



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

Number: **200545046**
Release Date: 11/10/05
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Date: 08/18/05

Contact Person:

Identification Number:

Contact Number:

FAX Number:

Employer Identification Number:

Uniform Issue List: 501.00-00

Legend:

M =
N =
State =
Date =
Z =

Dear

We have considered your application for recognition of exemption from federal income tax under section 501(a) of the Internal Revenue Code as an organization described in section 501(c)(3). Based on the information submitted, we have concluded that you do not qualify for exemption under that section. The basis for our conclusion is set forth below.

FACTS

You, M, are a State non-profit corporation, formed on Date. Your Articles of Incorporation state that you are organized and shall be operated "exclusively for religious, charitable and educational purposes, including, for such purposes, the making of distribution (*sic*) to organizations that qualify as exempt organizations under Section 501(c)(3) of the Internal Revenue Code of 1954 (or the corresponding provision of any future United States Internal Revenue Law)."

Your application, Form 1023, provides that you provide gift funds to qualified buyers

purchasing participating homes and using eligible loan programs. In your letter of December 1, 2003, you indicate that your gifts are available to any individual purchasing a home and having been approved by a mortgage company.

You distribute a brochure describing your gift program. The brochure indicates that there are no income limits with respect to prospective buyers. In addition, it provides that help is available to people residing in a specified, large metropolitan area.

The brochure states, "Buyers must be pre-qualified by N." A member of your governing board owns N. Your founder and president manages the local office of N.

You do not actually meet with the buyers. Contact is made through loan officers familiar with your program. You request a copy of the loan application and the related underwriting approval. Upon receipt, you furnish the loan officer with a gift letter for the buyer to sign. On the closing date, you send the down payment assistance to the closing agent. After the sale is completed, the closing agent remits the seller's contribution to you.

Your December 1, 2003 submission discusses the eligibility of buyers and the condition of the homes to be purchased. In that letter, you make the following representations:

1. "We do not have any set rules for eligibility of (*sic*) use of the program."
2. "We do not limit a buyer because of income and/or assets. The lender must determine their eligibility."
3. You do not determine the amount of the down payment assistance to be provided. That amount is determined by the lender. However, the amount of the down payment assistance cannot exceed 6% of the contract price.
4. You indicate that the only application required with respect to the gift program is a copy of the Uniform Residential Loan Application which the purchaser fills out at the time of the loan application. However, your brochure contains a gift application to be completed by the buyer. The brochure instructs the buyer to give the completed application to a community representative, realtor or lender.
5. "It is the job of the lender to make sure the down payment assistance is being used correctly with the loan program, for example a hud (*sic*) loan."
6. "M does not buy, sell, or rent properties. Because of that fact, we do not provide low-income housing to anyone."
7. "We do not determine if a home meets any requirements to use the down payment assistance program."
8. "It is the lender who the buyer is going through to determine if the home meets the loan

program the buyer is going through (*sic*). We do not approve or reject any home from participating in the program.”

9. “We have no requirements on the appraisal of the property.”
10. “At this time, we do not provide any homeowner education courses.”
11. “We do not provide any other services to the buyer after closing at this time. We do not require the buyer to use any other service to use our program. It is the responsibility of the lender to determine if the buyer needs to use any of those programs.”

With respect to the sellers, you make the following representations in your December 1, 2003 submission:

1. “Any seller can use the program. Typically, the seller contribution is contingent on the sale of the seller’s home.”
2. Sellers are required to enter into a Participating Home Agreement. That agreement was not furnished.
3. Sellers are required to pay a processing fee of 1% of the sales price not to exceed z.
4. The amount of the down payment assistance is not determined by you or the seller. The lender determines the amount necessary to approve the loan. You cap that amount at 6% of the sales price. The funds are provided to you by the seller and placed in a general fund.
5. The seller is required to deliver the real estate purchase contract and the receipt for the down payment assistance amount to the certified escrow office or closing agent.
6. “Any funds not used by the homebuyer would be returned to M by the closing agent. It is the closing agents (*sic*) responsibility to insure that M is returned the money from the seller that matches the gift. The closing agent would be responsible for any errors to the hud-1 (*sic*) settlement statement the (*sic*) show M not getting the correct amount.”
7. “We do promote the M program through real estate agents and mortgage lenders. Real estate agents are good sources of potential homebuyers that might need the down payment assistance program as well as mortgage lenders. As of right now, we market (*sic*) these people through direct contact and a computer generated brochure. Hopefully, we will get marketing items, such as M pads, pens, calendars, etc. to them to help sell the program.”

You make your services known through commercial advertising, realtors, mortgage companies, and mass mailings.

In an undated letter which was received subsequent to your December 1, 2003 letter, you state that you have always provided credit counseling services to your clients. You also provide your clients with a video prepared by another company. The video and instructional materials help prospective home buyers gain knowledge about the home buying process and develop a financial plan to help them set realistic goals in buying a home. After your clients watch the video, you provide help with the paper work.

In your March 13, 2004 submission, you state that although you did not have any requirements for participation in your down payment assistance program, you would begin to use HUD income limits to allow only low income clients, the disabled and the elderly to use your program; however, you stated that effective March 1, 2004, you suspended operations pending a ruling by the Internal Revenue Service.

You represent that you operate in a manner similar to a specified organization. The manner in which you and this organization operate is referred to as "seller-funded downpayment assistance" in the *Final Report, An Examination of Downpayment Gift Programs Administered by Non-Profit Organizations*, commissioned by the Office of Housing, United States Department of Housing and Urban Development, HUD Contract No: C-OPC-22550/M0001 (March 1, 2005). The report concludes that seller-funded downpayment assistance for mortgage downpayments has led to underwriting problems that require immediate attention. Furthermore, the report concludes that the effective costs of homeownership are increased even more by the processing fees charged by the seller-funded downpayment assistance providers which get passed through to borrowers in higher property prices. A copy of the report is enclosed with this determination letter.

You are governed by a four member board of directors. Your board consists of a managing general partner of a financial consulting firm, the owner of N, a mortgage company, and two attorneys employed by title companies.

You have two officers. Your president manages the local office of N. In that capacity, he originates mortgage loans. Your vice-president is the spouse of your president. Her last place of employment was a bank where she was a loan originator.

Your application indicates that your sole source of support is donations equal to 1% of the selling price of the home, not to exceed z. This is paid by the seller to cover your administrative costs. In fact, your primary source of support is "contributions" provided to you by the sellers.

You do not engage in any fundraising activities and have no plans to do so.

LAW

Section 501(c)(3) of the Code provides for the exemption from federal income tax of corporations organized and operated exclusively for charitable or educational purposes, provided no part of the net earnings inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(c)(1) of the Income Tax Regulations provides that an organization operates exclusively for exempt purposes only if it engages primarily in activities that accomplish exempt purposes specified in section 501(c)(3) of the Code. An organization must not engage in substantial activities that fail to further an exempt purpose.

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)(1)(ii) of the regulations provides that an organization is not organized or operated exclusively for exempt purposes unless it serves a public rather than a private interest. To meet this requirement it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests.

Section 1.501(c)(3)-1(d)(2) of the regulations defines the term “charitable” as used in section 501(c)(3) of the Code as including the relief of the poor and distressed or of the underprivileged. The term “charitable” also includes the advancement of education.

Section 1.501(c)(3)-1(d)(3)(i) of the regulations provides, in part, that the term “educational” as used in section 501(c)(3) of the Code relates to the instruction of the public on subjects useful to the individual and beneficial to the community.

Section 1.501(c)(3)-1(e) of the regulations provides that an organization that operates a trade or business as a substantial part of its activities may meet the requirements of section 501(c)(3) of the Code if the trade or business furthers an exempt purpose, and provided the organization’s primary purpose does not consist of carrying on an unrelated trade or business.

In Better Business Bureau of Washington, D.C. v. U.S., 326 U.S. 279, 283 (1945), the Supreme Court held that the “presence of a single . . . [nonexempt] purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly . . . [exempt] purposes.”

In Easter House v. U.S., 12 Cl. Ct. 476, 486 (1987), aff’d, 846 F. 2d 78 (Fed. Cir.) cert. denied, 488 U.S. 907 (1988), the court found an organization that operated an adoption agency was not exempt under section 501(c)(3) of the Code because a substantial purpose of the agency was a nonexempt commercial purpose. The court concluded that the organization did not qualify for exemption under section 501(c)(3) because its primary activity was placing children for adoption in a manner indistinguishable from that of a commercial adoption agency. The court rejected the organization’s argument that the adoption services merely complemented the health related services to unwed mothers and their children. Rather, the court found that the health-related services were merely incident to the organization’s operation of an adoption service, which, in and of itself, did not serve an exempt purpose. The organization’s sole source of support was the fees it charged adoptive parents, rather than contributions from the public. The court also found that the organization competed with for-profit adoption agencies, engaged in substantial advertising, and accumulated substantial profits. Accordingly, the court found that the “business purpose, and not the advancement of educational and charitable activities

purpose, of plaintiff's adoption service is its primary goal" and held that the organization was not operated exclusively for purposes described in section 501(c)(3). Easter House, 12 Cl. Ct. at 485-486.

In American Campaign Academy v. Commissioner, 92 T.C. 1053 (1989), the court held that an organization that operated a school to train individuals for careers as political campaign professionals, but that could not establish that it operated on a nonpartisan basis, did not exclusively serve purposes described in section 501(c)(3) of the Code because it also served private interests more than incidentally. The court found that the organization was created and funded by persons affiliated with Republican Party entities and that most of the organization's graduates worked in campaigns for Republican candidates. Consequently, the court concluded that the organization conducted its educational activities with the objective of benefiting Republican candidates and entities. Although the candidates and entities benefited were not organization "insiders," the court stated that the conferral of benefits on disinterested persons who are not members of a charitable class may cause an organization to serve a private interest within the meaning of section 1.501(c)(3)-1(d)(1)(ii) of the regulations. The court concluded by stating that even if the Republican candidates and entities did "comprise a charitable class, [the organization] would bear the burden of proving that its activities benefited members of the class in a non-select manner."

In Aid to Artisans, Inc. v. Commissioner, 71 T.C. 202 (1978), the court held an organization that marketed handicrafts made by disadvantaged artisans through museums and other non-profit organizations and shops be operated for exclusively charitable purposes within the meaning of section 501(c)(3) of the Code. The organization, in cooperation with national craft agencies, selected the handicrafts it would market from craft cooperatives in communities identified as disadvantaged based on objective evidence the Bureau of Indian Affairs or other government agencies. The organization marketed only handicrafts it purchased in bulk from these communities of craftsmen. It did not select individual craftsmen based on the needs of the purchasers. The court concluded that the overall purpose of the activity was to benefit disadvantaged communities. The method it used to achieve its purpose did not cause it to serve primarily private interests because the disadvantaged artisans directly benefited by the activity constituted a charitable class and the organization showed no selectivity with regard to benefiting specific artisans. Therefore, the court held that the organization operated exclusively for exempt purposes.

In Airlie Foundation v. Commissioner, 283 F. Supp. 2d 58 (D.D.C., 2003), the court relied on the "commerciality" doctrine in applying the operational test. Because of the commercial manner in which this organization conducted its activities, the court found that it was operated for a non-exempt commercial purpose, rather than for a tax-exempt purpose. "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, *inter alia*, whether the organization uses commercial promotional methods (e.g. advertising) and the extent to which the organization receives charitable donations."

In Church of Eternal Life and Liberty, Inc. v. Commissioner, 86 T.C. 916, 926 (1986), the court stated that while the payment of reasonable salaries does not constitute prohibited inurement, the payment of excessive salaries does.

Rev. Rul. 67-138, 1967-1 C.B. 129, holds that helping low income persons obtain adequate and affordable housing is "charitable" because it relieves the poor and distressed or underprivileged. The organization carried on several activities directed to assisting low-income families obtain improved housing, including (1) coordinating and supervising joint construction projects, (2) purchasing building sites for resale at cost, and (3) lending aid in obtaining home construction loans.

Rev. Rul. 70-585, 1970-2 C.B. 115, discusses four examples of organizations providing housing and whether each qualified as charitable within the meaning of section 501(c)(3) of the Code. Situation 1 describes an organization formed to construct new homes and renovate existing homes for sale to low-income families who could not obtain financing through conventional channels. The organization also provides financial aid to eligible families who do not have the necessary down payment. When possible, the organization recovered the cost of the homes through very small periodic payments, but its operating funds were obtained from federal loans and contributions from the general public. The revenue ruling holds that by providing homes for low-income families who otherwise could not afford them, the organization relieved the poor and distressed.

Situation 2 describes an organization formed to ameliorate the housing needs of minority groups by building housing units for sale to persons of low and moderate income on an open-occupancy basis. The housing is made available to members of minority groups who are unable to obtain adequate housing because of local discrimination. The housing units are located to help reduce racial and ethnic imbalances in the community. As the activities were designed to eliminate prejudice and discrimination and to lessen neighborhood tensions, the revenue ruling holds that the organization was engaged in charitable activities within the meaning of section 501(c)(3) of the Code.

Situation 3 describes an organization formed to formulate plans for the renewal and rehabilitation of a particular area in a city as a residential community. The median income level in the area was lower than in other sections of the city and the housing in the area was generally old and badly deteriorated. The organization developed an overall plan for the rehabilitation of the area; it sponsored a renewal project; and involved residents in the area renewal plan. The organization also purchased apartment buildings that it rehabilitated and rented at cost to low and moderate income families with a preference given to residents of the area. The revenue ruling holds that the organization is described in section 501(c)(3) of the Code because its purposes and activities combated community deterioration.

Situation 4 describes an organization formed to alleviate a shortage of housing for moderate-income families in a particular community. The organization planned to build housing to be rented at cost to moderate-income families. The Service held that the organization failed to qualify for exemption under section 501(c)(3) of the Code because the organization's program did not provide relief to the poor or further any other charitable purpose within the meaning of section 501(c)(3) and the regulations.

Rev. Rul. 72-147, 1972-1 C.B. 147, holds that an organization that provided housing to low income families did not qualify for exemption under section 501(c)(3) of the Code because it gave preference to employees of a business operated by the individual who also controlled the

organization. Although providing housing for low income families furthers charitable purposes, doing so in a manner that gives preference to employees of the founder's business primarily serves the private interest of the founder rather than a public interest.

RATIONALE AND CONCLUSION

Based on the information you provided in your application and supporting documentation, we conclude that you are not operated for exempt purposes under section 501(c)(3) of the Code. An organization cannot be recognized as exempt under section 501(c)(3) unless it shows that it is both organized and operated exclusively for charitable, education, or other exempt purposes. Among other things, the application and supporting documentation must demonstrate conclusively that the organization meets the operational test of section 1.501(c)(3)-1(c) of the regulations. Your information indicates that your primary purpose is to operate a down payment assistance program that does not exclusively serve a purpose described in section 501(c)(3).

Charitable purposes include relief of the poor and distressed. See section 1.501(c)(3)-1(d)(2) of the regulations. However, you do not conduct your down payment assistance program in a manner that establishes that your primary purpose is to address the needs of low-income grantees by enabling low-income individuals and families to obtain decent, safe housing. See Rev. Rul. 70-585, Situation 1.

For the three years you were operational, your down payment assistance program did not serve exclusively low-income persons. Instead, your program was open to anyone without any income limitations. You have not demonstrated that your down payment assistance program exclusively serves any other exempt purpose such as combating community deterioration and lessening racial tensions. You indicated that you do not specifically target the benefits of your program towards any one disadvantaged group. For example, you have not shown that your program is designed to attract a mixed-income group of homeowners to a specifically defined geographical area that has a history of racial problems. See Rev. Rul. 70-585, Situations 2 and 3. Further, though your March 13, 2004 submission indicates that you will use HUD guidelines in the future, you are not currently operational. You suspended your operations effective March 1, 2004.

Your information indicates that you do not limit your assistance to certain geographic areas or target those areas experiencing deterioration or racial tensions. See Rev. Rul. 70-585, Situation 4. Your program is available to anyone who is able to qualify for a mortgage in a large metropolitan area. Arranging the purchase of homes in a broadly defined metropolitan area does not combat community deterioration within the meaning of section 501(c)(3) of the Code.

Furthermore, you do not engage in any activity to ensure that the house will be habitable or that the buyer will be able to afford to maintain the house over time. Instead, you rely solely on the mortgage lender, insurance agency, home inspector or other third party to conduct such review. In your December 1, 2003 submission, you state that you do not provide any educational courses to buyers. That is consistent with your representation that you do not have direct contact with the buyers. You later indicated that you do provide educational material in the form of a video and study guide. You provided a copy of a video tape and guide. The video and instructional materials help prospective home buyers gain knowledge about the home buying process and develop a financial plan to help them set realistic goals in buying a home. You do not indicate when you began using this video tape or how many buyers received it. Accordingly, you do not provide oversight or conduct any educational program or other activity to ensure that buyers are purchasing properties that are safe, decent, sanitary, and affordable.

Only an insubstantial portion of the activity of an exempt organization may further a nonexempt purpose. As the Supreme Court held in Better Business Bureau of Washington D.C., Inc. v. United States, *supra*, the presence of a single non-exempt purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly exempt purposes. Your governing board and all of your officers are individuals directly or indirectly engaged in the selling of homes. Your brochure indicates that all applicants must have loan approval from a mortgage company owned by one of your directors and managed by your president. You conduct your operations in a manner that is consistent with a commercial firm seeking to maximize sales of services, rather than in a manner that would be consistent with a charitable or educational organization seeking to serve a charitable class or the public at large. The manner in which you operate your down payment assistance program indicates that you facilitate the sales of homes in a manner that is indistinguishable from an ordinary trade or business. You operate as a business that provides services to home sellers for which you charge a market rate fee. This type of approach, as well as your representation that the amount of the gift is determined by the loan officer rather than you maximizes the number of potential homeowners, helps to demonstrate that your primary purpose consists of maximizing the fees you derive from facilitating sales of real property. In this respect you are similar to an organization which was denied exemption because it operated a conference center for a commercial purpose. See Airlie Foundation, Inc. v. U.S., 283 F. Supp. 2d 58 (D.D.C., 2003). Likewise, operating a trade or business of facilitating home sales is not an inherently charitable activity. Thus, a substantial part of your activities further a nonexempt purpose.

Another indication of your substantial nonexempt purpose is your lack of public support. You are not supported by contributions from the general public, government or private foundation grants. Almost all of your revenue comes from the sellers you serve. That your primary activity is to promote and to further your private business interests is reflected in the financing structure of your down payment assistance program. In this respect you are similar to the organization described in Easter House, *supra*, which derived most of its support from fees it charged for its adoption services. In this case, the court stated that the substantial fees were not incidental to the organization's exempt purpose because they were designed to make a profit. Facilitating home sales, like running an adoption service, is not an inherently charitable activity, and receiving support primarily from fees charged to home sellers is indicative of your commercial purpose.

Even if your program was directed to exclusively low-income individuals, your reliance entirely on home sellers or other real-estate related businesses that stand to benefit from the transactions to finance your down payment assistance activities demonstrates that you are operated for the purpose of benefiting private parties.

Your grant making procedures indicate that gift funds are only provided if a seller has paid a processing fee and has made a contribution to you. In fact, while you call the funds you will receive from the sellers “contributions”, these transactions are not contributions because they will not “proceed from detached and disinterested generosity.” Commissioner v. Duberstein, 363 U.S. 278, 285 (1960). Your characterization of these transactions as contributions ignores the business realities surrounding the payments. The sellers will make the payments to you and indirectly to the homebuyer to facilitate the sale of their homes. In fact, your representation that an amount equal to the seller’s “contribution” will be returned to you by the closing agent demonstrates the circular character of the payments.

These “contributions” are more appropriately characterized as fees received in exchange for the sale of a service. Your information indicates that sellers are required to make contributions needed to cover the down payment assistance an applicant has requested. Further, the funds revert to the seller if there is no sale. The fact that you receive a payment from the closing agent corresponding to the amount of the down payment assistance provided by the seller indicates that the benefit to the home seller is not a mere accident but rather an intended outcome of your operations. In this respect, you are like Easter House, *supra*, which provided health care to indigent pregnant women, but only when a family willing to adopt a woman’s child sponsored the care financially. Similar to American Campaign Academy, *supra*, you are structured and operated to directly benefit the home sellers who pay for your services. Therefore, a substantial part of your activities serve a private rather than a public interest.

Finally, you assert that another organization similarly situated has been recognized as exempt under section 501(c)(3). While you may have provided some facts relating to that other organization, you have not provided all the facts relating to the applications for recognition of exempt status submitted by those organizations. In any event, you must establish based on the facts you submitted that you are organized and operated exclusively for exempt purposes described in section 501(c)(3). See Interneighborhood Housing Corporation v. Commissioner, T.C. Memo 1982-661.

Based on the facts and information submitted, you are not operated exclusively for exempt purposes. You have not established that you activities exclusively serve a charitable class or any other purpose defined in section 501(c)(3). Your proposed operations further a substantial nonexempt business purpose and will further the private interests of home sellers and other private parties. In addition, you have not established that your net earnings will not inure to the benefit of private shareholders or individuals. Therefore, you are not described in section 501(c)(3) of the Code.

Accordingly, you do not qualify for exemption as an organization described in section 501(c)(3) of the Code and you must file federal income tax returns.

Contributions to you are not deductible under section 170 of the Code.

You have the right to protest this ruling if you believe it is incorrect. To protest, you should submit a statement of your views to this office, with a full explanation of your reasoning. This statement, signed by one of your officers, must be submitted within 30 days from the date of this letter. You also have a right to a conference in this office after your statement is submitted. You must request the conference, if you want one, when you file your protest statement. If you are to be represented by someone who is not one of your officers, that person will need to file a proper power of attorney and otherwise qualify under our Conference and Practices Requirements.

If you do not protest this ruling 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 Code provides, in part, that a declaratory judgment or decree under this section 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 administrative remedies available to it within the Internal Revenue Service.

If we do not hear from you within 30 days, this ruling will become final and a copy will be forwarded to the Ohio Tax Exempt and Government Entities (TE/GE) office. Thereafter, any questions about your federal income tax status should be directed to that office, either by calling 877-829-5500 (a toll free number) or sending correspondence to: Internal Revenue Service, TE/GE Customer Service, P.O. Box 2508, Cincinnati, OH 45201. The appropriate State Officials will be notified of this action in accordance with section 6104(c) of the Code.

In the event this ruling becomes final, it will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, *Notice of Intention to Disclose*. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

If you decide to protest this ruling, your protest statement should be sent to the address shown below. If it is convenient, you may fax your reply using the fax number shown in the heading of this letter. If you fax your reply, please contact _____ by telephone to confirm that your fax was received.

Internal Revenue Service
TE/GE (SE:T:EO:RA:T:2)
PE
1111 Constitution Ave, N.W.,
Washington, D.C. 20224

If you do not intend to protest this ruling, and if you agree with our proposed deletions as shown in the letter attached to Notice 437, you do not need to take any further action.

This proposed determination supercedes our letter dated August 10, 2005.

If you have any questions, please contact .

Sincerely,

Lois G. Lerner
Director, Exempt Organizations
Rulings & Agreements

Enclosure

Notice 437

An Examination of Downpayment Gift Programs Administered by Non-Profit Organizations
HUD Contract No: C-OPC-22550/M0001 (March 1, 2005)