



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

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Release Date: 3/15/2013
Date: December 18, 2012
UIL Code: 501.32-00
501.33-00
501.03-24

Contact Person:
Identification Number:
Contact Number:
Employer Identification Number:
Form Required To Be Filed:
Tax Years:
All Years

Dear

This is our final determination that you do not qualify for exemption from Federal income tax as an organization described in Internal Revenue Code section 501(c)(3). Recently, we sent you a letter in response to your application that proposed an adverse determination. The letter explained the facts, law and rationale, and gave you 30 days to file a protest. Since we did not receive a protest within the requisite 30 days, the proposed adverse determination is now final.

Since you do not qualify for exemption as an organization described in Code section 501(c)(3), donors may not deduct contributions to you under Code section 170. You must file Federal income tax returns on the form and for the years listed above within 30 days of this letter, unless you request an extension of time to file.

We will make this letter and our proposed adverse determination letter available for public inspection under Code section 6110, after deleting certain identifying information. Please read the enclosed Notice 437, *Notice of Intention to Disclose*, and review the two attached letters that show our proposed deletions. If you disagree with our proposed deletions, you should follow the instructions in Notice 437. If you agree with our deletions, you do not need to take any further action.

In accordance with Code section 6104(c), we will notify the appropriate State officials of our determination by sending them a copy of this final letter and the proposed adverse letter. You should contact your State officials if you have any questions about how this determination may affect your State responsibilities and requirements.

Letter 4038(CG) (11-2005)
Catalog Number 47632S

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. If you have any questions about your Federal income tax status and responsibilities, please contact IRS Customer Service at 1-800-829-1040 or the IRS Customer Service number for businesses, 1-800-829-4933. The IRS Customer Service number for people with hearing impairments is 1-800-829-4059.

Sincerely,

Holly O. Paz
Director, Exempt Organizations
Rulings and Agreements

Enclosure
Notice 437
Redacted Proposed Adverse Determination Letter
Redacted Final Adverse Determination Letter



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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Date: 11/1/12

Contact Person:

Identification Number:

Contact Number:

FAX Number:

Employer Identification Number:

LEGEND:

UIL:

501.32-00
501-33-00
501.03-24

M = Name of for-profit company
N = State
R = Date
P = Name of company

Dear

We have considered your 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 you do not qualify for exemption under Code section 501(c)(3). The basis for our conclusion is set forth below.

Issues

Do you operate exclusively for 501(c)(3) purposes? No for the reasons described below.

Do you operate in a commercial manner? Yes, for the reasons described below.

Did you establish that your operations will not inure to the benefit of insiders? No for the reasons described below.

Facts

Your founder worked on developing a device used in the detection of a specific disease,

Letter 4036(C) ((11-2011))
Catalog Number 47630W

both as part of his PhD dissertation work and also through his wholly owned for-profit company, M. He was awarded a grant from a "local business incubator" to develop a business plan to develop and market the device. Your founder originally intended to create a medical technology company named P. Instead he created you and transferred P's business plan to you. "A great deal of basic research was needed to bring the device to a commercial stage of development making the introduction of a not for profit venture a more reasonable vehicle for the development of such technology...where public grants may be accessed more easily." You were incorporated in N on R. Your purpose in pertinent part is: "charitable scientific and educational purposes within the meaning of Section 501(c)(3)..."

Your governing body consists of your founder, his mother and his sister. Because your board members live in different parts of the country they will meet in person at least once a year to conduct business matters.

Your activities consist of building on your founder's previous research. With your formation you will apply for grants. You intend to produce prototypes of non-invasive devices to use in the detection of diseases. The devices will be "produced, manufactured and tested locally." M prepared a technical proposal which outlined the commercialization strategy. The product(s) will be marketed through direct sales and licensing agreements with medical supply companies. Further a provisional patent was granted to your founder for the device. You submitted an unexecuted licensing agreement between you and your founder. The agreement gave you "an exclusive license to use" the device and stated your founder "retains title and ownership" in the form of mutual funds in a brokerage account. You abandoned the licensing arrangement when your founder decided to transfer the patent rights to you. You did not substantiate ownership of the patent or the transfer to you.

You were asked to provide an expert valuation of the intellectual rights. In response you stated your founder valued the rights. His valuation was reviewed by an objective panel during a business plan competition and found to be sound. You did not substantiate the statement with any evidence or otherwise provide a valuation of the rights. You investigated hiring a legal firm to provide an independent appraisal of the intellectual property rights. However, to hire a legal firm....would cost you in excess of \$35,000.00. Such costs are prohibitive and repetitive as the appraisal expert you consulted said they would conduct the same analysis as previously performed for your founder and would use similar comparisons.

The financial viability of your products will be evaluated before projects are undertaken. All your research will be published. Marketing and pricing policies of these devices have yet to be developed.

You are continuing to perform basic scientific research, which is necessary for

understanding the science and building of such devices. You are responsible for developing and marketing the product and licensing supply companies, not M. Your founder will be responsible for the technical viability and commercialization of projects and will direct and conduct much of the research. Your founder will also continue a research relationship with the University after completing the PhD work. Mathematical modeling, computational work, simulation and administrative work will be completed at your office.

Publication of results for the device will include a dissertation as part of your founder's PhD requirements. Publication of research will be dependent upon the selection of the publishing entity, topic or research. You have made no commitments to any commercial entities relating the results of research.

You will sell your diagnostic tool device to interested parties. You have not identified an interested party and have no arrangement at this time. Further, commercialization of the device is not your primary purpose, but would provide needed funds for your on-going operation. Your primary function would continue to be research that is conducted in the public interest. You state you will maintain full control of any intellectual property resulting from research you conduct. Proceeds from the sale of the device will allow you to continue your research on diseases.

During your first and second year you received donations totaling more than \$500,000 which consisted of a transfer of marketable securities to you. You stated that the figure represented contributions from your founder's mother. No other gifts, grants or contributions were noted.

Expenses were for property transfer and notes payable to your founder of his company M. More than \$180,000.00 was transferred from you to M in order to settle a debt M accrued related to the development of the detection device. The debt included personal loans made by your founder to M for the technology development of the diagnostic tool device. Correspondence indicated different totals for payments and payments due to intellectual property rights, intellectual transfer fees or reimbursements. You stated that all payments to your founder and his for-profit company were reimbursements for expenses. You did not clarify the nature of the expenses or explain why you were reimbursing M. You did not document the exact amounts paid to and the nature of these payments. You describe the amounts as a "liability" owed to your founder. You explain that you reimbursed M and your founder for the personal funds they had expended in your creation. You contend that the amount paid is less than fair market value of the patent. Total assets on your balance sheet range from approximately \$330,000.00 to just under \$440,000.00. You list as your only asset a mutual fund held with a LLC. Your founder's mother (and your board member) contributed marketable securities to you. However your projected expenses reflect payments to your founder and M exceeding \$500,000.00. Other expenses include compensation to your officers

and professional fees. Compensation for your founder was arrived at through a meeting of your board (of directors).

Your founder determined the dollar amount for the property transfer fees which was decided upon by two factors. The first factor was the percentage of capital and personal investment by your founder and his for profit company M. The second factor M has historically functioned as an IT consulting company. The operations of M have been limited during the past few years due to economic factors and changes in IT consulting industry and have been currently ceased. Further, you indicated that if the economic climate improves and your founder decides to start M operations again, then M would function as a separate entity, performing IT consulting services. You describe M's services as very different from and unrelated to your objectives. M does continue in existence but does not currently operate. You stated you abandoned the licensing agreement, M did not receive royalty payments but instead a reimbursement of expenses. You state you provided an accounting of this information many times before, but you would attempt to recover and resubmit these documents. To date you have not submitted the supporting documents.

Law

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

Section 1.501(c)(3)-1(a)(1) of the Income Tax 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 states: An organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of 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.

Section 1.501(c)(3)-1(c)(2) of the regulations provides that an organization is not operated exclusively for one of more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals. Section 1.501(a)-1(c) of the regulations defines the words "private shareholder or individual" in section 501 to refer to persons having a personal and private interests in the activities of the organization.

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations state that: "an organization is not organized and operated exclusively for one or more of the purposes specified...unless it serves a public rather than a private interest. Thus, to meet the requirements of this subsection, it is necessary for an organization to establish that it is not organized or operated for the benefit or private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled directly or indirectly, by such private interests."

Section 1.501(c)(3)-1(d)(5)(iii) of the regulations provides in pertinent part that research will be regarded in the public interest if the results of such research (including any patents, copyrights, processes or formulae resulting from such research) are made available to the public on a non-discriminatory basis.

In Rev. Rul. 65-1, 1965-1 C.B. 226, the Service considered an organization which promotes and fosters the development and design of machinery in connection with a commercial operation, and in connection therewith has the power to sell, assign, and grant licenses with respect to its copyrights, trademarks, trade names, or patent rights. The Service concluded that the organization does not qualify for exemption from federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954.

Rev. Rul. 67-5, 1967-1 C.B. 123 held that a foundation controlled by the creator's family and operated to enable the creator and his family to engage in financial activities beneficial to them is not entitled to exemption.

Rev. Rul. 69-526, 1969-2 C.B. 115 held that a research organization operated by a group of physicians specializing in heart defects, that investigates the causes and treatment of cardiac and cardiovascular conditions and diseases is exempt under IRC 501(c)(3).

Rev. Rul. 69-266, 1969-1 C.B. 151 held that an organization formed and controlled by a medical doctor to conduct research programs consisting of examining and treating patients who are charged the prevailing fees is not exempt.

Orange County Agricultural Society, Inc., Petitioner v. Commissioner of Internal Revenue, Respondent USTC Docket No. 397-81'X' (1988) indicates that net earnings include more than net profits and may inure to an individual in more ways than in the distribution of dividends.

The Church of Eternal Life and Liberty v. Commissioner, 86 T.C. 916 (1986) describes an organization in which the court wrote that private inurement is strongly suggested where an individual or small group of individuals are the principle contributors to an organization and that individual or small group of individuals have exclusive control over

the management of the organization's funds.

In Better Business Bureau of Washington, D.C., Inc. v. United States, 326 U.S. 279 (1945), the Supreme Court held that 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.

American Science Foundation v. Commissioner, T.C. Memo. 1986-556. indicates that an organization must establish through the administrative record that it operates as a section 501(c)(3) organization.

The Court of Appeals in Parker v. Commissioner, 365 F.2d 792, 799 (8th Cir. 1963) affirmed, the findings of Tax Court that foundation was pursuing a substantially nonexempt purpose in the publication and commercial exploitation of the writings of the founder, director and prime functionary of foundation. The founder had control of the foundation's day to day activities, complete control of its finances and the founders personal funds were to a degree commingled with the funds of the foundation, and that the evidence clearly supported the finding that the foundation was pursuing a substantial non-exempt purpose.

In B.S.W. Group, Inc. v. Commissioner, 70 T.C. 352 (1978), the court found that a corporation formed to provide consulting services did not satisfy the operational test under section 501(c)(3) of the Code because its activities constituted the conduct of a trade or business that is ordinarily carried on by commercial ventures organized for profit. Its primary purpose was not charitable, educational, or scientific, but rather commercial. In addition, the court found that the organization's financing did not resemble that of the typical section 501(c)(3) organizations. It had not solicited, nor had it received, voluntary contributions from the public. Its only source of income was from fees from services, and those fees were set high enough to recoup all projected costs and to produce a profit. Moreover, it did not appear that the corporation ever planned to charge a fee less than "cost." And finally, the corporation did not limit its clientele to organizations that were section 501(c)(3) exempt organizations.

In Airlie Foundation v. Commissioner, 283 F. Supp. 2d 58 (D.D.C., 2003), the District 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. As the court stated: "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 whether the organization uses commercial promotional methods (e.g., advertising) and the extent to which the organization receives charitable donations."

Application of Law

You are not as described in section 501(c)(3) of the Code because you are not operated exclusively for 501(c)(3) purposes and because you have failed to establish your earnings do not inure to the benefit of insiders. Specifically, your operations are consistent with a commercial business and your founder benefits from your operations.

You are not as described in section 1.501(c)(3)-1(a)(1) of the regulations because you are not operated exclusively for one or more of the purposes specified in such section. The production, marketing and sale of devices are not among the purposes described in the regulations.

You are not as described in section 1.501(c)(3)-1(c)(1) of the regulations because more than an insubstantial part of activities are not in furtherance of an exempt purpose. More than an insubstantial part of your activities are commercial and your founder benefits from your operations.

As described in section 1.501(c)(3)-1(c)(2) you are not exempt because your earnings inure to the benefit of your founder and his for profit M.

As described in Section 1.501(c)(3)-1(d)(1)(ii) of the Regulations you are not exempt because you have failed to establish that you are not organized and operated for the benefit of private interests, especially your founder.

You are not described in section 1.501(c)(3)-1(d)(5)(iii) of the regulations because you have not substantiated your ownership of a patent and therefore it is unclear if you have authority to make the patent and corresponding research results public. Further you state you will sell the device and/or patent to interested parties but did not provide any information on the terms of the sale and therefore were unable to substantiate the sale would be in the interest of the public.

You are similar to the organization in Rev. Rul. 65-1 because you promote and foster the development and design of a product, and have the power to sell, assign, and grant licenses with respect to its patent rights.

You are similar to Rev Rul 67-5 because you too are controlled by your creator's family and are operated to enable the family to engage in financial activities beneficial to them. Specifically you are controlled by the founder, his mother and his sister. You were formed to secure grants for his research projects as well as to reimburse him, his for-profit M and his family for research expenses he incurred while a student pursuing his PhD. Accordingly, your founder and his family benefit from your operations.

You are not similar to Rev. Rul. 69-526 because you are not operated by a group of specialty physicians investigating a disease. Instead you have one individual your founder as the only investigator. Your operations are limited to your founder's research projects and development of prototype devices based on your founder's findings.

You are similar to Rev. Rul. 69-266 because you too are formed and controlled by a specific individual to conduct research programs. Even though you do not intend to sell patient services, you do intend to sell devices and/or patents at prevailing fees.

Like the organization in Orange County Agricultural Society, Inc., your net earnings include more than net profits and Inurement occurs through reimbursements to your founder for his expenses as well as continued funding for his future research, prototype development and sale of devices.

Like the organization in The Church of Eternal Life and Liberty inurement is strongly suggested because you too have a small group of individuals; namely your founder his mother, and his sister; who are the principal contributors and they have exclusive control over the management of your funds.

You are similar to Better Business Bureau of Washington, D.C., Inc. because you too have a substantial non-exempt purpose. Even though the public may benefit from your founders research and resulting devices, the facts overwhelmingly show you operate for a substantial non-exempt commercial purpose and you failed to establish that your founder will not benefit from your operations.

As in American Science Foundation v. Commissioner, you have failed to establish through the administrative record that you operate as a section 501(c)(3) organization. The facts in the administrative record do not substantiate your founder's claim that you own a patent, that the value of the patent is greater than the amount you paid or will pay to your founder or M and that the continued funding of your founders research is in the public interest. Further the administrative record does not distinguish your operations from a commercial business as insufficient details were provided on your proposed research activities and the marketing and sale of your research.

As in Parker v Commissioner you were formed to commercially exploit the research findings of your founder. Also the founder has complete control of your finances and your day to day activities.

Like the organizations in B.S.W. Group Inc and Arlie Foundation your activities are focused on the commercialization of the device produced based on your founder's research to interested parties.

Applicant's Position

You do not agree that you are being used to benefit your founder. Your founder no longer contributes a significant amount of time to M. The amount paid to your founder and M was less than fair market value. You have paid M in full. There is a small outstanding balance due to your founder. M will not perform any services or do business with you.

Your position is that the payments you made to both your founder and to M for intellectual property rights and property transfer fees are reasonable, when considering the debts and expenses realized in developing the intellectual property. Further, you contend that your founder used an objective method to develop a value for these intellectual property rights, which had the concurrence of experts in the field. You concluded that when considering these factors, the payments for the transfer fees and the intellectual property are reasonable and necessary expenses and are not an unwarranted or excessive benefit to your founder or to M.

You have not made any royalty payments to anyone including your founder or M. The payments to your founder and M were actually reimbursements for their personal expenses in creating your organization and the patent, not royalty payments.

It is correct to the best of your knowledge, that your financial data included a payment toward Intellectual property transfer and additional fees. Subsequently you stated the payment was to settle a debt accrued by M, related to the device. Further your founder attests that all payments received from you were reimbursement for expenses incurred in your formation and in the acquisition of the patent.

Service Response to Applicant's Position

Despite your claim that the amounts you paid to your founder and M were less than fair market value you provided no independent appraisal to substantiate your claim. Instead you referred to documents where your founder valued the "business" as either part of his dissertation or in his search for grants. Your balance sheet entries reflect assets valued at less than the amounts transferred to your founder and M. Transactions with you, your founder and M have not been arms length. Funds contributed were from your founder's mother and funds paid out were to your founder and M. Your founder is your only researcher and makes all decisions with respect to daily operations. You have failed to establish that the transactions and your operations will not inure to the benefit of your founder, his mother and his sister.

Even if the amounts paid to your founder and M are less than fair market value, as you state, the facts show that you are operated in a commercial manner. You are formed to

create a prototype device and sell the device to an interested party. You have not identified a buyer and do not know the terms of such sale. However, proceeds from the sale will be used to fund other research indicating that the device will be sold at a profit. You will operate with paid staff. The results of your founder's research will be published as part of his dissertation and will therefore, benefit him in his acquisition of a PhD. You did not substantiate who owns the rights to your research. It is unclear whether your research activity is in the public interest.

Conclusion

Based on the above facts and analysis you do not qualify for exemption under section 501(c)(3) because you are not operated exclusively for a 501(c)(3) purpose. In addition the facts show you are operated in a commercial manner as you were formed to conduct research, develop prototype devices, market and sell results and use proceeds to fund additional research activity. Finally the facts show your operations inure to the benefit of insiders, most notably your founder. Accordingly we conclude you do not qualify for exemption under section 501(c)(3).

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,

Holly O. Paz
Director, Exempt Organizations
Rulings & Agreements

Enclosure: Publication 892