considered your application for recognition of exemption from Federal income tax under the provisions of section 501(c)(3) of the Internal Revenue Code of 1986 and its applicable Income Tax Regulations. Based on the available information, we have determined that you do not qualify for the reasons set forth on Enclosure I.

Consideration was given to whether you qualify for exemption under other subsections of section 501(c) of the Code and we have concluded that you do not.

As your organization has not established exemption from Federal income tax, it will be necessary for you to file an annual income tax return on Form 1041 if you are a trust or Form 1120 if you are a corporation or an unincorporated association. Contributions to you are not deductible under section 170 of the Code.

If you are in agreement with our proposed denial, please sign and return one copy of the enclosed Form 6018, Consent to Proposed Adverse Action.

You have the right to protest this proposed determination if you believe that it is incorrect. To protest, you should submit a written appeal giving the facts, law and other information to support your position as explained in the enclosed Publication 892, "Exempt Organizations Appeal Procedures for Unagreed Issues". The appeal must be submitted within 30 days from the date of this letter and must be signed by one of your principal officers. You may request a hearing with a member of the Office of the Regional Director of Appeals when you file your appeal. If a hearing is requested, you will be contacted to arrange a date for it. The hearing may be held at the Regional Office, or, if you request, at any mutually convenient District Office. If you are to be represented by someone who is not one of your principal officers, he or she must file a proper power of attorney and other wise qualify under our Conference and Practice Requirements as set forth in Section 601.502 of the Statement of Procedural Rules, Treasury Department Circular No. 230.

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[redacted]

If you do not protest this proposed determination in a timely manner, it will be considered by the Internal Revenue Service as a failure to exhaust available administrative remedies. Section 7428(b) (2) of the Internal Revenue code provides in part that:

> A declaratory judgement or decree under this section shall not be issued in any proceeding unless the Tax Court, the Claims Court, or the district court of the United States for the District of Columbia determines that the organization involved has exhausted administrative remedies available to it within the Internal Revenue Service.

If we do not hear from you within the time specified, this will become our final determination. In that event, appropriate State officials will be notified of this action in accordance with the provisions of section 6104(c) of the Code.

Sincerely yours,

[redacted]

District Director

Enclosures: 3

cc: [redacted]

ENCLOSURE I

[redacted]

[redacted] was incorporated in the State of [redacted] on [redacted]. The Application for Recognition of Exemption under Section 501(c)(3), Form 1023, was filed on [redacted].

The Articles of Incorporation provides among its purposes the following: to organize, equip, operate and maintain a residential facility for troubled youths and to provide education and counseling services to such youths and to provide adequate supervision and guidance. The Articles of Incorporation states that the organization will receive funds, and contributions for exclusively charitable, religious, educational and scientific purposes.

The Code of Regulations provides that the organization is to be governed by a Board of Trustees. The Board shall elect officers of which the president shall be one of the Trustees.

The application, Form 1023, provides that the activities of the organization will include the provision of comprehensive residential treatment services, such as various types of therapy, basic living skills, and on grounds school. The children are admitted directly into [redacted] from Children's Services Bureau and juvenile court settings.

The application reveals that the organization shares a facility with a for profit organization, [redacted], which is owned by [redacted] and [redacted]. The for profit organization also operates a residential care facility. Both [redacted] and [redacted] serve on the Board of Trustees for [redacted]. [redacted] serves as the president.

The organization has indicated that it has entered into a management contract with [redacted], whereby services are provided by the for profit organization to the nonprofit organization for a fee. This contract was not competitively bid. The terms of the contract were determined by an allocation of the total costs of the facility allocated over the total number of children. Employees of the for-profit will serve as the employees of the nonprofit.

The application further indicates that the organization is an "outgrowth" of the for profit corporation, [redacted], and that the "outgrowth" was necessary in order to allow the governmental agencies who fund the organization for eligible special needs children to receive reimbursement under Title IV-E (4E). The application indicates that the for profit organization will continue to operate as a residential center for youth not subject to the 4E rules.

ENCLOSURE I CONTINUED

[redacted]

In response to our request for copies of contracts to which you are a party, the organization submitted documents with the name of the organization under which the for profit organization does business, [redacted] stating that a specific county was unwilling to enter into contracts with [redacted] unless they obtain Title IV-E eligibility.

The sources of financial support for the organization will include county and court per diem rates, grants, and donations. These funds will be expended on rent, food, salaries, vehicle, laundry, office supplies, counseling, education and various other expenses. Based on the information submitted, the majority of expenses will be payable to [redacted] under the Management Contract.

Section 501(c)(3) of the Internal Revenue Code of 1986 provides, in part, for the exemption from Federal income tax:

> Organizations 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 Income Tax Regulations states:

> In order to qualify under section 501(c)(3) of the Code, an organization must be both organized and operated exclusively for one or more exempt purposes. If an organization fails to meet either the organizational or operational test, it is not exempt.

Section 1.501(c)(3)-1(c)(2) of the Regulations states 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)(1)(ii) of the Regulations states that an organization is not operated exclusively for one or more exempt purposes 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.

In International Postgraduate Medical Foundation v. Commissioner, TCM 1989-36, the Tax Court considered the qualification for exemption under section 501(c)(3) of the Code of a nonprofit corporation that conducted continuing medical educational tours. Michael Helin, trustee and executive director of the nonprofit corporation, was also a shareholder and president of H & C Tours, a travel agency. The Foundation used H & C tours for all travel arrangements. The Foundation did not solicit competitive bids from any entity other than H & C Tours. In holding the Foundation not to be exempt, the Court stated:

ENCLOSURE I CONTINUED

[redacted]

> 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.

Revenue Ruling 69-266, 1969-1 C.B. 151 holds that a nonprofit organization formed and controlled by a physician, "hired" to conduct research programs consisting of examining and treating patients who are charged the prevailing fees for services rendered, is not exempt under section 501(c)(3) of the Code. The revenue ruling concludes that the operation of the medical practice does not differ significantly from the private practice of medicine. The organization's primary function is to serve the private interest of its creator rather than a public interest.

The organization holds that it should be granted exemption based on the fact that the activities it conducts are charitable. In a telephone conversation with [redacted], he stated that he did not want to release control of the organization to persons who may not know anything about operating a residential care facility. He further indicated that it was necessary to protect his private interests in the building and that the facility would remain for profit. He stated that due to the way the facility was operated that on the surface it was difficult to distinguish those children who have been placed with the for profit from those placed with the nonprofit but that the books and records separate them. He stated that the organization was continually seeking a separate location but has not yet been able to find one due to the popularity and interest of other organizations in obtaining Title IV-E eligible children.

Based on the facts presented above, we hold that your organization does not meet the operational test for exemption under section 501(c)(3) of the Code.

The role of an employee or independent contractor must be that of someone contracted to perform specific services pursuant to arm's length bargaining. When the employee/independent contractor is found to be a controlling element in the arrangement, prima facie evidence of inurement exists, and exemption under section 501(c)(3) of the Code will be denied.

[redacted] is involved in activities which are a substantial part of your organization. Based on the facts and circumstances and [redacted]'s relationship with the for profit and your organization, the interests in both organizations are intermingled.

ENCLOSURE I CONTINUED

[redacted]

Their proprietary interest in [redacted] can no longer be separated from the public interest that an organization described in section 501(c)(3) would be required to serve, thus precluding you from being operated exclusively for exempt purposes within the meaning of section 1.501(c)(3)-1(d)(1) of the Regulations. The benefits to [redacted], through [redacted], constitutes private benefit and inurement in violation of section 1.501(c)(3)-1(c)(2) of the Regulations.

[redacted]'s arrangement with [redacted] is similar to the one described in International Postgraduate Medical Foundation V. Commissioner in that there were no competitive bids for the management contract and the for profit organization benefits substantially from the activities carried on by [redacted]. Therefore, even if charitable activities are conducted, the evidence of inurement and private benefit precludes exemption under section 501(c)(3) of the Code.

Further, you are similar to the organization described in the Revenue Ruling 69-266 in that the activities conducted by the nonprofit organization are not distinguishable from those of the for profit organization and private interests are being served.

Accordingly, we conclude that you do not qualify for exemption under section 501(c)(3) of the Code.