# **Bond Case Briefs**

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# IRS Declines to Limit Retroactive Effect of Revocation of Exemption.

In technical advice, the IRS declined to provide relief from retroactive revocation of an organization's tax-exempt status. On its exemption application, the organization said it would provide Bible-based financial education. But the IRS subsequently discovered that the organization's primary activity was promoting and enrolling people in debt management plans for a for-profit entity that processed the debt management plans. The organization also did not offer any educational seminars or workshops even though it had said on its exemption application that it would do so, and it charged fees for services after having said on its exemption application that it would not do that. Also, contrary to what it said on its exemption application, the organization was a direct outgrowth of its founders' family and marriage counseling organization. The organization did not inform the IRS of these changes in its operations.

Therefore, the IRS concluded that revocation may be retroactive to the year under examination when the agency determined that the organization had made material changes to its operations.

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Area Director, Area 4 TEGE Appeals, Philadelphia, PA

Taxpayer's Name: \* \* \*
Taxpayer's Address: \* \* \*
Taxpayer's ID No.: \* \* \*
Year(s) Involved: \* \* \*
Conference Held: \* \* \*

LEGEND:

Taxpayer = \* \* \*

#### **ISSUE**

Whether the Commissioner, TE/GE, should exercise discretion to grant the Taxpayer relief under § 7805(b) of the Internal Revenue Code to limit the retroactive effect of revocation of its exempt status under § 501(c)(3).

Application for ExemptionTaxpayer applied for tax-exempt status, describing its activities on the Form 1023. It stated it was formed "to meet the needs of persons experiencing financial difficulties by offering Biblical based financial counseling, education, encouragement and empowerment." Further, its organizing documents provide it is organized and operated exclusively for religious purposes within the meaning of § 501(c)(3). It was founded by two persons who are both clinical psychologists and licensed family and marriage counselors ("Founders"). Its Board of Directors consisted of one of the founders serving as Chairman and President, the other founder as Vice President, and three other individuals; none of the directors were to be compensated.

To achieve its objectives, Taxpayer stated the following programs would form the basis of its services:

o (1)

## **Telephone Counseling**

- Provide telephone financial counseling for those individuals who are unable to physically access its facilities.
- (2) <u>Face-to-Face Counseling</u> Provide face-to-face financial counseling for those seeking assistance with restoration of credit, financial management, debt management, and debt elimination. This will be accomplished within the context and with the partnership of the local church.
- (3) <u>Seminars</u> Provide seminars and workshops that disseminate information about financial management, budgeting, stewardship and Biblical financial principles, primarily through the local church.
- (4) <u>Resource Support</u> Produce and make available to clients, resources that support its efforts to fulfill its mission. These products will be made available to its clients as they interface with its programs.
- (5) <u>Media Ministry</u> Produce and broadcast various media programs such as radio, television, and Internet communications that fulfill its mission and purpose.

Taxpayer's financial support, listed in order of size, was to consist of (1) Donations, and (2) a third party organization will provide debt management services. It described its fundraising program as "Initial start-up and seed monies will be acquired from individual donors. Monies acquired from seminars and workshops will be based upon free will offerings. Products will be provided for a suggested donation."Taxpayer answered "No" when asked if it was the outgrowth of (or successor to) another organization, or had a special relationship with another organization by reason of interlocking directorates or other factors. Taxpayer also answered "No" when asked if recipients are required to pay for Taxpayer's benefits, services, or products.

Based on these representations, the Service issued a favorable determination letter and classified Taxpayer as a public charity.

#### Examination

The examination found that Taxpayer's primary activity was enrolling individuals in debt management plans ("DMP") in return for fees from debtors and fair share payments from its creditors. Taxpayer's phone counselors enrolled callers; it did not process the DMP applications itself, but rather forwarded completed DMP packages to a for-profit company for processing. Taxpayer's DMP agreement required clients to make a monthly "suggested donation" of \$29, in addition to payments to creditors. DMP clients made payments directly to the for-profit company.

The for-profit company disbursed the payments to creditors, and on a weekly basis, paid Taxpayer for its portion of the "fair share" payments and monthly DMP client's suggested donation. The examination revealed that 99 percent of Taxpayer's revenue came from DMP activity.

Taxpayer's training manual instructed counselors and administrators to aggressively pursue potential clients. It provided a specific script to keep the conversations short, but to collect all the information required by the creditors for DMP enrollment. The manual appears to instruct the counselors to do one thing — sell DMPs to potential clients.

Taxpayer acknowledged that it did not conduct any educational seminars or workshops, through the local church or elsewhere, during the tax years under exam. Taxpayer spent less than \$800 on educational activities during the years under exam. The only "resources" that it made available to its clients consisted of a PowerPoint presentation on subjects of money management and finding meaningful employment posted on its website. It did not produce or broadcast any educational programs for a "media ministry."

The examination revealed that Taxpayer had been conducting transactions with several related forprofit businesses and exempt entities. Such relationships were not disclosed during the application process, including the fact that Taxpayer was an outgrowth of the founders' family and marriage counseling organization. The Founders received compensation from Taxpayer and the related organizations. However, Taxpayer had no written employment agreements with Founders, and did not offer evidence of the hours each Founder devoted to his position at Taxpayer. Furthermore, Taxpayer paid one of the related organizations rent during one of the exam years.

Taxpayer did not report any of these changes in operation to the Service.

Taxpayer appealed the proposed revocation. Appeals sustained the revocation. Following the appeals process, the National Office received this request for relief from retroactive revocation as a mandatory TAM.

### **Legal Standard:**

Section 7805(b)(8) provides that the Secretary may prescribe the extent, if any, to which any ruling (including any judicial decision or any administrative determination other than by regulation) relating to the internal revenue laws shall be applied without retroactive effect.

Section 1.501(a)-1(a)(2) of the Income Tax Regulations states that an organization that the Commissioner has determined to be exempt under § 501(a) may rely upon such determination so long as there are no substantial changes in the organization's character, purposes, or methods of operation, and subject to the Commissioner's inherent power to revoke rulings because of a change in the law or regulations, or for other good cause.

Section 301.7805-1(b) of the Procedure and Administration Regulations grants the Commissioner authority to prescribe the extent to which any ruling issued by his authorization shall be applied without retroactive effect.

Section 4.04 of Rev. Proc. 2013-5, 2013-1 I.R.B.170, states that all requests for relief under § 7805(b) must be made through a request for technical advice (TAM). Section 19.04 states further that when, during the course of an examination by EO Examinations or consideration by the Appeals Area Director, a taxpayer is informed of a proposed revocation, a request to limit the retroactive application of the revocation must itself be made in the form of a request for a TAM and should discuss the items listed in § 18.06 of Rev. Proc. 2013-5, as they relate to the taxpayer's situation.

Section 18 of Rev. Proc. 2013-5 lists the criteria necessary for granting § 7805(b) relief as well as the effect of such relief. Section 18.06 states, in part, that a TAM that revokes a determination letter is not applied retroactively if:

- (1) there has been no misstatement or omission of material facts;
- (2) the facts at the time of the transaction are not materially different from the facts on which the determination letter was based;
- (3) there has been no change in the applicable law; and
- (4) the taxpayer directly involved in the determination letter acted in good faith in relying on the determination letter, and the retroactive revocation would be to the taxpayer's detriment. Rev. Proc. 2013-9, 2013-2 I.R.B. 255, sets forth procedures for issuing determination letters (from EO Determinations) and rulings (on applications for recognition of exempt status by EO Technical) on the exempt status of organizations under § 501. These procedures also apply to revocation or modification of determination letters or rulings. Section 12.01 of Rev. Proc. 2013-9 states, in part, that the revocation or modification of a determination letter or ruling recognizing exemption may be retroactive if the organization omitted or misstated a material fact, or operated in a manner materially different from that originally represented. In certain cases an organization may seek relief from retroactive revocation or modification of a determination or ruling under § 7805(b) using the procedures set forth in Rev. Proc. 2013-5, §§ 18 and 19.

Section 12.01(1) of Rev. Proc. 2013-9 states that where there is a material change inconsistent with exemption in the character, purpose, or method of operation of an organization, revocation or modification will ordinarily take effect as of the date of such material change.

In <u>Automobile Club of Michigan v. Commissioner</u>, 353 U.S. 180, 184 (1957), the Supreme Court held that the Commissioner has broad discretion to revoke a ruling retroactively. It further held that a retroactive ruling "may not be disturbed unless . . . the Commissioner abused his discretion vested in him . . ." Id.

In <u>Stevens Bros. Foundation</u>, <u>Inc. v. Commissioner</u>, 324 F.2d 633, 641 (1963), the court found the Foundation's efforts "far from convincing" to demonstrate that its information reports were adequate and sufficient to apprise the Commissioner of its entry into the business activities which led to denial of its tax-exempt status. Shortly after receiving its tax-exempt ruling, the Foundation contracted with a for-profit company, but failed to disclose this fact to the Commissioner on its Forms 990. The court upheld the Service's retroactive revocation.

In <u>Variety Club Tent No. 6 Charities</u>, <u>Inc. v. Commissioner</u>, 74 T.C.M. (CCH) 1485 (1997), the court held that petitioner "operated in a manner materially different from that originally represented." The organization represented in its exemption application and articles of incorporation that no part of its net income would inure to the benefit of any private shareholder or individual. But the court found instances of inurement over several years, and upheld the Service's retroactive revocation for such years.

#### **ANALYSIS**

During the years under examination, Taxpayer's operations were materially different from the description it provided in its exemption application. See Variety Club Tent No. 6 Charities, T.C. Memo 1997-575; Rev. Proc. 2013-9, § 12.01; Rev. Proc. 2013-5 at § 18.06 (no misstatement or omission of material facts or materially different facts). In its application, Taxpayer described

multiple plans for Bible-based financial education through in-person counseling, seminars and workshops, resource support, and public media. However, the examination established that Taxpayer's primary activity was promoting, marketing, and enrolling individuals in DMPs for the forprofit entity that processed the DMPs. It also failed to offer any educational seminars or workshops, or media activities, as it had represented in its Form 1023. Contrary to Taxpayer's representation in its Form 1023, the examination also established that Taxpayer charged customers fees for its services, including a monthly service fee for DMPs. Furthermore, despite representing its source of revenue would be derived from "donations", Taxpayer did not receive public support nor public donations. Taxpayer also represented in its Form 1023 that it was not the outgrowth of another organization; however, the exam revealed it was a direct outgrowth of the founders' family and marriage counseling organization. Contrary to Taxpayer's representations, the examination revealed that it had several business relationships with other related entities that it did not disclose. Taxpayer did not apprise the Service of these material changes in its operations. See Stevens Bros. Foundation, 324 F.2d at 641 (failure to adequately and sufficiently inform the Service of material changes in operations). Therefore, revocation may be retroactive to the year under examination when the Service determined Taxpayer had made material changes in its operations. See Automobile Club of Michigan, 353 U.S. at 184 (Commissioner has broad discretion to revoke a ruling retroactively); Rev. Proc. 2013-9, section 12.01(1) (revocation ordinarily applies as of the date of the material changes in operations).

#### CONCLUSION

The Commissioner, TEGE, has declined to exercise discretion to limit the retroactive effect of revocation of exempt status under  $\S 501(c)(3)$ . Revocation is effective as of \* \* \*.

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