



Department of the Treasury
Internal Revenue Service
P.O. Box 2508
Cincinnati, OH 45201

Release Number: **201832015**
Release Date: 8/10/2018

Date:
May 15, 2018
Employer ID number:

Contact person/ID number:

Contact telephone number:

Form you must file:

Tax years:

UIL: 501.00-00, 501.03-05, 501.33-00, 501.36-00

Dear _____ :

This letter is our final determination that you don't qualify for tax-exempt status under Section 501(c)(3) of the Internal Revenue Code (the Code). Recently, we sent you a proposed adverse determination in response to your application. The proposed adverse determination explained the facts, law, and basis for our conclusion, and it gave you 30 days to file a protest. Because we didn't receive a protest within the required 30 days, the proposed determination is now final.

Because you don't qualify as a tax-exempt organization under Section 501(c)(3) of the Code, donors can't deduct contributions to you under Section 170 of the Code. You must file federal income tax returns for the tax years listed at the top of this letter using the required form (also listed at the top of this letter) within 30 days of this letter unless you request an extension of time to file.

We'll make this final adverse determination letter and the proposed adverse determination letter available for public inspection (as required under Section 6110 of the Code) 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, follow the instructions in the Notice 437 on how to notify us. If you agree with our deletions, you don't need to take any further action.

We'll also notify the appropriate state officials of our determination by sending them a copy of this final letter and the proposed determination letter (under Section 6104(c) of the Code). You should contact your state officials if you have questions about how this determination will affect your state responsibilities and requirements.

If you have questions about this letter, you can contact the person listed at the top of this letter. If you have questions about your federal income tax status and responsibilities, call our customer service number at 1-800-829-1040 (TTY 1-800-829-4933 for deaf or hard of hearing) or customer service for businesses at 1-800-829-4933.

We sent a copy of this letter to your representative as indicated in your power of attorney.

Sincerely,

Stephen A. Martin
Director, Exempt Organizations
Rulings and Agreements

Enclosures:

Notice 437

Redacted Letter 4036, *Proposed Adverse Determination Under IRC Section 501(c)(3)*

Redacted Letter 4038, *Final Adverse Determination Under IRC Section 501(c)(3) - No Protest*



**Department of the Treasury
Internal Revenue Service**

P.O. Box 2508
Cincinnati, OH 45201

Date:
March 29, 2018
Employer ID number:

Contact person/ID number:

Contact telephone number:

Contact fax number:

Legend:

E = State
F = Date of formation
G = Region

UIL:

501.00-00
501.03-05
501.33-00
501.36-00

Dear _____ :

We considered your application for recognition of exemption from federal income tax under Section 501(a) of the Internal Revenue Code (the Code). Based on the information provided, we determined that you don't qualify for exemption under Section 501(c)(3) of the Code. This letter explains the basis for our conclusion. Please keep it for your records.

Issues

Do you qualify for exemption under Section 501(c)(3) of the Code? No, for the reasons stated below.

Facts

You were incorporated in the state of E on F. Your Articles of Incorporation states, in part, that you will establish, design, install, maintain and make available an open and competitive basis telecommunications infrastructure. Specifically, you will provide a neutral internet exchange. This exchange will enable your members, educational institutions, and the general public to benefit from using a local, regional internet exchange.

You were founded by three individuals who have many years of combined experience in the telecommunications and internet industries. Your founders share a mutual interest in creating internet efficiencies that will have economic, educational and practical benefits for the residents and businesses of E. While you will initially be overseen by your three founders, you will ultimately consist of a range of directors and members that you anticipate will include several regional ISPs, a university, a school in E, a library network, content providers that host critical information, and larger international internet providers.

You were created to introduce specific internet efficiencies for the direct benefit of E residents, businesses, non-profit organizations and educational institutions. It is expected that these benefits will expand to include other states over time. As internet connectivity is currently structured in E, all E residents, businesses, and the public sector access the internet via a variety of wholesale connections and resold access arrangements that converge at major internet exchange points in remote cities. The vast majority of E internet traffic, including traffic that

might originate in E and be destined for a next-door neighbor or a local business down the street, is exchanged between various internet backbone providers at those distant convergence points. You intend to move a significant amount of local E internet traffic off those distant exchange points and significantly reduce the cost of exchanging local internet traffic. Your members will pay below-market rates for access ports on the exchange, and will share "local" internet traffic freely.

You will speed up local internet traffic, reduce the number of routing points, and improve reliability by reducing the distance local internet traffic travels. By eliminating dependence upon distant routing points, you benefit public infrastructure safety by continuing to connect local internet traffic in the event of a catastrophic failure at one or more of the major internet convergence points in the United States.

Your success in achieving these aims will be largely determined by the type and number of members you can attract. As the number of members and associated local traffic increases, so do the appeal and benefit of becoming a member for companies that have not yet done so. This is known as the "network effect" or the "network externality." Your founders expect a concerted marketing and promotion effort during your first 12-18 months in an effort to reach the necessary "critical mass" of daily traffic.

You will promote yourself in relatively low-cost venues such as social media, industry blogs, local business publications, and conferences focused on technology. You have already received offers to donate switching equipment from three vendors, as well as interest in participation from several E-based ISPs and telecom providers. You have also been contacted by a large international ISP and two major content providers. Initial membership consisting of large ISPs and content providers will provide a significant incentive for others to join you.

In addition to economic, performance and reliability improvements, your existence creates an opportunity to educate a wide range of end-users and industry employees regarding the mechanics of the internet. On a rotating basis, a subset of your members will participate on your Education Committee, a group that will pursue the following activities:

- Development and refinement of presentations for industry conferences and meetings
- Development of curriculum for K- 12 and higher educational institutions, and
- Providing public tours of your facilities.

You will also have a charitable mission, with a focus on increasing internet penetration in rural or remote areas and use of the internet to help new and existing small business.

Your location will leverage the federally funded open-access, non-discriminatory fiber optic network, facilitating affordable fiber optic connections to your members. Your members will be an assembly of E's larger commercial and public-sector internet users. That core membership will be tapped to support your educational and charitable mission improve internet adoption among E consumers, small businesses, educational communities, state and local governments and E nonprofit organizations, yielding both direct and indirect economic efficiencies for E.

The direct economic benefits include:

- Reduced member cost for intrastate internet traffic
- Higher internet traffic speeds for increased internet traffic

- Introduction of competitive forces for wholesale internet access delivered to E public sector networks and large enterprise organizations without regulatory intervention, and
- Opportunities for small business startups to utilize free or discounted internet services.

The indirect economic benefits include:

- Reduced overall cost of internet access for ISPs should result in lower internet usage for E's small businesses and consumers
- Introduction of competitive forces for wholesale internet access can attract more internet-dependent businesses to locate in E, resulting in increased jobs, investments, and revenues, and
- Provision of underwritten access for startups can result in additional small businesses, jobs and tax revenues.

From an operating perspective, you will take in access (or "port") revenues from participating members which will account for about % of your revenues. Donations will cover operating expenses and widespread educational outreach activities. A range of port prices will allow even small ISPs and public-sector entities to take advantage of your benefits. Larger ports, while more expensive to members, will allow larger international ISPs, interexchange carriers, cable companies, and content providers to exchange high volumes of traffic. These larger participants are familiar with the neutral exchange concept and have pre-established engineering standards and business cases that help them determine where to locate their company's equipment and how to participate.

You will begin with a moderate amount of startup funding from the founders, as well as donations of space, power and switching equipment. It is expected that the startup funds will be replenished within 18 months, based on the initial four-year plan. Ongoing revenues will cover the operating costs and to the extent that revenues exceed operating cost, you will expand your educational expenditures and/or reduce port prices for members.

Initially you will spend some of the gross receipts on marketing and promotion to help grow the number of members utilizing the exchange. The initial business objective is to establish a steady amount of traffic flowing across the exchange and consistent port revenues that will pay back your line of credit and cover the operating costs with a small amount of contingency money to cover unexpected expenses. Primary operating expenses will be associated with acquiring space, operating power, administrative costs, education outreach, and marketing.

Law

Section 501(c)(3) of the Code provides for the recognition of exemption of organizations that are organized and operated exclusively for religious, charitable or other purposes as specified in the statute. No part of the net earnings may inure to the benefit of any private shareholder or individual.

Treasury Regulation Section 1.501(c)(3)-1(a)(1) states that, in order to be exempt as an organization described in Section 501(c)(3) of the Code, 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.

Treas. Reg. Section 1.501(c)(3)-1(c)(1) provides that 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) of the Code. 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. Section 1.501(c)(3)-1(d)(1)(ii) provides that an organization is not organized or operated exclusively for any exempt purpose set forth in Section 501(c)(3) of the Code unless it serves a public rather than a private interest.

Treas. Reg. Section 1.501(c)(3)-1(d)(2) defines the term charitable as including the relief of the poor and distressed or of the underprivileged, and the promotion of social welfare by organizations designed to lessen neighborhood tensions, to eliminate prejudice and discrimination, or to combat community deterioration. The term "charitable" also includes lessening of the burdens of government.

Treas. Reg. Section 1.501(c)(3)-1(d)(3)(i) defines the term educational as the instruction or training of the individual for the purpose of improving or developing his capabilities or the instruction of the public on subjects useful to the individual and beneficial to the community.

Treas. Reg. Section 1.501(c)(3)-1(e)(1) provides that an organization may meet the requirements of Section 501(c)(3) although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business, as defined in Section 513. In determining the existence or nonexistence of such primary purpose, all the circumstances must be considered, including the size and extent of the trade or business and the size and extent of the activities which are in furtherance of one or more exempt purposes. An organization which is organized and operated for the primary purpose of carrying on an unrelated trade or business is not exempt under Section 501(c)(3).

Rev. Rul. 69-175, 1969-1 C.B. 149, describes an organization formed by parents of pupils attending a private school, that provides school bus transportation for its members' children. It was found that it serves a private rather than a public interest and does not qualify for exemption under Section 501(c)(3) of the Code. When a group of individuals associate to provide a cooperative service for themselves, they are serving a private interest. Thus, the organization serves a private rather than a public interest. Accordingly, it is not exempt from federal income tax under Section 501(c)(3).

Rev. Rul. 80-287, 1980-2 C.B. 185, involved a nonprofit lawyer referral service that arranged, at the request of any member of the public, an initial half-hour appointment for a nominal charge with a lawyer whose name was on an approved list maintained by the organization. Generally, providing services of an ordinary commercial nature in a community, even though the undertaking is conducted on a nonprofit basis, is not regarded as conferring a charitable benefit on the community unless the service directly accomplishes one of the established categories of charitable purposes. The organization's activities were directed toward assisting individuals in obtaining preventive or remedial legal services and, as such, were not specifically designed to confer a charitable benefit on the community. Although the lawyer referral service provided some public benefit, a substantial purpose of the program was promotion of the legal profession.

In Better Business Bureau of Washington, D.C., Inc. v. United States, 326 U.S. 279 (1945), the Supreme Court stated that the presence of a single nonexempt purpose, if substantial in nature, will preclude exemption under Section 501(c)(3) of the Code, regardless of the number or importance of statutorily exempt purposes. Thus, the operational test standard prohibiting a substantial non-exempt purpose is broad

enough to include inurement, private benefit, and operations that further nonprofit goals outside of the scope of Section 501(c)(3).

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 Living Faith, Inc. v. Commissioner, 950 F.2d 365 (1991), the Court of Appeals upheld a Tax Court decision that an organization operating restaurants and health food stores in a manner consistent with the doctrines of the Seventh Day Adventist Church did not qualify for exemption under Section 501(c)(3) of the Code because the organization was operated for a substantial nonexempt commercial purpose. The court found that the organization's activities were "presumptively commercial" because the organization was in competition with other restaurants, engaged in marketing, and generally operated in a manner similar to commercial businesses.

Application of law

To be exempt as an organization described in section 501(c)(3) of the Code, you must be both organized and operated exclusively for one or more of the purposes specified in such section. Your primary activity is the creation and maintenance of a neutral internet exchange for the benefit of your members. You are not operating exclusively for charitable purposes as required under Treas. Reg. Section 1.501(c)(3)-1(a)(1).

To satisfy the operational test under Treas. Reg. Section 1.501(c)(3)-1(c)(1) an organization must establish that it is operated exclusively for one or more exempt purposes. You were formed for the non-exempt purpose of providing a substantial private benefit to your members through your internet exchange activities. Because your activities do not accomplish an exempt purpose you do not qualify for exemption.

You are operated for the private interests of your members, which disqualifies you from exemption as described in Treas. Reg. Section 1.501(c)(3)-1(d)(1)(ii). Your activities are not those of a charitable nature described in Treas. Reg. Section 1.501(c)(3)-1(d)(2) nor are they exclusively educational as described in Treas. Reg. Section 1.501(c)(3)-1(d)(3)(i). Any charitable or educational components to your activities are incidental to your overall purpose of providing an internet exchange for your members.

Providing services of an ordinary commercial nature, regardless of whether the undertaking is conducted on a non-profit basis and is beneficial to the community, does not further a charitable purpose, unless the service directly accomplishes a tax-exempt purpose. See Treas. Reg. Section 1.501(c)(3)-1(e)(1) and Rev. Rul. 80-287. Providing an internet exchange to your members for a fee does not exclusively further exempt purposes.

Like the organization described in Rev. Rul. 69-175, you were formed to provide a service and benefit to your members. In your case, a substantial portion of your activities consists of providing an internet exchange for members. These activities serve private, rather than public, interests, which precludes you from exemption.

As stated in Better Business Bureau, a single non-exempt purpose, if substantial, will preclude tax exemption under Section 501(c)(3) of the Code. Although your activities may have some educational value, you are primarily engaged in providing internet exchange ports for a fee. The presence of this substantial non-exempt purpose precludes exemption under Section 501(c)(3).

You are like the organizations described in B.S.W. Group, Inc. and Living Faith, Inc. because you are operating for a substantial non-exempt purpose rather than for a tax-exempt purpose. You provide internet exchange services for your members and you are generally operated in a manner similar to an ordinary business. Your activities are neither inherently charitable, nor in furtherance of a charitable purpose, but resemble activities carried on by for-profit businesses, a factor that supports the non-exempt nature of your activities.

Conclusion

You operate in a non-exempt manner and your operations further the private interests of your members. Any public purposes for which you may operate are only incidental to your substantial non-exempt purpose of providing an internet exchange for your members. Therefore, you do not qualify for exemption under Section 501(c)(3) of the Code.

If you don't agree

You have a right to file a protest if you don't agree with our proposed adverse determination. To do so, you must send a statement to us within 30 days of the date of this letter. The statement must include:

- Your name, address, employer identification number (EIN), and a daytime phone number
- A copy of this letter highlighting the findings you disagree with
- An explanation of why you disagree, including any supporting documents
- The law or authority, if any, you are relying on
- The signature of an officer, director, trustee, or other official who is authorized to sign for the organization, or your authorized representative
- One of the following declarations:

For an officer, director, trustee, or other official who is authorized to sign for the organization:

Under penalties of perjury, I declare that I examined this protest statement, including accompanying documents, and to the best of my knowledge and belief, the statement contains all relevant facts and such facts are true, correct, and complete.

For authorized representatives:

Under penalties of perjury, I declare that I prepared this protest statement, including accompanying documents, and to the best of my knowledge and belief, the statement contains all relevant facts and such facts are true, correct, and complete.

Your representative (attorney, certified public accountant, or other individual enrolled to practice before the IRS) must file a Form 2848, *Power of Attorney and Declaration of Representative*, with us if he or she hasn't already done so. You can find more information about representation in Publication 947, *Practice Before the IRS and Power of Attorney*.

We'll review your protest statement and decide if you provided a basis for us to reconsider our determination. If so, we'll continue to process your case considering the information you provided. If you haven't provided a basis for reconsideration, we'll forward your case to the Office of Appeals and notify you. You can find more information about the role of the Appeals Office in Publication 892, *How to Appeal an IRS Decision on Tax-Exempt Status*.

If you don't file a protest within 30 days, you can't seek a declaratory judgment in court at a later date because the law requires that you use the IRS administrative process first (Section 7428(b)(2) of the Code).

Where to send your protest

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

U.S. mail:

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

Street address for delivery service:

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

You can also fax your statement and supporting documents to the fax number listed at the top of this letter. If you fax your statement, please contact the person listed at the top of this letter to confirm that he or she received it.

If you agree

If you agree with our proposed adverse determination, you don't need to do anything. If we don't hear from you within 30 days, we'll issue a final adverse determination letter. That letter will provide information on your income tax filing requirements.

You can find all forms and publications mentioned in this letter on our website at www.irs.gov/formspubs. If you have questions, you can contact the person listed at the top of this letter.

We sent a copy of this letter to your representative as indicated in your power of attorney.

Sincerely,

Stephen A. Martin
Director, Exempt Organizations
Rulings and Agreements

Enclosure:
Publication 892