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MEMORANDUM

TO: AmeriDream, Incorporated

FROM: Howard N. Solodky
Desmond D. Connall, Jr.

DATE: August 24, 2005

RE: Deductibility of Seller's Contributions as "Charitable Contributions"

You have asked whether the policies of some of your competitors in the down payment assistance industry (collectively, "Other DPAs"; in the singular, an "Other DPA") for soliciting and utilizing "charitable contributions" comply with federal income tax requirements for treatment of those contributions as tax deductible. The results of our analysis are presented in this memorandum. Please note that while none of the cases or rulings cited directly involve down payment assistance organizations, the referenced precedents provide ample guidance for analyzing the federal income tax consequences of payments made to these types of nonprofit organizations.

As discussed in greater detail below, claims by certain Other DPA's that payments by home sellers and home builders to such Other DPA's are tax deductible as charitable contributions are not supported by relevant tax law. To the contrary, because a home seller or home builder participating in an Other DPA's program receives in return for its payment to the Other DPA significant value in the form of (i) administrative and other services from the Other DPA, (ii) an expanded pool of potential home buyers who would not otherwise have funds sufficient for a down payment and (iii) ultimately, a specific home buyer ready, willing and able to close, the payment to the Other DPA cannot legitimately be characterized as a "gift" to the Other DPA. The Internal Revenue Service and the courts have made it clear that in order for a payment to a section 501(c)(3) organization to constitute a fully tax-deductible gift it must be made without adequate consideration received in return.

You should also note that on August 8, 2005, the Treasury Department's Office of Tax Policy and the IRS published their business plan for the 2005-2006 fiscal year in which they listed down payment assistance organizations among the tax-exempt organizations for which they will issue priority policy guidance. We have had informal discussions with an attorney in the IRS National Office who stated he would be working on the preparation of written guidance concerning (i) the deductibility of payments made to a tax-exempt down payment assistance organization and (ii) how such an organization should be organized and operated to qualify for 501(c)(3) status. He stated that the National Office believes that payments by home sellers and builders to such organizations are non-deductible payments for services. The discussion below explains the IRS National Office's proposed treatment of such payments.

I. Comparison of Down Payment Assistance Programs[1]

[1] The information contained in this portion of the memorandum was obtained from the websites maintained by certain nonprofit DPA organizations.

Charities that operate down payment assistance programs help individuals and families hoping to purchase homes by providing them with monetary gifts to be used as down payments. In each transaction, these down payment assistance providers also seek comparably sized payments from the seller or builder of the home to be purchased in an effort to replenish the pool of funds from which future gifts will be made. In no case will a payment received from a seller or builder be used directly to fund a gift to a buyer seeking to purchase that particular seller's or builder's property.

Most of the Other DPAs require participating sellers and builders to pay the same amount (or approximately the same amount) and for similar purposes. Those purposes generally consist of (i) restoring the pool of funds available for down payment assistance gifts and (ii) defraying the administrative costs associated with processing down payment assistance gift transactions. As discussed in more detail in Part III of this memorandum, certain Other DPAs apparently also use a portion of available funds to make charitable contributions to other tax-exempt organizations. In any event, some of the Other DPAs characterize the payments they receive from each home seller or home builder as being (i) <u>entirely</u> a tax deductible charitable contribution or (ii) in part a charitable contribution and in part a service fee intended to cover the processing costs associated with the gift transaction. In the latter case, the portion of the payment constituting a "charitable contribution" is the amount equal to the gift paid by the Other DPAs to the home buyer for use as a down payment in the related purchase transaction. For purposes of this memorandum, we have assumed that a home seller or builder cannot participate in the Other DPAs down payment assistance programs without paying the requested amount in full.

II. <u>Requiring Mandatory Charitable Contributions</u>

In contrast to certain Other DPAs, AmeriDream categorizes the payments it receives from home sellers and builders as fees for services and informs those sellers and builders that the payments cannot be deducted as charitable contributions. As noted above, certain Other DPAs refer to these payments as entirely charitable contributions, or, to the extent they exceed the service fee component, as partly charitable contributions, and allow the sellers or builders to assume that, as such, the payments may be deducted in whole or in part under Code § 170. Such treatment, however, conflicts with established legal precedent. In particular, based upon our understanding of how AmeriDream and the Other DPAs operate, <u>under no circumstances is the entire payment made by a home seller or builder to a DPA provider tax deductible under Code § 170</u> as certain Other DPAs claim. Moreover, as discussed in greater detail below, the relevant legal authority supports the conclusion that no portion of such payments to DPA providers is a tax deductible charitable contribution.

As long ago as 1967, the Internal Revenue Service provided detailed guidance on the proper tax treatment of "dual purpose" payments made to a 501(c)(3) organization. In Rev. Rul. 67-246, 1967-2 C.B. 104, the IRS provided advice concerning certain fund-raising practices that are frequently employed by tax-exempt organizations and that involve the deductibility as charitable contributions of payments for admission to or other participation in activities such as charity balls, bazaars, banquets, shows and athletic events. For purposes of analyzing whether such payments are in whole or in part deductible charitable contributions, the IRS set forth the following legal principles: (i) to be deductible as a charitable contribution for federal income tax purposes under Code § 170, a payment to or for the use of a qualified charitable organization must be a gift; (ii) to be a gift, a payment of money or transfer of property to a tax-exempt organization must be "without adequate consideration;" (iii) if a transaction involving a payment to a charitable organization is in the form of a purchase of an item of value or a service, the presumption arises that no gift has been made for charitable contribution purposes and that the payment is simply the purchase price for such item or service; (iv) if a charitable contribution deduction is claimed with respect to such a payment, the burden of proof is on the taxpayer to establish that the amount paid is not the purchase price of the privileges or benefits received back and that part of the payment does, in fact, qualify as a gift; (v) in order to show that a gift has been made to the charitable organization, an essential element of proof is that the portion of the payment claimed as a deductible gift represents the excess of the total amount paid over the fair market value of the consideration received back from the organization; and (vi) another element that is important in establishing that a gift was donated to the charitable organization is evidence that the amount of the payment in excess of the fair market value of the privileges or benefits received back was made with a donative intent. Importantly, the ruling concludes that "regardless of the intention of the parties," a payment to a charitable organization where the payor receives some item of value or service in return, can qualify, at least in part, as a deductible gift "only to the extent it is shown to exceed the fair market value of any consideration received [back] in the form of privileges or other benefits."

Additionally, in United States v. American Bar Endowment, 477 U.S. 105 (1986), the U.S. Supreme Court addressed the precise issue of whether a mandatory payment resembling both a charitable contribution and a payment for goods or services can be deducted under Code § 170. In that case, the American Bar Endowment ("ABE"), a charitable organization exempt from federal income taxation under Code § 501(c)(3), provided group insurance to members that was underwritten by third-party insurance companies. In return for this service, the ABE required that its members assign to it any excess premiums refunded to them by the insurance companies. ABE used these "dividends" in furtherance of its charitable activities and characterized the required assignment as a fundraising technique. The Supreme Court disagreed, however, and instead ruled that ABE's provision of group insurance to its members was not merely a fundraising effort. The Court found that the activity constituted an "unrelated trade or business" because it involved both the sale of goods and the performance of services outside the recognized charitable purposes of the organization. Therefore, the Court held that the profits derived from this unrelated trade or business were subject to income taxation at regular corporate tax rates under Code § 511.

In addition, the Court ruled that any members of ABE that claimed a charitable contribution deduction in the amount of the dividends they assigned to ABE did so improperly. The Court stated that the assigned dividends were payments "having the 'dual character' of a purchase and a contribution" and that, at a minimum, a taxpayer must prove that he purposely contributed money or property in excess of the value of any benefit he received in return for the payment before a deduction could be valid. Citing Rev. Rul. 67-246, the Court found that a payment is deductible as a charitable contribution only if and to the extent it exceeds the fair market value of the benefit received in exchange for the payment.[2]

Given the facts described above, it seems unlikely that Other DPAs can accurately characterize the payments they solicit as tax-deductible charitable contributions. To the extent payments are solicited to pay for the processing costs associated with a down payment gift transaction, the payments are for services rendered, and not contributions (a point apparently conceded by at least some Other DPAs). In order to prove that the remaining portion of each payment is truly a charitable contribution, Other DPAs would have to show, under American Bar Endowment and Rev. Rul. 67-246, that the remaining portion is in excess of the market value of the benefit received in exchange for the payment.

Certain Other DPAs that characterize the home seller's or builder's payment as entirely tax deductible as a charitable contribution attempt to argue that the seller or builder receives no goods or services from the down payment assistance program and that any value derived from the program by the seller or builder is negligible in comparison to the amount of the payment to the DPA. Clearly, however, such Other DPAs are providing the valuable, but perhaps difficult to quantify, service of enlarging the pool of buyers that could feasibly purchase the payor's property, by providing a subsidy to individuals and families otherwise falling outside of the ordinary class of eligible buyers. In fact, we understand that marketing materials published by several down payment assistance providers advise home sellers and builders that participation in a down payment assistance program will increase the probability that a property will be sold quickly and for its full asking price. If challenged by the IRS, such a seller or builder would have a difficult time persuading the Service or a court that the value of the services rendered by the Other DPA, not to mention the value of the actual down payment received by the seller or builder and funded by the Other DPA to enable the seller's or builder's home to be sold, is negligible in comparison to the amount of the payment to the Other DPA. Not surprisingly, in cases where taxpayers have paid an allegedly tax deductible fee to an exempt organization and have received back intangible benefits from the organization, the courts have

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[2] Notably, Rev. Rul. 67-246 explicitly states that it was issued in response to the IRS' belief that "taxpayers are being misled by questionable solicitation practices which make it appear from the wording of the solicitation that taxpayer's payment is a "contribution," whereas the payment solicited is simply the purchase price of an item offered for sale by an organization." The same solicitation practices and wording appear to be employed by Other DPAs.

consistently found that the amount paid in connection with the transaction resulting in the benefit was not in the nature of a charitable contribution or gift. See, e.g., Arceneaux v. Commissioner, 36 T.C.M. 1461 (1977) (no deduction allowed for a payment to a religious organization which payment, in substance, represented an adoption fee for services rendered by the religious organization in connection with the adoption of a child by the taxpayer); Sedam v. United States, 518 F.2d 242 (7th Cir. 1975) (no deduction allowed for payment to a tax-exempt nursing home where the payment facilitated the admission of the taxpayer's mother to the home).

In 1993, Congress added section 6115 to the Code to address "quid pro quo" contributions to charitable organizations. Code § 6115(b) defines a "quid pro quo" contribution as a payment made partly as a contribution and partly in consideration for goods or services provided to the payor by the donee organization. Under Code § 6115(a), a charitable organization that receives a "quid pro quo" contribution in excess of $75.00 is required, in connection with the solicitation or receipt of such a contribution, to provide a written statement to the donor that (i) informs the donor that the amount of the contribution that is deductible for federal income tax purposes is limited to the excess of the amount of any money (and the value of any property other than money) contributed by the donor over the value of the goods or services provided by the organization, and (ii) provides the donor with a good faith estimate of the value of the goods or services furnished to the donor by the organization. The regulations under Code § 6115 advise that a good faith estimate of the value of goods or services that are not generally available in a commercial transaction may be determined by reference to the fair market value of similar or comparable goods or services.

The legislative history accompanying the enactment of Code § 6115 states that the required disclosure by the charitable organization must be made in a manner that is reasonably likely to come to the attention of the donor. For example, a disclosure of the required information in small print set forth within a larger document might not meet this requirement. If a charitable organization fails to meet the disclosure requirement of Code § 6115, the organization must pay a penalty under Code § 6714 of $10.00 for each contribution in respect of which the organization fails to make the required disclosure, except that the total penalty imposed with respect to a particular fundraising event or mailing may not exceed $5,000.00.

III. Contributions to Other § 501(c)(3) Organizations

Certain Other DPAs explicitly state in their marketing materials that a portion of each "charitable contribution" paid to them by the seller or builder of a property for sale will be contributed to one or more other nonprofit entities (we assume other charitable organizations recognized as tax-exempt under Code § 501(c)(3)). Such marketing materials imply, if not expressly state, that the contributions to other charities result in the payments to the Other DPA being tax deductible. While we understand that one of the purposes behind theses contributions to other section 501(c)(3) organizations is to strengthen local communities by increasing community involvement and citizenship, this laudable purpose does not transform a portion of the payment made by each seller and builder to such Other DPAs into a tax-deductible charitable contribution.

In Rev. Rul. 55-192, 1955-1 C.B. 294, the IRS considered whether amounts paid as membership dues to a social club and distributed to qualified charities constituted deductible charitable contributions by the members. The rules of the club provided that each member had to pay annual dues of $100. Of that amount, $30 was consideration for two tickets to a dinner-dance and the remaining $70 constituted a direct contribution by the member to one or more organizations, contributions to which were tax-deductible under the predecessor of Code § 170. Checks in payment of the dues were made payable to the treasurer of the social club, who had been authorized both by the club and the donee charitable organization to act as agent to receive members' contributions for such purposes. Because (i) the amount of the membership dues exceeded by $70 the value of the goods and services received by each member in the form of the dinner-dance, and (ii) the club's treasurer was acting as agent for the donee charitable organization, the ruling concludes that each member could claim a $70 charitable contribution deduction. However, it is our understanding that neither of these facts is present in Other DPAs' programs; that is, it is unlikely that payors to the Other DPAs can demonstrate that the amount of their payment exceeds the value of benefits received from the Other DPAs in return, and the Other DPAs, as we understand it, have not been authorized by any charitable organization to act as their agent.

Likewise, in PLR 200228001 (April 10, 2002), the Service held that "rebates" received from participating merchants in a credit card program that were voluntarily donated to charitable organizations constituted deductible charitable contributions by the credit card holders. In that ruling, a for-profit corporation (the "Company") had developed a brand-name affinity credit card program. Under the program, the Company helped charities raise funds in two ways: (i) through "basis point" donations made by issuing banks in connection with all credit card purchases; and (ii) through "rebates" furnished by participating local and national retail merchants to the Company or its agent banks. The "basis point" donations were made as a fixed, relatively small percentage of each credit card transaction. Cardholders had the ability to designate a charity or charities to receive these donations, and were notified of the amounts. However, unlike the "rebates," these amounts were not available to the cardholders and were mandatorily contributed to the designated charitable organizations. The Company advised cardholders that the "basis point" donations were not tax deductible.

In connection with the merchant rebate component of the program, the Company entered into contracts with individual merchants under which the merchants transferred to the Company an agreed-upon percentage of the revenue generated by purchases made with the affinity credit card. After a sale by a participating merchant to a cardholder, the agreed-upon rebate was transferred from the merchant to the Company. When an individual joined the affinity credit card program, usually as the result of a direct solicitation by a participating charity, the individual had to elect whether to receive back the "rebates," or to have the rebates donated to the soliciting charity or to another charity or charities participating in the program. If the individual elected to have the rebates donated to charity, then the Company would, after a period of time designed to take into account returns of purchased merchandise, distribute the rebates to the designated charity or charities.

The Service concludes in the ruling that the "rebates" contributed to a charitable organization on behalf of a cardholder by the Company did constitute tax-deductible charitable contributions by the cardholder. The Service relies heavily on the fact that each cardholder had the opportunity to decide whether to donate to charity the rebates held by the Company on his or her behalf, or to direct the Company to pay the rebates to him or her. The ruling cites to the American Bar Endowment case in which the Court suggested it would have reached a different result if ABE had given each member a choice between retaining his or her pro rata share of the dividends or assigning them to the organization. In effect, what both the Supreme Court in the American Bar Endowment case and the Service in PLR 200228001 are suggesting is that if an individual has a choice whether or not to receive back from a for-profit entity (the insurance companies in the American Bar Endowment case and the Company in PLR 200228001) a specified amount, then that amount must not have been consideration paid by the individual for any goods or services received in return. Instead, that amount becomes truly a voluntary, tax-deductible donation made without adequate return consideration if remitted on his or her behalf by a third-party to a charitable organization contributions to which are deductible under Code § 170.

Application of this legal principle produces the conclusion that no portion of the mandatory payment received from a home seller or builder by an Other DPA and then distributed by the Other DPA to a charitable organization constitutes a tax-deductible charitable contribution by the seller or builder. In that case, the seller or builder does not have the option of whether to retain or pay to the Other DPA the amount ultimately distributed by the Other DPA to charity. As a consequence, the payment by the seller or builder is not a voluntary gift, and appears instead to be a payment for services rendered by the Other DPA that ultimately results in the sale of the seller's or builder's property.

Indeed, our assumption that all payments by sellers and builders to Other DPAs are mandatory creates a strong presumption that the payments are entirely consideration for the receipt of services from the Other DPAs. We do not believe that payors to Other DPAs or the Other DPAs themselves can overcome that presumption given that (i) the amount of the payment in excess of the non-deductible service fee matches exactly the amount of the down payment ultimately received back by the seller or builder, (ii) some of the Other DPAs' marketing materials expressly state that their programs help sellers and builders achieve a quick sale at the full asking price, and (iii) Other DPAs do, in fact, increase the number of potential buyers of a seller's or builder's property and ultimately enable one of those homebuyers to consummate such a transaction. That certain of the Other DPAs may then take a portion of the mandatory payment made by the seller or builder and remit it or some other source of funds to a charitable organization does not change the character of the payment for federal income tax purposes from the perspective of the seller or builder as a payment in exchange for valuable services.

IV. Circular 230 Disclosure

In order to comply with requirements imposed by new IRS regulations, we inform you that (i) the advice contained in this memorandum was not intended or written to be used, and cannot be used, for the purpose of avoiding penalties under the Internal Revenue Code, (ii) we understand that the advice contained in this memorandum will be used to support the promotion or marketing of certain down payment assistance programs and (iii) any taxpayer who reads this memorandum should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.