Internal Revenue Service
Appeals

Department of the Treasury

Address any reply to:
Ohio Appeals Office
P.O. Box 2026
Cincinnati, Ohio 45201

Release Number: 201019034
Release Date: 5/14/10
Date: 5/14/09

A
B
C

UIL Code: 501.03-02

Employer Identification Number:
D
Form Number:
Person to Contact:

Contact Telephone Number:

Fax Number:

Legend

A = Taxpayer's Name
B = Taxpayer's Street Address
C = Taxpayer's City & State
D = Employer Identification Number (EIN)

Dear Taxpayer:

This is a final adverse determination as to your private foundation classification under Internal Revenue Code section 509(a).

Our adverse determination was made for the following reason(s):

You are not an organization described in section 509(a)(3) of the Code because you are not organized and operated solely for the benefit of, or in connection with one or more of the organizations described in sections 509(a)(1) or 509(a)(2) of the Code.

If you have questions about this letter, you may write to or call the contact person whose name, telephone number, and IRS address are shown on the first page of this letter.

Sincerely yours,

Charles F. Fisher
Appeals Team Manager

Internal Revenue Service

Department of the Treasury

Taxpayer Identification Number:
EIN

Date: June 8, 2006

Form:

Tax Year(s) Ended:
December x, 200X; 200X; 200X; 200X; and 200X

Person to Contact/ID Number:

Contact Numbers:

Telephone:

Fax:

Legend
ORG = Name of organization
EIN= EIN of organization

ORG

Certified Mail - Return Receipt Requested

Dear

We have enclosed a copy of our report of examination explaining why we propose modifying your foundation status under section 509(a) of the Internal Revenue Code (Code).

Your exempt status under section 501(c)(3) of the Code is still in effect.

If you accept our findings, take no further action. We will issue a final letter modifying your foundation status.

If you do not agree with our proposed modification of your foundation status, you may provide additional information that you would like to have considered, or you may submit a written appeal. The enclosed Publication 3498, *The Examination Process,* and Publication 892, *Exempt Organization Appeal Procedures for Unagreed Issues,* explain how to appeal an Internal Revenue Service (IRS) decision. Publication 3498 also includes information on your rights as a taxpayer and the IRS collection process.

If you request a conference with Appeals, you must submit a written protest within 30 days from the date of this letter. An Appeals officer will review your case. The Appeals Office is independent of the Director, EO Examinations. The Appeals Office resolves most disputes informally and promptly.

You may also request that we refer this matter for technical advice as explained in Publication 892. If we issue a determination letter to you based on technical advice, no further administrative appeal is available to you within the IRS regarding the issue that was the subject of the technical advice.

If we do not hear from you within 30 days from the date of this letter, we will process your case based on the recommendations shown in the report of examination. If you do not protest this proposed determination within 30 days from the date of this letter, the IRS will consider it to be a failure to exhaust your available administrative remedies. Section 7428(b)(2) of the Code provides, in part: "A declaratory judgment or decree under this section shall not be issued in any proceeding unless the Tax Court, the Claims Court, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted its administrative remedies within the Internal Revenue Service." We will then issue a final letter.

You have the right to contact the office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. You may call toll-free 1-877-777-4778 and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate at:

If you have any questions, please call the contact person at the telephone number shown in the heading of this letter. If you write, please provide a telephone number and the most convenient time to call if we need to contact you.

Thank you for your cooperation.

Sincerely,

Marsha A. Ramirez
Director, EO Examinations

Enclosures:
Publication 3498
Publication 892
Report of Examination

Legend

ORG= Name of organization
NN= Name of individual
RR= Related organization
UU= Unrelated organization
x= number
X= Year
ST= State
CY= Country
AD= Address
CT= County
EIN= EIN Number
CTY= City

ISSUE:

1. Whether the ORG fails to meet the requirements of IRC section 509(a)(3) so that the organization's classification must be changed from that of a public charity to a private foundation?

FACTS:

INITIAL DETERMINATION AND TRUST DOCUMENT

DETERMINATION APPLICATION

The ORG (ORG) was formed on July x, 200X, per the Declaration of Trust (Trust document). The original application for exempt status, Form 1023, was prepared by UU, .

The ORG received determination letter 947 dated September x, 200X, recognizing it as exempt from federal taxation under section 501(a) as an organization described in section 501(c)(3) and classifying as a supporting organization described in section 509(a)(3).

Form 1023 Application, Part II, Activities and Operational Information provides the following:

> "The purpose of the organization is to distribute substantially all of its income to and for the use of various public charities and to help the RR(the "Primary Charity") carry out its purposes and perform its functions. The organization's Board will collaborate with the Primary Charity to determine the most effective utilization of the funds generated by the Organization. Thus focus of the efforts of the Organization will be toward projects and programs which provide assistance to and for children and families in underdeveloped countries and regions of the United States. The specific program to be targeted with the Primary Charity, initially, will be the RR. Each year at least x (x%) percent of the net income of the organization will be distributed to the Primary Charity. The organization's Board, which includes a member appointed by the Primary Charity, will work with the governing board of the Primary Charity to establish the use of these distributions. It is intended that the distributions will be used each year to carry out or fund a substantial and important program or function of the Primary Charity. In addition, each year at least x) percent of the net income of the organization will be distributed among designated public charities listed on

Schedule A of the organization's indenture, as determined by the organization's Board."

TRUST DOCUMENT

The Trust document, Section 1.1 states ORG's purposes as follows:

> "The Trust is established for the purpose of establishing an organization which is described in § 501(c)(3) and § 509(a)(3) of the *Internal Revenue Code* of 1986, as amended, or corresponding provisions of any subsequent federal tax laws (hereinafter sometimes referred to as the "Code"), and which is tax exempt under § 501(a) of the Code. This Trust is organized, and all times thereafter will be operated exclusively to support or benefit, as defined by Treasury Regulation § 1.509(a)-4(b)(1), one or more publicly supported organizations and to comply with all other requirements of § 509(a)(3) of the Code. No part of the net earnings of this Trust shall inure to the benefit of any individual, and no part of the activities of this Trust shall consist of carrying on propaganda, or otherwise attempting to influence legislation, or of participating in or intervening in (including the publication or distribution of statements) any political campaign on behalf of any candidate for public office. Notwithstanding any other provision hereof, this Trust shall not conduct or carry on any activities not permitted to be conducted or carried on by an organization which is tax exempt or by an organization that receives Donations which are deductible from taxable income to the extent allowed by the provisions of the Code and other applicable legislation and regulations as they now exist or may hereafter be amended. All of the provisions of this Trust Agreement shall be read and interpreted so as to satisfy the purposes of this Trust as stated above.""

Section 2.2.1 of the Trust document requires distributions to be made to the RR as follows:

> "**Required Distributions to RR**. Each year, the Trustee shall distribute x (x%) of the net income of this Trust to the RR...Prior to making any donation, grant or distribution to RR, the Trustee shall obtain written confirmation that RR is then currently recognized as a tax exempt organization under § 501(c)(3) *IRC.* "

Section 2.2.2 of the Trust document requires distributions to other organizations as follows:

> "**Other Required Distributions**. In addition to the distribution to be made pursuant to Section 2.2.1 above, each year, the Trustee shall distribute a total of x percent (x%) of the net income of this Trust to one or more of the organizations listed on Schedule A, which by this reference is made a part hereof, or to RR as is direct by the Board in writing signed by at least two (2) members of a three (3) member Board

or at least three (3) members of a larger member Board, provided that each such distribution shall be a distribution which can be made by an organization described in § 509(a)(3) of the Code...Prior to making any Donation, grant or distribution to any organization listed on Schedule A, the organization shall obtain written confirmation that said organization is then currently recognized as a tax exempt organization under § 501(c)(3) of the Code."

Also, section 2.2.2 of the Trust document provides for the timing of the distributions as follows:

"...Each distribution shall be made on or before the end of the fourth month immediately following the year in which the income was earned..."

Section 2.2.3 of the Trust document provides for discretionary distributions as follows:

"**Discretionary Distributions.** In addition to the Required Distributions under Section 2.2.1 and 2.2.2 above, the Trustee may make such discretionary distributions of the income in excess of x (x%) of the net income and principal of this Trust to one or more of the organizations listed on Schedule A or to RR...Prior to making any discretionary Donation, grant or distribution to either RR or any organization listed on Schedule A, the organization shall obtain written confirmation that said organization is then currently recognized as a tax exempt organization under § 501(c)(3) of the Code."

Section 2.3 of the Trust document provides for the requirement of charitable distributions as follows:

"**Requirement of Charitable Distributions:** If at any time RR (or the alternative organization chosen pursuant to this Section) is not an organization to which distributions can be made by an organization described in § 509(a)(3) of the Code, then the Board shall select an organization from those listed on Schedule A which is an organization to which distributions can be made by an organization described in § 509(a)(3) of the Code, and such organization shall, for all purposes of this Trust, including while not being limited to those specified by Section 2.2.1, above and 3.1.1., below, be entitled to all of the rights and benefits as are herewith designated for RR."

SCHEDULE A TO TRUST DOCUMENT

Schedule A to the Trust document (as referenced to in sections 2.2.2 and 2.3 of the Trust) lists the following charities: RR; RR, RR; and RR.

TRUST DISSOLUTION CLAUSE

The dissolution clause in the Trust document, section 2.5, states in part:

> "...In the event that the Trust does not obtain tax exempt status under §§ 501(c)(3) and 509(a)(3) of the Code, the assets of the Trust shall go to the ORG or their designate or by power of appointment, as defined herein, as a contingent remainder."

However, in a letter dated April x, 200X, ORG included an Amendment to the Trust deleting the reversionary right contained in the original charitable support trust document. The attached First Amendment deleted the prior section 2.5 in its entirety and replaced it with the following:

> "Termination of Trust. Upon winding up and dissolution of this Trust, after paying or adequately providing for the debts and obligations of the Trust, the remaining assets shall be distributed to a non-profit fund, foundation, or corporation which is organized and operated exclusively for charitable, educational, religious, or scientific purposes and which has established its tax exempt status under IRC section 501[c][3] of the Internal Revenue Code."

TRUST BOARD PROVISIONS

Section 3.1 of the Trust document, in part, provides:

> "3.1 **Board**:" The Board shall be that body that has the authority, power and discretion as described herein. The Initial Board shall consist of five (5) members or reduced to three (3) members. The members of the Board shall be determined as follows:"
>
> > "3.1.1 **Charity Member of the Board**: One (1) Board member shall be appointed by RR or its designated agent..."
> >
> > "3.1.2 **Trust Members of the Board:** Two (2) Board members shall be from the class consisting of NN and NN and each of their descendants (the "ORG"), provided that there are then at least two (2) members of the ORG who are willing and able to so act."
> >
> > "3.1.3 **Other Members of the Board:** The remaining members of the Board, including any vacancies caused by not having the members as designated in Section 3.1.2 above, shall be appointed by a majority vote by the remaining

members of the Board, except as may be provided below. The initial remaining Board members shall be NN and NN."

COSTS OF SETTING UP THE ORG

Information Document Request (IDR) #5, question 5, was sent to the ORG and asked for all retained documents relating to any benefits paid to establish the ORG.

In a letter dated November x, 200X, ORG wrote:

> "The amount of $x was paid to theUU for implementation fees covering estate planning documents, the creation of four LLC's, setting up the UU, and for setting up the ORG. There was not separate billing for the different parts of the project. However, the NN paid $ on June 29, 200X from RR's account, and $ on November 3, 200X from the NN's personal account. The division was based on what the NN felt was a fair division between personal and business expense."

OPERATIONS OF THE ORG

BOARD ACTIVITIES / BOARD MEMBERS

Per interview with the prior Power of Attorney, NN, and per review of the bank statements and cancelled checks, no one from ORG and no one from the Board received any money or any compensation.

The Board members per the Form 1023 application and per the year 200X Form 990 were: NN and NN; NN; NN; and NN (RR).

The Board members per the years 200X, 200X, 2003, and 200X Forms 990 were: NN and NN; NN; NN (RR); and NN (CPA and preparer of Form 990).

However, per an interview on July xx, 200X, with NN the Board members in 200X were: NN and NN; NN, CPA (preparer of Form 990 and Form 1040 for the NN); NN, RR; and NN (wife of) RR.

The trust document provided that there would be a member from the RR (primary supported organization) on ORG's Board. However, per an interview with the prior Power of Attorney, NN, NN was not "officially" on the Board. NN, said that the ORG tried to get the RR to have a person on its board, however, the RR declined. NN said that NN and NN (and others at the RR) talk back and forth – letters, calls, e-mails. At the end of the year, when NN knows how much money the ORG earned, NN and NN discuss how to best spend the money. At least x% goes to the RR, but usually more.

IDR #6, question 5, was sent to the ORG and asked (a) why the Board appeared to consist primarily of NN and NN and their CPA/Form 990 preparer, NN; (b) why the Trust document provided that there will always be two members of the ORG on the Board; and (c) if the ORG planned to expand the board to include non-family members and to place control in the hands of unrelated individuals selected from the community.

In a letter dated November x 200X, ORG responded:

> "The Board members are NNs, NNs, NN, NN and NN.
>
> A. The Board does not consist "primarily" of the three individuals. The Board consists of the five named individuals. Each was aware of their Board position and was involved. You must remember that ST and ST are rural communities. It is common to include a client's certified public accountant or attorney as members of an organization's governing board."
>
> B. That is how the UU suggested it be set up.
>
> C. It is my clients' position that the Board is already independent with the three unrelated board members, one of which is involved with the public charity served by the ORG. Further, as discussed in number 3 above, my client is open to simply transferring the ORG assets to a recognized, national public charity to carry on the purposes established for the ORG."

IDR #6, question 6, stated that the Trust document provides that one board member shall be appointed by the RR, but that prior attorney, NN, said that no one from the RR is on the Board.

In a letter dated November x, 200X, ORG responded:

> "NN is not correct on this point. NN is and always has been part of the board. He has represented RR, the public charity, which was initially confused regarding the relationship with the ORG. NN involvement included input into meetings on annual distribution of ORG funds."

BOARD MINUTES

Per interview with prior attorney, NN, there were no Board minutes taken by ORG.

However in a letter dated November x, 200X, ORG stated the following in response to IDR #6, question 4:

"NN is incorrect. The Board Meeting was held by phone. The primary purpose was to determine the distribution of monies from the ORG. Summary minutes were prepared and copies accompany this response."

IDR #10, question 2, asked if there were additional summary minutes for the years 200X through 200X (which had not been submitted with the November x, 200X, letter) to provide a copy. Also, minutes for the years 200X and 200X were requested.

In a letter dated June x, 200X, ORG responded:

"There are no additional minutes for tax years 200X through 200X. Since neither tax year 200X or 200X is being audited, I do not see the relevance for requesting any summary minutes for these tax years."

IDR #12, question 2, again asked for minutes for the years 200X and 200X.

In a letter dated September x, 200X, ORG provided summary minutes for the year 200X and he stated that no minutes have yet been prepared for 200X.

BOARD ACTIVITIES – RR'S RESPONSES

In order to have an understanding of how the RR sees its involvement on the ORG's board and how it is supported by the ORG, on October x 200X, a third party-contact letter and an IDR were sent to NN, Assistant Director of Projects, RR.

On November x, 200X, the RR responded to IDR questions as follows:

1. Are you aware that you are listed as the supported organization for the ORG?

   "YES"

2. How much in annual support are you expecting to receive from the ORG?

   "THE TOTAL AMOUNT WOULD DEPEND UPON DECISIONS MADE BY THE ORGANIZATION'S BOARD AND THE AMOUNT OF FUNDS THEY HAVE AVAILABLE TO DISBURSE."

3. How much support have you received from the ORG during the years 200X and 200X?

   "200X – $x
   200X – $x

4. What was your total support for all sources for each of the years 200X, 200X, and 200X?

"200X – x 200X – x
200X – x

5. Please provide for each of the years 200X and 200X the following:

(a) The names of the projects which were paid for or by the ORG.
UU

(b) How much support for each project was given by the ORG.

UU

(c) How each project was selected.

"SP RECEIVES SEVERAL HUNDREDS OF REUQESTS EACH YEAR FROM ALL AROUND THE WORLD. THESE REQUIRE EVALUATIONS BASED ON THE NEED, THE HISTORY OF THE REQUESTING ORGANIZATION & SUBSTANTIALITY OF PROGRM. THE NN & NN ORG. USES SIMILAR CRITERIAS IN SELECTING & APPROVING PROJECTS THAT ARE PRESENTED TO THEM."

(d) How much each project paid for/supported by the ORG cost the RR.

"THE x% ADMINISTRATIVE FEE."

(e) Are the projects paid for/supported by the ORG considered to be substantial programs by the RR? Please explain.

"YES, RR POLICY BEING THAT WE WILL NOT REQUEST NOR RECEIVE MONEY FROM A CHARITABLE ORG. FOR A PROJECT UNLESS IT IS A PROJECT THAT IS AN ONGOING APPROVED PROJECT BY RR."

6. Is the money given by the ORG to the earmarked projects is (sic) x% or more of that project? Please provide the percentage of each project paid for/supported by the ORG.

"YES, ALL PROJECTS SUPPORTED BY NN & NN'S ORG. ARE ONGOING PROJECTS BY INDIGENOUS NON-GOV. ORGANIZATIONS IN THE COUNTRY IN WHICH THEY OPERATE. WE DO NOT HAVE A TOTAL BUDGET OF EACH OF THESE ORGANIZATIONS, BUT KNOW THAT RR

CONTRIBUTES IN ONLY A SMALL PORTION OF THEIR ONGOING PROGRAMS."

7. Would each project be continued but for giving of money from the ORG? Would it be interrupted in any way?

   "THE PROJECT WOULD BE CONTINUED BY SAM. PURSE IF NN ORG. SUPPORT WERE NOT INVOLVED. THE DIFFERENCE BEING THAT WITHOUT THE NN & NN'S CHARITABLE SUPPORT ORG, THERE IS THE POSSIBLITY THAT WE WOULD HAVE TO REDUCE THE LEVEL OF SUPPORT THAT WE GIVE TO THESE PROJECTS."

8. Describe the purpose of your organization and what other charitable entities you intend to support or contribute to. List the names and addresses of the organizations that you supported during the years 200X and 200X and the amount of support provided:
   Description of purpose:

   "SEE THE MISSION STATEMENT ATTACHED."

   Names and address of organizations supported:
   Name Address Amount Paid

   "SEE THE RR FORM #990 FOR LISTING."

In addition, a fax dated March x, 200X, was received from NN/RR. The fax was signed by NN, Associate Director of Projects, and stated:

> "I am writing to verify the fact that I have served on the Board of Directors of the ORG. I have served in this capacity since 200X. During this period of time, I have been actively involved in making recommendations and being a part of the decisions as to which projects and programs the NN and NN Charitable Support Organization should support with the funds available."

EXEMPT ACTIVITIES

SUPPORT OF PRIMARY CHARITY – RR

Included in correspondence received with letter dated June x, 200X, from prior Power of Attorney, NN, was a letter dated March x 200X, from NN to NN (from the RR). The March x, 200X, letter described projects to be supported by the ORG.

Per the letter, NN traveled with NN to CY and CY to visit the orphanages and work in
The letter stated that after his travels visiting various projects, NN decided to support all of them. Per the letter, NN enclosed a check for $x and he said that the money should be used at the RR's discretion, but that he wanted the money to be spent toward the following projects:

1. RR
2. RR
3. RR
4. RR
5. RR

Total $x
=======

Prior attorney, NN, said that NN did not use any of the ORG's money for the trip.

Per review of the year December x, 200X Form 990 for the RR, it is a large organization which received $x in contributions and $x in government grants. The ORG only gives about $x per year to the NN. However, NN said that he fully pays for (through the RR) one of the programs provided for by the RR.

DISTRIBUTIONS TO RR'S PROJECTS – YEARS 200X AND 200X

Distributions were made during the years 200X and 200X (as well as subsequent years) to the RR, the primary supported organization.

IDR #9, question 6, asked if the projects and amounts listed for this item on the IDR were correct for 200X and 200X. In addition, question 6 asked how each project was selected by the ORG and what the ORG's involvement was in the selection of each project.

For the year 200X, the following projects were listed in the IDR:

1. RR
2. RR
3. RR
4. RR
5. RR

Total $x

For the year 200X, the following projects were listed in the IDR:

1. RR
2. RR

3. RR
4. RR
5. RR

Total $x

In a letter dated November x, 200X, ORG responded:

> "It appears that the listing of projects and amounts contributed listed on the IDR are correct for 200X and 200X. These projects, and others, were initially recommended by NN on behalf of the RR. NN then undertook his personal review of the suggested projects. With input from NN an (sic) NN, the Board then decided which projects to fund."

DISTRIBUTIONS TO ORGANIZATIONS NOT LISTED AND TO PRIVATE FOUNDATIONS

ORG made grants to organizations not listed on Schedule A of the Trust document. In addition, ORG made grants to an organization that is a private foundation.

IDR #6, question 7 stated that for the year 200X the ORG made a distribution of $x to RR in RR (RR), but that RR is not listed on Schedule A attached to the Trust document. Also, question 7 stated that prior attorney, NN, stated that the ORG switched from RR (charity listed on Schedule A) to RR because the NN investigated RR and did not like what it was doing. Question 7 asked if the statement from NN was accurate and if there were any other reasons why the ORG didn't use the charities listed on Schedule A.

In a letter dated November x, 200X, ORG responded:

> "NN' statement is correct on this point. NNs continually researches potential charities to locate those that deserve financial support. RR in RR was doing an excellent work of caring for the children of AIDS sufferers in CY. The ORG provided a one time gift of $x in one of the years. NN was not aware of the need to amend the trust to substitute a different charity, as well as to restrict ORG distributions to the name charities. This type of regulation is one reason why my client is considering rolling the ORG assets into a public charity, which will be familiar with these complex regulations."

The ORG made grants to or for the benefit of RR every year from 200X through 200X. RR is a private foundation.

IDR #6, question 8 asked the ORG why it chose RR as a charity listed on Schedule A of the Trust Document when it had private foundation status and why it made distributions to RR when it had private foundation status.

In a letter dated November x, 200X, ORG responded:

> "Again, this is an illustration of why the NN are willing to consider transferring the ORG assets to a large public charity. NN had no idea that the RR was a private foundation instead of a recognized public charity. He was not aware that the IRS publishes lists of 501(c)(3) charities. He recently found out that it was a private foundation, but did not know it had any effect on the distributed monies of the ORG."

x% REQUIRED DISTRIBUTIONS

Per review of Form 990, contemporaneous written acknowledgments, bank statements, and cancelled checks, the ORG has followed the Trust document by granting x% of the net income annually to charities. As required by the Trust document, section 2.2.2, the grants were made by the fourth month immediately following the year in which the income was earned.

Year 200X Distributions / Expenses

Net income for year 200X was $x. Per review of bank statements, there was $x from interest income and $x from rental gross income from the NN rental buildings = $x. Per review of Form 990, profit & loss statement, bank statements, and cancelled checks, Register Report, and Operations for the year 200X, expenses were accounting fees $x; bank charges $x; rental expenses (utilities) $x; supplies $x; property taxes $x = $x. $x gross income - $x expenses = $x net income.

The required grant per the trust document for the year 200X was $x ($x x % = $x).

Year 200X Form 990 showed grants of $x. Grant checks written in the year 200X were $x (8/27/200X for $x and 8/31/100X for $x).

Per copies of checks, the actual grants to charities for the year 200X were $x consisting of: (a) 08/27/200X .written to UU.com for two air hockey tables to be sent to the *RR; (b) 08/31/200X check #x in the amount of $x check #x written to UU (used for UU); (c) 01/07/200X check #x in the amount of $ written to **RR in RR; and (d) 03/21/200X check #xx in the amount of $x written to the ***RR, the primary charity.

Notes regarding grants:

*Note: Per a contribution receipt from RR (ST,), the UU, and the UU, is a Ministry of RR. The RR was named as a charity on Schedule A of the Trust document.

However, RR is a private foundation. In addition, the RR has been filing Form 990-PFs.

Note: RR in RR is **not an E.O. named on Schedule A of the Trust document. The RR in RR is a public charity since it received a letter dated 6-xx-199X verifying that it was recognized as tax exempt in February 198X under section 501(c)(3) with foundation status under section 509(a)(1) and 170(b)(1)(A)(vi).

***Note: The RR received exempt status in November 198X under section 501(c)(3) with foundation status under section 509(a)(1) and 170(b)(1)(A)(vi).

Income/Grants

For the years 200X, 200X, and 200X, the grants disbursed to public charities exceeded x% of the Foundation's net income.

RENTAL ACTIVITIES

NN owned three rental properties which he contributed to the ORG per the Warranty Deeds.

RENTAL PROPERTIES

Rental Property One – AD

Per warranty deed, on December x, 200X, NN contributed the AD, ST, rental building to the ORG. Per phone call on July x, 200X, to the CT, the auditor said that the warranty deed showed "The NN and NN Charitable Supporting Organization" as the grantee (new owner) and it was the last thing filed for this property. The auditor stated that there are no loans or mortgages showing as recorded for this property.

Lessees of AD Property / Determination of Rental Amount

During an interview with NN, he stated that the ORG rents the AD property to RR and RR. Both of these are corporations owned by NN. The rent is $x per month from each entity. RR is a nutritional health store. RR is a manufacturing facility of nutritional products.

Per NN, RR and RR were lessees of the buildings two to three year prior to the Donation of the buildings and they are continuing to pay the same rent as before. NN stated that rental value is usually determined to be x% of the value of the property. The AD property had a Donated value of approximately $x. If the ORG paid x% of $x that rent would be $x per year. However, RR and RR paid $x for rent in the year 200X.

Rental Property Two – AD, ST (ST)

Per warranty deed, on February x, 200X, NN contributed the AD, ST, rental building. Per phone call on July 21, 200X, to the CT office, the warranty deed shows "The NN and NN Charitable Supporting Organization" as the grantee (new owner).

Lessees of AD, ST Property / Determination of Rental Amount

Lessee: ST UU

During an interview with NN, he stated that no rent was received from the ST UU other than utilities. ORG provided the UU building to the UU rent free as a charitable act.

Per an interview with NN, the ST UU started in ST xyears ago. NN's daughter was participating in the UU. Therefore, NN had an interest in the UU since his daughter needed a place to go. NN built the building at AD in 199X and he owned the building.

The UU was operating in the AD location when the building was completed in 199X. No rent was charged to UU, however the UU paid the utilities.

The ST UU continued to use the AD building until June 200X when the ST UU moved into another building block away to its current location at AD, ST, WA. NN said that the reason for the UU moved was because there was too much traffic on the street at the AD location. The building currently being used by the ST UU is not owned by ORG.

Lessee: RR

The current use of the AD building is a rental property. A tour of the building showed that it had as a tenant a natural food market business. Per NN during an interview and tour of the properties, the ST UU vacated the building in June of 200X. He prepared the building and opened a business in the building called "RR UU." The business was owned by NN and NN and it opened in December 200X. NN began paying rent of $x per month in January 200X and paid rent each month until the business was sold in October/November 200X.

Per NN, in October/November 200X, the RR was sold to NN and NN. The business is still run out of the AD building. NN are paying rent of $x per month, which is comparable to other rents charged in ST. NN felt that $x per month was the most that could be charged for the building and still be rented.

NN is the Director of the ST UU. NN have no other relationship to the NN.

Rental Property Three – AD, ST (ST UU)

Per warranty deed, on February x, 200X, NN contributed the AD, ST, rental building.

Per phone call on July x, 200X, to the NN office, the warranty deed shows "The NN and NN Charitable Supporting Organization" as the grantee (new owner).

Lessee of AD Property / Determination of Rental Amount

The ORG leases the building to the ST . Per an interview with NN, the rent received by the ORG from the ST UU is $x per month. There are no rental agreements. The reason for the $x per month is because that is the amount that the UU had paid to a previous landlord for a building that was not as large or as nice a facility as the AD rental building.

During a tour of the buildings, NN said that the RR still operates out of the AD, ST, location. NN said that the rent paid by the RR to the ORG is $x per month.

NN stated that he acquired the building in x. NN gutted and remodeled the building and the UU moved into the building after it was remodeled in x. The UU had been in another building that was falling down and it was paying rent of $x for that building. Therefore, NN continued to charge the same $x per month for a much nicer building.

A tour of the building showed that it has two air hockey tables (Donated by the ORG per check #x of $x dated August x, 200X, to UU.Com); foosball tables, kitchen, and a lounge used for talking about values. NN stated that the ST UU provides free meals to the kids.

LEASE AGREEMENTS

There are no written lease agreements for any of the three rental properties owned by ORG. The prior Power of Attorney, NN, stated that there are oral contracts only.

Questions and Responses Regarding Oral Lease Agreements

IDR #6, question 9 stated that prior attorney, NN, said that there were no written lease agreements for the three rental buildings: AD building; AD building; and AD (ST UU). The IDR asked for following regarding the years 200X and 200X: (a) why there were no written lease agreements; (b) what was the monthly rental amount; (c) how was the fair rental value determined; (d) copies of cancelled checks for the rent receipts for 200X and 200X; (e) for the AD building – why companies owned by NN were renting the building; and (f) for the AD building – why a company owned by NN was renting the building.

In a letter dated November x, 200X, ORG responded:

> "A. NN was correct, there were no written lease agreements because they were not considered necessary by NN. He had not been advised that a written lease is required when dealing with a ORG."

B. For AD the rent received was $x per month. For AD the rent was -0- while it was a UU, then $x while it was operated by NN & NN, then $x after it was operated by NN & NN. For the UU at AD the rent has always been $x per month.

C. The fair rental value was determined by agreement of the parties involved, based on their knowledge of rents being charged locally.

D. No rent receipts or copies of deposited rent checks were maintained by the ORG.

E. I understand from NNs that you have inspected the subject building. So being, you should recognize that its use and location adjacent to my clients' business make those businesses the logical tenants. Again, this is not downtown CTY where multiple tenants may vie for a particular lease space [at least when downtown CTY's economy is not in a slump.] This is a rural area.

F. Again, I understand you have seen the subject health food store. After the UU moved out it sat vacant for a number of months. It was then decided to put in a health food store so that it would be used for something productive."

RENT AMOUNTS AND OWNERSHIP OF LESSEE COMPANIES

A letter and an IDR were sent to the ORG regarding the rent amounts that the lessees paid the ORG and the ownership of the lessee companies. The questions and responses are shown below:

RR

IDR #8, question 1, asked about rental activities and asked the following about ownership of the companies, RR as follows: (a) is it accurate that RR rented AD property from the ORG for the period x for $x per month; (b) is it accurate that RR (replacing The UU) rented the AD property from the ORG for the period x for $x per month; (c) has RR rented the AD property from the ORG for the period x through the present time at $x per month; (d) UU - NN's ownership percentage and title; (e) UU – NN's ownership percentage and title; (f) RR – NN's ownership percentage and title; and (g) RR – NN's ownership percentage and title.

In a letter dated January x, 200X, ORG responded:

"A & B My client cannot recall the exact changeover date. RR may have rented the property until as late as August 200X. In any event, the rent was $x a month paid by both entities. We accept your finding that the RR rented from January x, 200X to March x, 200X, with RR renting from April x, 200X to present date.

C Yes.

D NN owned x% of RR. and was its president.

E NN owned x% of RR. and was not an officer.

F NN owned -0- % of RR. and is its current president, though not an officer for the period in question.

G NN owned x% of RRc. and was its president during the period in question".

RR:

IDR #8, question 2, asked about rental activities and asked the following about ownership of the company, RR as follows: (a) has RR rented the AD from the ORG for the period January x, 200X through the present time at $x per month; (b) what was NN's ownership percentage and title; (c) what was NN's ownership percentage and title.

In a letter dated January x, 200X, ORG responded:

"A Yes

B NN owned x% of RR and was its president.

C NN owned x% of RR(sic) RR, Inc. and was not an officer."

RR:

IDR #8, question 3, asked about rental activities and asked the following about the ownership of the company, RR as follows: (c) If RR sold to new owners in October 200X, with rents starting in October 200X – please explain why it appears that rents of $x were paid from 1/14/200X through 7/12/200X for a total of $x paid by NN and then no rent for August 200X and rents of $x paid from 9/13/200X through 12/17/200X for a total of $x (paid by new owners of RR); (d) what was NN's ownership percentage during 200X when it was owned by the NN and what was NN's title; what was NN's ownership percentage during 200X and what has NN title.

In a letter dated January x, 200X, ORG responded:

"C While the business was owned by RR, it was failing. NN made efforts to improve the business, but was not successful. When the business was sold to the new owners, the rent was lowered to $x in hopes that the new owners could make a go of the business at that location.

D NN owned x% of RR RR and was its president.

E NN owned x% of RR RR and was not an officer.

DECLARATION OF RENTS PAID TO THE ORG

Because ORG previously stated that the ORG did not maintain copies of the cancelled checks for rental amounts received, IDR #8, question 4 asked if the ORG could have someone else provide copies of cancelled checks for rental receipts for the years 200X and 200X.

In a letter dated January x, 200X, ORG responded:

> "The four identified renters all maintain canceled checks. For 200X and 200X, these encompass approximately x boxes at approximately x checks per box or x checks. These documents have been previously provided to the IRS for review. My client is willing to make the documents available again to the IRS for your review in an effort to identify the rent checks. An alternative might be to just accept a signed declaration from each renter in regards to their recollection of the paid rent."

IDR #9, question 1 asked for a signed and dated declaration from each of the following renters in regards to their recollection of paid rent for the years 200X through the present time: (a) UU; (b) RR; (c) RR ; and (d) RR (during the time owned by the NN).

In a letter dated April x, 200X, ORG provided declarations (all were signed by NN, as President, on March x, 200X) with a computer print-out of the checks issued by each entity for rent. The computer print-outs showed the following:

A. RR showed rents from January x, 200X, through July x, 200X, at $x per month.
B. RR, Inc. showed rents from August x, 200X, through February x, 200X, at $x per month.
C. RR showed rents from January x, 200X, through February x, 200X, at $x per month.
D. RR RR showed rents from January x, 200X through September x, 200X, at $x per month with $x for the September x, 200X payment.

In addition to the rents shown above, ORG sent a letter dated February x, 200X, to show rents for the year 200X for RR and RR. The letter stated the following:

> "NN advises me that at the first of 200X, RR continued to pay $x per month rent. However, RR's rent was raised to $x. This rent increase was due to the construction of a new lab building for RR. The new building is quite large, being approximately x square feet of lab space and warehouse. This rental arrangement was in effect for all of 200X. At the beginning of 200X, the rents were adjusted based on past actual usage as an indicator for future use. RR's rent was increased to $x per month and RR's rent was reduced to $x per month."

Also attached to the letter dated February x, 200X, was a year 200X transaction detail for RR showing rents each month of $x and a year 200X transaction detail for RR showing rents each month of $x.

LOANS

NN took out a loan in the amount of $x from the ORG on October 11, 200X, at x% interest. The loan was repaid with interest on August x, 200X. However, because the interest was not correctly computed, interest of $x was still owed as of the end of May 200X. Per copy of cancelled check, which was posted at the bank on May x, 200X, NN paid the remaining interest owed of $x. NN did not take out any other loans from the ORG.

Questions and Responses Regarding the Loan

November x, 200X response

A letter and IDR #5 were sent to the ORG. Question 26 of the IDR asked about loans.

In a letter dated November x, 200X, ORG responded:

> "There was one loan made in 200X. It was paid back in 200X plus interest. Copies of documents are attached. A short explanation is in order. NNs was disgusted that the ORG was only receiving a x% or less return on the money from the bank. NN recalls being told by someone that it was no proper for the ORG to invest its extra money in the stock market or otherwise. Consequently, NN decided to borrow $x from the ORG at x% interest. This loan was paid back in 200X. NNs invested the money in the stock market and lost a substantial portion of it. However, he did pay the whole amount back—plus the x% interest."

Also, attached to the November x, 200X, letter was a copy of a loan document dated October x, 200X, from RR, borrowing from the ORG $x at x% interest. The repayment terms were that interest and principal were due in fully by October x, 200X, but prepayment was allowed. The document was signed by NN for UU. Also attached was a copy of a cancelled check dated October x, 200X, for $x issued to NN.

January x, 200X, response

A letter and IDR #8 were sent to the ORG.

Question 6 of the IDR asked the ORG to provide the following: (a) copies of documents showing the collateral to secure the loan; (b) copies of cancelled checks showing all the payments of

interest and principal made; (c) copy of the loan amortization schedule; (d) how the x% interest rate was determined; (e) if the loan was made to RR, as shown on the loan document or if the loan was made to NN as shown on the cancelled check; and (f) to explain the relationship between RR, NN and NN, and/or the ORG.

In a letter dated January x, 200X, ORG responded:

"A No collateral was required since the lender [ORG] knew of and accepted the general credit worthiness of the borrower [NN].

B There were two checks involved, with NN as the maker and the ORG as the payee. The checks are not readily available. Since you have the bank statements, this letter regarding the parties, and the information on the principal and interest rate; you have all the relevant information that would be shown on the cancelled checks.

C There was no loan amortization schedule due to no set payments. The interest rate was a fixed x%.

D Based on the current low market rate, the x% interest rate was selected as being appropriate for unsecured loan with no fixed repayment date.

E&F RR is owned by NN & NN. As such, the LLC is a disregarded entity under IRS regulations; that is, it is one in the same with NN."

Question 7 of the IDR asked the ORG the following items: (a) explain why the $x check # issued to NN was not recorded in the check register; (b) why the check register showed check #x as check #; and (c) why the check register showed a balance of $x at 12/31/200X when the balance appears it should have been only $x (after the $x check issued to NN).

In a letter dated January x, 200X, ORG responded:

"A-C The $x loan from the ORG to NN was made during October 200X. From your explanation and review of the documents, it simply appears that the $x was overlooked until a future reconciliation of the check register and checks. Clearly, other checks were mistakenly entered into the check register."

February x, 200X, response

A faxed letter dated February x, 200X, was received from the ORG which stated the following:

"Summarizing, the $x loan was made by the ORG to NN on October x, 200X. The loan was paid back as follows:

March x, 200X	x
March x, 200X	x
August x, 200X	x

April x, 200X, response

A letter and IDR #9 were sent to the ORG. Question 2 of the IDR asked for copies of the checks showing the payments of principal and interest.

In a letter dated April x, 200X, the ORG provided copies of the checks and the bank statements. Also, the ORG stated:

> "By my count, the loan was outstanding approximately 10 months. The interest paid to the ORG on repayment is a bit over 6%, being substantially more than the ORG could have earned from a bank or other depository at the time."

June x, 200X, and September x, 200X, responses

A letter and IDR #10 were sent to the ORG.

Attached to IDR #10, question 1, was IRS' computation of the loan amounts which were due. The computations show that NN would have still owed an additional $x on August x 200X, and at x% interest, he would owe $x at May X, 200X. The ORG was asked that if it agreed with the IRS computations to show proof of the repayment such as a cancelled check.

In a letter dated June x, 200X, ORG responded:

> "Both myself and my clients accept your computation of additional interest due the ORG in the amount of $x. This amount was paid by the NN to the ORG by check dated May x, 200X which was deposited May x, 200X. The cancelled check will not be available for approximately one month."

In a letter dated September x, 200X, ORG provided a copy of the front and back of a cancelled check from NN to the ORG in the amount of $x with a posting date of May x, 200X.

MOBILE HOME

In September 200X, the ORG paid for a rental hook-up in the amount of $x and paid for the moving of a mobile home in the amount of $x. The intent is that the mobile home will be donated to the ORG at some time in the future. A detail of questions regarding the mobile home are shown below.

IDR #8, question 8, asked about: (a) check written for a rental hook-up (c) check written for moving a mobile home.

In a letter dated January x, 200X, ORG responded:

> "A This related to a mobile home moved onto the approximately x acres comprising the AD property.
>
> C The mobile home was purchased by UU It was moved to the Donated property to provide security for the buildings on the property. The intent is that the mobile be Donated to the ORG at some point."

SOURCES OF INCOME

The year 200X was the first year of the ORG. Sources of income for the years 200X through 200X are shown below.

YEAR 200X

Per review of the Trust document, the ORG did not begin until July 17, 200X, and per review of bank statements there were cash contributions of $x on August 22, 200X, and $x December 28, 200X. Non-cash contributions included a rental building Donated on 12/26/200X per review of the warranty deed.

The year 200X Form 990 showed interest income of $x. In addition, Form 990 showed cash contributions of $x and property contributions of $x for total contributions of $x. There were no other sources of income.

Property Donations

A review of the CT Warranty Deed dated December 26, 200X, shows a property NN of the AD, ST, , to the NN & NN . In addition, per a phone call on July 21, 200X, to the CT the warranty deed showed "The NN and NN Charitable Supporting Organization" as the grantee (new owner) was the last thing filed for that property. The auditor stated that there are no loans or mortgages showing as recorded for this property.

The ADproperty was the only property donated during the year 200X.

Value of Donated Property

The donated value used and shown on Form 990 was $x. However, the appraiser's report showed the assessed value at June 29, 200X, was only $x.

Per the prior Power of attorney, NN, there was a storage building/improvement of $x that was added before the building was Donated. NN said that he would try to get documentation for the $x.

Since no documentation was received, IDR #5 included question 1 which asked for verification of improvements of $x to justify the $x value used by the ORG.

In a letter dated November x, 200X, ORG responded:

> "Referring to the improvements to the RR building on AD, attached are billings in the amount of $x from UU and $x from UU, which total $x. While my client believes there must have been a good reason for utilizing the $x figure, at this time the above receipts are all that can be accounted for."

Because the appraisal showed a value of x and the ORG could only show receipts totaling $x, the donated value to the ORG should have only been the verified amount of $x.

Total Year 200X Contributions

The total year 200X verified contributions were $x consisting of property NN of $x ($x + $x) and cash contributions of $x.

YEAR 200X

During the year 200X, ORG did not receive any cash contributions. ORG did receive non-cash contributions of two rental buildings each NN on February x, 200X, per review of the Warranty Deeds.

The year 200X Form 990 showed interest income $x net rental income of $x; and non-cash contributions of $x.

The interest income of $x was verified per review of the bank statements.

The gross rental income of $x was verified per review of bank statements showing the deposits and per review of the Register Report. Per attachment to Form 990, rental expenses were: utilities $x; supplies $x; and taxes of $x.

Rental expenses were verified per a review of cancelled checks and bank statements. Per the cancelled checks and bank statements the utilities were $x, the bank charges were $x; and property taxes were $x. Therefore, the net rental income was $x ($x - $x).

Property Donations

The year 200X Form 990 showed two non-cash Donations from NN: $xfor the ST UU building located at AD, ST; and $x for the ST building located at AD, ST,. The property Donations shown on Form 990 totaled $x and were the only Donations made.

A review of a dated February 27, 200X, UU showed a property NN of the AD property, ST, to the NN & NN . Also, a review of a dated February 27, 200X, UU showed a property Donation of the AD property, ST, .

Value of Donated Property

AD Property

The Donated value used on Form 990 was x. The date of the property Donation was February 27, 200X, and it was appraised on March 15, 200X, for x. The correct Donated value of x was used since the appraisal agrees with Form 990.

AD Property

The Donated value shown on Form 990 was x. The date of the property Donation was February 27, 200X, and it was appraised on March 15, 200X. The appraiser's report dated March 15, 200X, showed a value of only x. Per the prior Power of Attorney, NN, the NN originally paid x for the property and used the amount that they had paid for the building since they felt that the building was worth x. NN had also stated that there were no receipts to show improvements of x. In order to determine the correct value, an IDR was sent to the ORG and NN.

IDR #5, question 4, asked the ORG to provide copies of the original purchase documents to show that the purchase price was x.

In a letter dated November 16, 200X, NN responded:

> "NN was confused. The NN built the building in 199X. The construction was financed with a loan from UU after it was finished. The bank's appraiser appraised the building for x. When the building was donated to the ORG, the appraisal was only x. At this time, my clients can not recall why the x was used rather than the current x appraisal amount."

Since the appraisal dated March 15, 200X was the only verified amount, the donated value to the ORG should have been the appraised amount of x.

Total Year 200X Contributions

The total year 200X verified contributions were consisted of two property donations: x for the AD property and x from the AD property for a total of $x.

YEAR 200X

During the year 200X, ORG received cash contributions of $x. Per review of bank statement, cancelled check and deposit slip there was a cash deposit of $x on January 22, 200X, and a check deposit of $x on January 22, 200X.

The year 200X Form 990 showed cash contributions of $x; interest income of $x; and net rental income of $x for total revenue of $x.

The interest income of $x was verified per review of the bank statements.

The gross rental income of $x was verified per review of bank statements showing the deposits and per review of the Register Report. Per attachment to Form 990, rental expenses were: insurance $x; taxes $x; utilities $x; and miscellaneous $x.

Rental expenses were verified per a review of cancelled checks and bank statements. Per the cancelled checks rental expenses were: insurance $x; property taxes $x; utilities (rent hook-up) $x; and $x consisting of moving mobile home $x plus $x balance adjustment (as shown on 200X Register Report received in correspondence dated November 16, 200X) for a total of $x. Therefore, the net rental income was $x ($x - $x).

Total Year 200X Contributions

The total year 200X verified contributions were cash of $.

YEAR 200X

During the year 200X, ORG did not receive any cash or property donations.

The year 200X Form 990 showed interest income of $ and net rental income of $ for total revenue of $.

The interest income of $ consisted of $ from checking account interest per review of the bank statements and consisted of $ received from the NN loan per review of cancelled check # from NN dated August x, 200X.

The gross rental income of $was verified per review of bank statements showing the deposits and per review of the Register Report. Per attachment to Form 990, rental expenses were: insurance $; taxes $; and repairs and maintenance $.

Rental expenses were verified per a review of cancelled checks. Per the cancelled checks rental expenses were: insurance $; property taxes $; and repairs and maintenance $ for a total of $. Therefore, the net rental income was $7 ($ - $).

In addition to the interest of $received on the NN loan, review of cancelled checks from NN showed that principal payments were received on March x 200X for $; March x, 200X for $; and August x, 200X for $

Total Year 200X Contributions

There were no contributions for the year 200X.

YEAR 200X

During the year 200X, ORG received $ in cash Donations per review of year 200X Form 990. Also, per review of "Donations In" ledger and also per the check register "Transactions", there were two deposits: February 13, 200X, for $ and December 21, 200X, for $x.

The year 200X Form 990 showed cash contributions of $; interest income of $; and net rental income of $ for total revenue of $.

The "Bank Summary" (Income and Expense statement) and Interest Inc ledger showed interest income as $. The "Bank Summary" and "Rent" ledger showed rental income as $ (gross rental income). The expenses for rent were property taxes $1 and insurance $ ($) for net rental income of $.

Total Year 200X Contributions

The total year 200X contributions were cash of $x.

EXPENSES

The year 200X was the first year of the ORG. Expenses for the years 200X through 200X are shown below.

YEAR 200X

The year 200X Form 990 showed bank charges of $x as the only expense. A review of the bank statements showed bank charges of $x.

YEAR 200X

The year 200X Form 990 showed expenses as: grants $x; accounting fees $x; bank charges $x; and rental expenses consisting of utilities x, check supplies $x, and property taxes $.

The grants were verified per review of check x in the amount of $x to the UU.com (for two air hockey tables to be sent to the UU r) and check #x in the amount of $ to UU) for a total of $x.

The accounting fee of $x was verified per review of check #x written to CPA, NN.

Bank Charges of $x were verified per review of bank statements.

Rental Expenses of $x were verified per review of bank statements and cancelled checks. The rental expenses consisted of utilities $x, check supplies of $x, and property taxes of $x.

The property taxes were paid to the CT on April x 200X, per cashier's check # in the amount of $x and paid to the AD on October 15, 200X, per check x in the amount of $x. There were no checks written to the CT Treasurer (AD property) for the year 200X.

YEAR 200X

The year 200X Form 990 showed expenses as: grants $x; accounting fees $x appraisal fee $x0; bank charges $x; and rental expenses consisting of insurance $x, taxes $x, utilities $x and miscellaneous $x.

The grants were verified per review of check #x dated January 7, 200X, in the amount of $ to RR; check#x d March 21, 200X, in the amount of $x to RR; and check #x to UUr – ST in the amount of $x.

The accounting fee of $x was verified per review of check #x written to CPA, NN.

The appraisal fee of $x was verified per review of check #x written toUU.

Bank Charges of $x were verified per review of the February 200X bank statement.

Rental expenses were verified per of review of cancelled checks and bank statements. Per the cancelled checks rental expenses were: insurance check # and check #; property taxes check #, check #, and check #1; utilities (rent hook-up) check #; and $consisting of moving mobile home check #1 $ plus balance adjustment (as shown on 200X Register Report received in correspondence dated November 16, 200X) for a total of $x.

In addition, not reported on Form 990 was check #1025, dated October 11, 200X, in the amount of $x which was paid to NN for a loan from the ORG to NN.

YEAR 200

The year 200 Form 990 showed expenses as: grants $ accounting fees $; bank charges $; and rental expenses consisting of insurance $, taxes $, and repairs and maintenance $.

The grants were verified per review of check # dated February , 200X, in the amount of $ to RR; check# dated March , 200X, in the amount of $x to RR. In addition the following checks were made on behalf of the RR: checks #on March x, 200X for $; # on October 2, 200X, for $; # on October 31, 200X, for $, # on November 28, 200X, for $, and # on December 31, 200X, for $0; and checks written for items to be used on behalf of RR – checks #1028 on January 3, 200X, to UUc. (equipment) for $ and # UU, Inc. for $ (equipment); = $.

The accounting fee of $sx was verified per review of check # written to NN.

Bank Charges of $x were verified per review of the bank statements. Service charges were: February 28, 200X, for $x (bank statement missing); March 31, 200X, for $x; April 30, 200X, for $x; and May 30, 200X, for $x = $x.

Rental expenses were verified per of review of cancelled checks. Per the cancelled checks rental expenses were x.

YEAR 200X

The year 200X Form 990 showed expenses as: grants $x; accounting fees $x; bank charges $x insurance $x and property taxes $x.

"Banking Summary" (Income and Expense statement) and "Transaction" (check register), expenses were: accounting fees $100; bank charges $x; insurance $x; and property taxes $x for a total of $x.

In addition to the expenses shown on Form 990, the "Banking Summary" and "New Lab Building" ledger showed construction costs of $x for the period of March 23, 200X, through December 9, 200X. The expenses for the "New Lab Building" were not shown on Form 990 as an expense but were included on the Form 990 Balance Sheet as a part of the buildings. The Form 990 beginning balance for buildings for the year 200X was $x and the ending balance $x ($x+ $x).

ASSETS

The year 200X was the first year of the ORG. Assets for the years 200X through 200X are shown below.

YEAR 200X

The year 200X Form 990, Balance Sheet showed cash of $x and investments – land building, and equipment of $x.

The cash balance of $x was verified per review of the bank statements.

The investments – land, building, and equipment consisted of the property Donation of the ADproperty.

Per warranty deed, on 12/26/200X, NN contributed theAD, rental building. The Donated value used was $x.

The CT Warranty Deed dated 12/26/200X verified the property Donation of the ADproperty, ST,

The property was assessed on June 29, 200X, for $x. Since the assessed value of $x did not agree with the $x amount used on Form 990, an IDR was sent to the ORG.

In a letter dated November 16, 200X, ORG responded:

> "Referring to the improvements to the RR building on AD, attached are billings in the amount of $x from UU and $x from UU, which total $x. While my client believes that there must have been a good reason for utilizing the $x figure, at this time the above receipts are all that can be accounted for."

Since the appraisal showed a value of $x and the ORG could only show receipts totaling $x, the Donated value to the ORG should have only been the verified amount of $x.

The year 200X verified assets were the ending cash balance of $x and the Donated property with a value of $x (including the improvements).

YEAR 200X

The year 200X Form 990, Balance Sheet showed cash of $x and investments – land building, and equipment of $x.

The cash balance of $x was verified per review of the bank statements.

The investments – land, building, and equipment consisted of the property Donation of the AD property, the AD property, and the AD property.

The property Donations were shown on Form 990 as: the AD Property at $x; AD property at x; and the AD property, at x for a total of $x.

CT Deeds dated February 21, 200X, showed property Donations of the AD property, ST, , and the AD property, ST, to the NN & NN Charitable Supporting Organization.

An appraisal dated March 15, 200X, for the AD, ST, property showed the assessed value as x which agrees with the contribution amount shown on Form 990.

However, an appraisal dated March 15, 200X, for the AD, ST, property showed the assessed value was only x which is less than the x shown on Form 990. Therefore, an IDR was sent to the ORG to determine the correct amount.

In a letter dated November 16, 200X, ORG responded to the IDR as follows:

> "NNs was confused. The NN built the building in 199X. The construction was financed with a loan from UU after it was finished. The bank's appraiser appraised the building for x. When the building was Donated to the ORG, the appraisal was only x. At this time, my clients can not recall why the x was used rather than the current x appraisal amount."

Since the appraisal dated March 15, 200X for the AD property was the only verified amount, the Donated value to the ORG should have been the amount shown in that appraisal of x.

The total basis for the buildings accounted for is $x for the AD property (including the improvements), x for the AD property, and x for the AD property for a total of $x.

The year 200X verified assets were cash $x and buildings $x.

YEAR 200X

The year 200X Form 990, Balance Sheet showed cash of $x and investments – land building, and equipment of $x.

However, per review of the December 31, 200X, bank statement, the cash balance was only $x.

The difference between the cash amount of $x shown on the Balance Sheet and the actual bank statement balance of $x was due to a loan of $x to NN which was not shown on the Form 990.

Since there were no loans shown on Form 990, an IDR was sent to the ORG.

In a letter dated November 16, 200X, ORG responded:

> "There was one loan made in 200X. It was paid back in 200X plus interest. Copies of documents are attached. A short explanation is in order. NN was disgusted that the ORG was only receiving 1% or less return on the money from the bank. NNs recalls being told by someone that it was not proper for the ORG to invest its extra money in the stock market or otherwise. Consequently, NNs decided to borrow the $x from the ORG at 7% interest. This loan was paid back in 2003. NNs invested the money in the stock market and lost a substantial portion of it. However, he did pay the whole amount back—plus the 7% interest."

Question 7 of a subsequent IDR, stated that the check register did not show an entry for the $x loan per check #x issued on October 11, 200X, to NN. Question 7 asked why the $x check was not recorded in the check register and why the check register showed a balance of $x at December 31, 200X, when it appeared that the balance should have been only $x (after the $x loan).

In addition, question 10 of the subsequent IDR, stated that the bank statement showed a balance of $x at December 31, 200X, and asked the ORG why the Balance Sheet line 46 (savings and temporary cash investments) showed a End of Year balance of $x and why line 50 (receivables from officers, directors, trustees, and key employees) or line 51 (other notes & loans receivable) did not show a balance of $x and why there was no schedule attached.

In a letter dated January x, 200X, Power of Attorney, NN, responded:

> "7. A-C The $x loan from the ORG to NN was made during October 200X. From your explanation and review of the documents, it simply appears that the $x was overlooked until a future reconciliation of the check register and checks. Clearly, other checks were mistakenly entered into the check register."
>
> "10. A-B As noted in item 7 above, the $x loan during October 200X was mistakenly overlooked in the books and not corrected until discovered in 2003."

The verified year 200X assets consisted of cash $x, loans to NN $x, and buildings $x. The buildings consisted of $x for the ADproperty (including the improvements), x for the AD property, and x for the AD property for a total of $x.

YEAR 200X

The year 200X Form 990, Balance Sheet showed cash of $x and investments – land building, and equipment of $x.

Per review of the bank statements, the cash balance at December 31, 200X, was $x and per review of the Register Report (check register) the balance at December 31, 200X, was $x. The difference is due to a check written on December 31, 200X, in the amount of $x to RR.

The verified year 200X assets consisted of cash $x and buildings of $x.

YEAR 200X

The year 200X Form 990, Balance Sheet showed cash of $x and investments – land building, and equipment of $x.

Per review of "Transaction" (check register) the ending December 31, 200X, balance was $x.

Per review of the "Banking Summary" (check register) and "New Lab Building" ledger showed construction costs of $x for the period of March 23, 200X, through December 9, 200X.

The expenses for the "New Lab Building" were included on the Form 990 Balance Sheet as a part of the buildings. The Form 990 beginning balance for buildings for the year 200X was $x and the ending balance $x ($x + $x).

However, the buildings should have been shown on Form 990 as $x (xinstead of $x since the verified buildings in prior years was only $x.

The year 200X assets were cash $x and buildings $x (as verified in prior years) and $x for the new lab building.

ISSUE 1. Whether the ORG fails to meet the requirements of IRC section 509(a)(3), so that the organization's classification must be changed from that of a public charity to a private foundation?

LAW:

Under IRC section 509(a) any organization described in 501(c)(3), which does not demonstrate that it falls within the definition of a publicly supported organization, will be treated as a private foundation. Thus, an organization described in IRC section 501(c)(3) is a private foundation, unless it demonstrates that it is described in IRC 509(a)(1) through (4).

Section 509(a)(3) provides that the term "private foundation" does not include an organization that is organized, and at all times thereafter is operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified organizations described in

section 509(a)(1) or (2) if the organization is operated, supervised, or controlled by or in connection directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more organizations described in section 509(a)(1) or (2).

Income Tax Regulations section 1.509(a)-4(c) regarding the organizational test a 509(a)(3) organization must meet provides:

(1) In general.—An organization is organized exclusively for one or more the purposes specified in section 509(a)(3)(A) only if its articles of organization (as defined in section 1.501(c)(3)-1(b)(2)):

(i) Limit the purposes of such organization to one or more of the purposes set forth in section 509(a)(3)(A);
(ii) Do not expressly empower the organization in engage in activities which are not in furtherance of the purposes referred to in subdivision (i) of this subparagraph;
(iii) State the specified publicly supported organizations on whose behalf such organization is to be operated (within the meaning of paragraph (d) of this section); and
(iv) Do not expressly empower the organization to operate to support or benefit any organization other than the specified publicly supported organizations referred to in subdivision (iii) of this subparagraph.

Income Tax Regulations section 1.509(a)-4(e) regarding the operational test a 509(a)(3) organization must meet provides:

(1) Permissible beneficiaries.—A supporting organization will be regarded as "operated exclusively" to support one or more specified publicly supported organizations (herein referred to as the "operational test") only if it engages solely in activities which support or benefit the specified publicly supported organizations. Such activities may include making payments to or for the use of, or providing services or facilities for, individual members of the charitable class benefited by the specified publicly supported organization. A supporting organization may also, for example, make a payment indirectly through another unrelated organization to a member of a charitable class benefited by a specified publicly supported organization, but only if such a payment constitutes a grant to an individual rather than a grant to an organization. In determining whether a grant is indirectly to any individual rather than to an organization the same standard shall be applied as in section 54.5945-4(a)4 of this chapter. Similarly, an organization will be regarded as "operated exclusively" to support or benefit one or more specified publicly supported organizations even if it supports or benefits an organization, other than a private foundation, which is described in section 501(c)(3) and is operated, supervised, or controlled directly by or in connection with such publicly supported organizations, or which described in section 511(a)(2)(B). However, an organization will not be regarded as operated exclusively if any part of its activities is in furtherance of a purpose other than supporting or benefiting one or more specified publicly supported organizations.

(2). Permissible activities.—A supporting organization is not required to pay over its income to the publicly supported organizations in order to meet the operational test. It may satisfy the test by using its income to carry on an independent activity or program which supports or benefits the specified publicly supported organizations. All such support must, however, be limited to permissible beneficiaries in accordance with subparagraph (1) of this paragraph. The supporting organization may also engage in fund raising activities, such as solicitations, fund raising dinners, and unrelated trade or business to raise funds for the publicly supported organizations, or for the permissible beneficiaries.

Income Tax Regulations section 1.509(a)-4(f) regarding the nature of relationships required for 509(a)(3) organizations provides:

(1) In general.—Section 509(a)(3)(B) describes the nature of the relationship required between a section 501(c)(3) organization and one or more publicly supported organizations in order for such section 501(c)(3) organization to qualify under the provisions of section 509(a)(3). To meet the requirements of section 509(a)(3), an organization must be operated, supervised, or controlled by or in connection with one or more publicly supported organizations. If an organization does not stand in one of such relationships (as provided in this paragraph) to one or more publicly supported organizations, it is not an organization described in section 509(a)(3).

(2) Types of relationships.—Section 509(a)(3)(B) sets forth three different types of relationships, one of which must be met to meet the requirements of subparagraph (1) of this paragraph. Thus, a supporting organization may be:

(i) Operated, supervised, or controlled by,
(ii) Supervised or controlled in connection with, or
(iii) Operated in connection with, one or more publicly supported organizations.

(3) Requirements of relationships.—Although more than one type of relationship may exist in any one case, any relationship described in section 509(a)(3) must insure that:

(i) The supporting organization will be responsive to the needs or demands of one or more publicly supported organizations; and
(ii) The supporting organization will constitute an integral part of, or maintain a significant involvement in, the operations of one or more publicly supported organizations.

(4) General description of relationships.—In the case of supporting organizations which are "operated, supervised, or controlled by" one or more publicly supported organizations, the distinguishing feature of this type of relationship is the presence of a substantial degree of direction by the publicly supported organizations over the conduct of the supporting organization, as described in paragraph (g) of this section. In the case of the supporting organization which are "supervised or controlled in connection with" one or more publicly supported organizations, the

distinguishing feature is the presence of common supervision or control among the governing bodies of all organizations involved, such as the presence of common directors, as described in paragraph (h) of this section. In the case of a supporting organization, which is "operated in connection with" one or more publicly supported organizations, the distinguishing feature is that the supporting organization is responsive to, and significantly involved in the operations of, the publicly supported organization, as described in paragraph (i) of this section.

Income Tax Regulations section 1.509(a)-4(g) provides guidance on the meaning of "operated, supervised, or controlled by" as follows:

(1)
(i) Each of the items "operated by", "supervised by", and "controlled by", as used in section 509(a)(3)(B), presupposes a substantial degree of direction over the policies, programs, and activities of a supporting organization by one or more publicly supported organizations. The relationships required under any one of these terms is comparable to that of a parent and subsidiary, where the subsidiary is under the direction of, and accountable or responsible to, the parent organization. This relationship is established by the fact that a majority of the officers, directors, or trustees of the supporting organization are appointed or elected by the governing body, members of the governing body, officers acting in their official capacity, or the membership of one or more publicly supported organizations.

(ii) A supporting organization may be "operated, supervised or controlled by" one or more publicly supported organizations within the meaning of section 509(a)(3)(B) even though its governing body is not comprised of representatives of the specified publicly supported organizations for whose benefit it is operated within the meaning of section 509(a)(3)(A). A supporting organization may be "operated, supervised, or controlled by" one or more publicly supported organizations (within the meaning of section 509(a)(3)(B) and be operated "for the benefit of" one or more different publicly supported organizations (within the meaning of section 509(a)(3)(A)) only if it can be demonstrated that the purposes of the former organizations are carried out by benefiting the latter organizations.

Income Tax Regulations section 1.509(a)-4(h) provides guidance on the meaning of "supervised or controlled in connection with" as follows:

(1) In order for a supporting organization to be "supervised or controlled in connection with" one or more publicly supported organizations, there must be common supervision or control by the persons supervising or controlling both the supporting organization and the publicly supported organizations to insure that the supporting organization will be responsive to the needs and requirements of the publicly supported organizations. Therefore, in order to meet such requirement, the control or management of the supporting organization must be vested in the same persons that control or manage the publicly supported organizations.

(2) A supporting organization will not be considered to be "supervised or controlled in connection with" one or more publicly supported organizations if such organization merely makes payments

(mandatory or discretionary) to one or more named publicly supported organizations, even if the obligation to make payments to the named beneficiaries is enforceable under state law by such beneficiaries and the supporting organization's governing instrument contains provisions whose effect is described in section 508(e)(1)(A) and (B). Such arrangements do not provide a sufficient "connection" between the payor organization and the needs and requirements of the publicly supported organization to constitute supervisions or control in connection with such organizations.

Income Tax Regulations section 1.509(a)-4(i) provides guidance on the meaning of "operated in connection with" as follows:

(1) General rule
(i) Except as provided in subdivisions (ii) and (iii) of this subparagraph and subparagraph (4) of this paragraph, a supporting organization will be considered as being operated in connection with one or more publicly supported organizations only if it meets the "responsiveness test" which is defined in subparagraph (2) of this paragraph and the "integral part test" which is defined in subparagraph (3) of this paragraph.

(2) Responsiveness test
(i) For purposes of this paragraph, a supporting organization will be considered to meet the "responsiveness test" if the organization is responsive to the needs or demands of the publicly supported organizations within the meaning of this subparagraph. In order to meet this test, either subdivision (ii) or subdivision (iii) of this subparagraph must be satisfied.
(ii)
(a) One or more officers, directors, or trustees of the supporting organization are elected or appointed by the officers, directors, trustees, or membership of the publicly supported organizations;

(b) One or more members of the governing bodies of the publicly supported organizations are also officers, directors or trustees of, or hold other important offices in, the supporting organizations; or

(c) The officers, directors or trustees of the supporting organization maintain a close and continuous working relationship with the officers, directors or trustees of the publicly supported organizations; and

(d) By reason of (a), (b), or (c) of this subdivision, the officers, directors or trustees of the publicly supported organization have a significant voice in the investment policies of the supporting organization, the timing of grants, the manner of making them, and the selection of recipients of such supporting organization, and in otherwise directing the use of the income or assets of such supporting organization.

(iii)
(a) The supporting organization is a charitable trust under State law;

(b) Each specified publicly supported organization is a named beneficiary under such charitable trust's governing instrument; and

(c) The beneficiary organization has the power to enforce the trust and compel an accounting under State law.

(3) Integral part test; general rule

(i) For purposes of this paragraph, a supporting organization will be considered to meet the "integral part test" if it maintains a significant involvement in the operations of one or more publicly supported organizations and such publicly supported organizations are in turn dependent upon the supporting organization for the type of support which it provides. In order to meet this test, either subdivision (ii) or subdivision (iii) of this subparagraph must be satisfied.

(ii) The activities engaged in for or on behalf of the publicly supported organizations are activities to perform the functions of, or to carry out the purposes of, such organizations, and but for the involvement of the supporting organization, would normally be engaged in by the publicly supported organizations themselves.

(iii)

(a) The supporting organization makes payments of substantially all of its income to or for the use of one or more publicly supported organizations, and the amount of support received by one or more of such publicly supported organizations is sufficient to insure the attentiveness of such organizations to the operations of the supporting organization. In addition, a substantial amount of the total support of the supporting organization must go to those publicly supported organizations which meet the attentiveness requirement of this subdivision with respect to such supporting organization. Except as provided in (b) of this subdivision, the amount of support received by a publicly supported organization must represent a sufficient part of the organization's total support so as to insure such attentiveness. In applying the preceding sentence, if such supporting organization makes payments to, or for the use of, a particular department or school of a university, hospital or church, the total support of the department or school shall be substituted for the total support of the beneficiary organization.

(b) Even where the amount of support received by a publicly supported beneficiary organization does not represent a sufficient part of the beneficiary organization's total support, the amount of support received from a supporting organization may be sufficient to meet the requirements of this subdivision if it can be demonstrated that in order to avoid the interruption of the carrying on of a particular function or activity, the beneficiary organization will be sufficiently attentive to the operations of the supporting organization. This may be the case where either the supporting organization or the beneficiary organization earmarks the support received from the supporting organization for a particular program or activity, even if such program or activity is not the beneficiary organization's primary program or activity so long as the program or activity is a substantial one.

(d) All pertinent facts, including the number of beneficiaries, the length and nature of the relationship between the beneficiary and supporting organization and nature of the relationship

between the beneficiary and the supporting organization and the purpose to which the funds are put (as illustrated by subdivision (iii)(b) and (c) of this subparagraph), will be considered in determining whether the amount of support received by a publicly supported beneficiary organization is sufficient to insure the attentiveness of such organization to the operations of the supporting organization. Normally the attentiveness of a beneficiary organization is motivated by reason of the amounts received from the supporting organization. Thus, the more substantial the amount involved, in terms of a percentage of the publicly supported organization's total support the greater the likelihood that the required degree of attentiveness will be present. However, in determining whether the amount received from the supporting organization is sufficient to insure the attentiveness of the beneficiary organization to the operations of the supporting organization (including attentiveness to the nature and yield of such supporting organization's investments), evidence of actual attentiveness by the beneficiary organization is of almost equal importance. An example of acceptable evidence of actual attentiveness is the imposition of a requirement that the supporting organization furnish reports at least annually for taxable years beginning after December 31, 1971, to the beneficiary organization to assist such beneficiary organization in insuring that the supporting organization has invested its endowment in assets productive of a reasonable rate of return (taking appreciation into account) and has not engaged in any activity which would rise to liability for a tax imposed under sections 4941, 4943, 4944, or 4955 if such organization were a private foundation. The imposition of such requirement within 120 days after October 16, 1972, will be deemed to have retroactive effect to January 1, 1970, for purposes of determining whether a supporting organization has met the requirement of this subdivision for its first two taxable years beginning after December 31, 1969. The imposition of such requirement is, however, merely one of the factors in determining whether a supporting organization is complying with this subdivision and the absence of such requirement will not preclude an organization from classification as a supporting organization based on other factors.

(e) However, where none of the beneficiary organizations is dependent upon the supporting organization for a sufficient amount of the beneficiary organization's support within the meaning of this subdivision, the requirements of this subparagraph will not be satisfied, even though such beneficiary organizations have enforceable rights against such organization under State law.

Revenue Ruling 76-32, 1976-1 C.B. 160, held that an agreement to voluntarily submit reports, so long as the agreement is observed, is considered evidence of actual attentiveness within the meaning of section 1.509(a)-4(i)(3)(iii)(d) of the Regulations for purposes of determining whether the attentiveness requirement of the integral part test of section 1.509(a)-4(i)(3)(iii) is satisfied. However, while the agreement will not be considered evidence of actual attentiveness under section 1.509(a)-4(i)(3)(iii)(d), it will not, in itself, satisfy the attentiveness requirement of the integral part test of section 1.509(a)-4(i)(3)(iii). Rather, in order to satisfy that requirement, all of the factors mentioned in the regulations must be taken into consideration.

Income Tax Regulations section 1.509(a)-4(j) regarding control by disqualified person provides:

(1) In general.—Under the provisions of section 509(a)(3)(C) a supporting organization may not be controlled directly or indirectly by one or more disqualified persons (as defined in section 4946)

other than foundation managers and other than one or more publicly supported organizations. If a person who is a disqualified person with respect to a supporting organization, such as a substantial contributor to the supporting organization, is appointed or designated as a foundation manager of the supporting organization by a publicly supported beneficiary organization to serve as the representative of such publicly supported organization, then for purposes of this paragraph such person will be regarded as a disqualified person, rather than as a representative of the publicly supported organization. An organization will be considered "controlled", for purposes of section 509(a)(3)(C), if the disqualified persons, by aggregating their votes or positions of authority, may require such organization to perform any act which significantly affects its operations or may prevent such organization from performing such act. This includes, but is not limited to, the right of any substantial contributor or his spouse to designate annually the recipients, from among the publicly supported organizations of the income attributable to his contribution to the supporting organization. Except at provided in subparagraph (2) of this paragraph, a supporting organization will be considered to be controlled directly or indirectly by one or more disqualified persons if the voting power of such persons is 50 percent or more of the total voting power of the organization's governing body or if one or more of the total voting power of the organization's governing body or if one or more such persons have the right to exercise veto power over the actions of the organization. Thus, if the governing body of a foundation is composed of five trustees, none of whom has a veto power over the actions of the foundation, and no more than two trustees are at any time disqualified person, such foundation will not be considered to be controlled directly or indirectly by one or more disqualified persons by reason of this fact alone. However, all pertinent facts and circumstances including the nature, diversity, and income yield of an organization's holdings, the length of time particular stocks, securities, or other assets are retained, and the manner in exercising its voting rights with respect to stocks in which members of its governing body also have some interest, will be taken into consideration in determining whether a disqualified person does in fact indirectly control an organization.

GOVERNMENT'S POSITION:

It is the government's position that the ORG should be reclassified as a private foundation because it fails to meet the requirements of section 509(a)(3) which defines supporting organizations.

Due to Congressional concerns about wide-spread abuses of their tax-exempt status by private foundations, private foundations were defined and subjected to significant regulations and controls by the Tax Reform Act of 1969. The definition of a private foundation was intentionally inclusive so that all organizations exempted from tax by section 501(c)(3) are private foundations except for those specified in section 509(a)(1) through (4). Roe Foundation Charitable Trust v. Commission, T.C. Memo. 1989-566, 58 T.C.M. (CCH) 402, 404 (1989); Quarrie Charitable Fund v. Commissioner, 603 F.2d 1274, 1277 (7th Cir. 1979). The ORG claims that it is not a private foundation because it is described in section 509(a)(3) which defines supporting organizations.

Publicly supported organizations as defined in sections 509(a)(1) and (2) are excepted from private foundation status on the theory that their exposure to public scrutiny and their dependence on public support keep them from the abuses to which private foundations are subject. Supporting organizations are similarly excepted from private foundation status, because Congress believed the public charities that they support would provide sufficient oversight and keep supporting organizations from the types of abuses to which private foundations are prone. Quarrie Charitable Fund, 603 F.2d at 1277-78.

To qualify as a supporting organization described in section 509(a)(3), an organization must meet all of the following tests:

1) Organizational and Operational Tests under IRC section 509(a)(3)(A).
2) Relationship Test under IRC section 509(a)(3)(B).
3) Lack of Disqualified Person Control Test under IRC section 509(a)(3)(C).

Overall, these tests are meant to ensure that a supporting organization is responsive to the needs of a public charity and intimately involved in its operations and that the public charity (or publicly supported organization) is attentive to the operations of the supporting organization and that the supporting organization is not controlled, directly or indirectly, by disqualified persons. In the instant case, ORG fails to satisfy all of these tests.

Organizational Test

ORG is not organized to benefit one or more specified publicly supported organizations. Pursuant to sections 1.509(a)-4(c)(1)(iii) and (iv) of the regulations, an organization's governing instrument must state the specified publicly supported organization(s) on whose behalf the organization is to be operated and cannot expressly empower the organization to support or benefit any organizations other than the specified publicly supported organizations(s). ORG's dissolution clause allows distributions to organizations other than the specified publicly supported organizations upon its termination. The possible beneficiaries are not limited to the RR or the organizations listed on Schedule A. Therefore, the organizational test is not met. See Quarrie Charitable Fund v. Commissioner, 603 F.2d 1274 (7th Cir. 1979) (the court held the organizational test was not satisfied where the trustee had the power to determine the charitable use was unnecessary or impracticable and to distribute the income to any charitable corporation he selected).

Operational Test

The operational test set forth in Income Tax Regulation section 1.509(a)-4(e)(1) is not satisfied. A supporting organization will be regarded as "operated exclusively" to support a specified publicly supported organization(s) only if it engages in activities which support or benefit the specified publicly supported organization(s).

ORG supported an organization, RR in RR, which is not listed as a supported organization on Schedule A of the Trust document. Also, ORG has been supporting two UUs, the RR and the RR (a ministry of RR). However, the RR is a private foundation.[1]

Because ORG was making distributions to an organization which was not named on Schedule A of the Trust document and since ORG was making distributions to a private foundation, the distributions are in violation of Income Tax Regulation section 1.509(a)(4)(e)(1).

Relationship Test

As set forth in Income Tax Regulations section 1.509(a)-4(f)(2), there are three permissible relationships: (a) operated, supervised, or controlled by; (b) supervised or controlled in connection with; and (c) operated in connection with one or more publicly supported organizations.

The relationships "operated, supervised or controlled by" and "supervised or controlled in connection with" presuppose a substantial degree of direction over the policies programs, and activities of the supporting organization by publicly supported organization. The "operated, supervised or controlled by" relationship is established by the fact that a majority of the officers, directors, or trustees of the supporting organization are appointed by or elected by the governing body, members of the governing body, officers acting in their official capacity or the membership of the publicly supported organization. The "supervised or controlled in connection with" relationship requires common supervision or control by the persons supervising or controlling both the supporting and the publicly supported organizations, i.e., that control or management of the supporting organization is vested in the same persons that control or manage the publicly supported organization.

In the present case, the facts indicate that there was no substantial control or direction over the policies or activities of ORG by the specified publicly supported organization, the RR. All of the meetings were held over the telephone and although NN, a board member of the ORG from the RR, made recommendations for which project to fund it was NN who made the final determination for how the ORG made its distributions to the publicly supported organizations. In addition, a majority of the ORG's governance is not appointed or elected by the specified publicly supported organizations. There is no common supervision or control by the person supervising or controlling both the supporting and the publicly supported organizations. Thus, ORG has failed to meet either of the first two relationship tests.

[1] In 200X, the RR (RR) notified the IRS, pursuant to section 507(b)(1)(B) that it was terminating its private foundation status to operate as a public charity under section 509(a)(1). RR's private foundation status will be terminated if it operates as a public charity for sixty continuous months. Treas. Reg. § 1.507-2(d). In connection with its attempt to terminate its private foundation status, RR received an advance ruling in April of 200X, that it could be expected to be a public charity described in section 509(a)(1) and for the purposes of certain grants or contributions to it, RR is treated as a public charity described in section 509(a)(1) until notice that the advance ruling is being revoked is made to the public. Treas. Reg. § 1.507-2(e).

The third and final relationship possible for section 509(a)(3) organizations is the "operated in connection with" relationship, which requires that the supporting organization be responsive to the needs or demands of the publicly supported organization, and constitute an integral part of, or maintain a significant involvement in the affairs of the publicly supported organization. This relationship is satisfied where the supporting organization meets both the "responsiveness" and "integral part" test. Neither test has been met in this case.

In order to meet the responsiveness test, either Treas. Reg. § 1.509(a)-4(i)(2)(ii) or (iii) must be satisfied. Treas. Reg. § 1.509(a)-4(i)(2)(ii) requires that the board member appointed by the supported organization have a significant voice in the operations of the supporting organization. There is no evidence that the board member selected by the Academy had a significant voice in determining the investment policies of the supporting organization or in the timing of grants or the selection of recipients. Although NN, a board member of the ORG from the RR, made recommendations for which project to fund it was NN who made the final determination for how the ORG made its distributions to the publicly supported organizations. See Roe Foundation Charitable Trust v. Commissioner, 58 T.C. Memo. 402 (1989).

Alternatively, the supporting organization must be a charitable trust under state law and each specified publicly supported organization must be a named beneficiary under the charitable trust's governing instrument and the beneficiary organization must have the power to enforce the trust and compel an accounting under state law. Treas. Reg. § 1.509(a)-4(i)(2)(iii). The Trust document states that each year, the Trustee shall distribute x% of its net income to the RR and x% of the net income to one or more of the organizations listed on Schedule A. There are four organizations listed on Schedule A, including the RR. Except for the RR, none of these organizations are entitled to receive distributions under the terms of Trust. Therefore, ORG has not established that each publicly supported organization has the power to enforce the trust.

Therefore, the Organization does not meet either of the responsiveness tests.

While the responsiveness test guarantees that the publicly supported organization can influence the activities of the supporting organization, the integral part test ensures that the publicly supported organization will be attendant to the operations of the supporting organization. The integral part test is considered to have been satisfied if the supporting organization maintains a significant involvement in the operations of one or more publicly supported organizations and the publicly supported organizations are in turn dependent upon the supporting organization for the type of support, which it provides. Income Tax Regulations section 1.509-4(i)(3)(ii) or (iii) must be satisfied for the integral part test to be met.

Income Tax Regulations section 1.509(a)-4(i)(3)(ii) provides that the activities engaged in for or on behalf of the publicly supported organizations must be activities to perform the functions of, or to carry out the purposes of, such organizations and, but for the involvement of the supporting organization, would normally be engaged in by the publicly supported organizations themselves. Thus, this part of the integral part test applies in those situations in which the supporting organization actually engages in activities which benefit the publicly supported organizations as

opposed to simply making grants to the publicly supported organizations. Compare to Income Tax Regulations section 1.509(a)-4(i)(3)(iii) (which sets forth the rules of the integral part test applicable to supporting organizations that make payments to or for the use of publicly supported organizations), see also Roe Foundation, T.C. Memo. 1989-566; Cuddeback Foundation v. Commissioner, T.C. Memo. 200X-300. ORG does not meet this test because it does not perform any activities for or on behalf of the publicly supported organization. The ORG only makes grants to publicly supported organizations.

Because ORG makes grants to publicly supported organizations the applicable rules for satisfying the integral part test are in Income Tax Regulations section 1.509(a)-4(i)(3)(iii). This section of the regulation has 3 basic requirements: 1) payment of substantially all of its income to publicly supported organizations; 2) the amount received by one publicly supported organization must be sufficient to motivate it to pay attention to the operations of the supporting organization; and 3) a substantial amount of the total support of the organization must go to those publicly supported organizations that meet the attentiveness requirement. In the present situation, the ORG does not meet the second requirement, and therefore, it cannot meet the third requirement.

Income Tax Regulations section 1.509(a)-4(i)(3)(iii)(a) provides that the amount of support received by a publicly supported organization must represent a sufficient part of the organization's total support so as to insure its attentiveness. Income Tax Regulations section 1.509(a)-4(i)(3)(iii)(b) provides that a supporting organization can meet the attentiveness requirement, even where the amount of support received by the publicly supported organization does not represent a sufficient part of the publicly supported organization's total support, if it can be demonstrated that support is earmarked for a substantial program of the publicly supported organization that would be interrupted without the supporting organization's support. And finally, Income Tax Regulations section 1.509(a)-4(i)(3)(d) provides that "all pertinent factors...will be considered in determining whether the amount of support received by a publicly supported organization is sufficient to insure the attentiveness of such organization to the operations of the supporting organization." It goes on to note the importance of the percentage of the income received from the supporting organization is in determining if the publicly supported organization will have the requisite degree of attentiveness and concludes that evidence of actual attentiveness is almost as important.

For its taxable year ending December x, 200X, RR reported total support of $x. For its taxable year ending December x, 200X, RR reported support of $x. For its taxable year ending December x, 200X, RR reported support of $x. For its taxable year ending December x, 200X, RR reported support of $x. The year 200X was the first year of the ORG and no grants were made since it had net income of only $x. In 200X, 200X, 200X, and 200X the ORG made grants of $x; $x $x; and $x, respectively to RR. The grants amount to less than .04 percent of RR's total support and are insufficient to insure the attentiveness of RR.

In addition, the support received by the RR from the ORG does not represent a sufficient part of the RR's total support since the earmarked support is not for substantial programs of the RR and the programs would not be interrupted without the ORG's support. Per information received from the RR, during the years 200X and 200X, the ORG gave the RR money to the fund the following

projects: RR, $x; CY, $x CY, $x; and CY, $x. The RR stated that all projects supported by the ORG are ongoing projects by indigenous non-government organizations in the country in which they operate. The RR did not have a total budget for each of the organizations but they know that the RR contributes in only a small portion to their ongoing programs. The RR further stated that the projects would be continued by the RR if the ORG's support were not involved but there was the possibility that the RR would have to reduce the level of support that it gives to the projects.

Further, there is no evidence that the RR attended to the operations of ORG. While its representative discussed with NN which grants to make, there is no evidence he was involved in deciding the use of the income or assets of ORG.

Because the ORG provided less than .04 percent of the support of the RR, because the ORG did not support a substantial program of the RR which would be interrupted without the support of the ORG, and because there is no evidence that the RR was actually attentive to the operations of ORG, the integral part test under Income Tax Regulations 1.509(a)-4(i)(3)(iii)(a), (b), and (d) has not been satisfied.

Control Test

Internal Revenue Code section 509(a)(3)(C) and Income Tax Regulations section 1.509(a)-4(j)(1) provides that a supporting organization may not be controlled, directly or indirectly, by disqualified person. The NN were substantial contributors to ORG and are, therefore, disqualified person to ORG. The trust document provides that two board members shall be from the class consisting of NN and NN and each of their descendents (the "ORG"). Therefore, trust document ensures that the NN and their descendents are the only board members who can never be removed from their positions.

Substantially all of ORG's assets are commercial rental buildings. The Income Tax Regulations state that all pertinent facts, including an organization's assets (nature, diversity and income yield, length of time assets are retained and the way voting rights are exercised with respect to stocks in which members of its governing body have some interest) will be taken into consideration in determining whether a disqualified person indirectly controls an organization. NN and NN own the two companies renting a commercial rental building from ORG. Therefore, disqualified persons, NN and NN, are controlling ORG since it rents one of its commercial rental buildings to companies owned by NN and NN.[2] Accordingly, the ORG does not meet the control test under Income Tax Regulations section 1.509(a)-4)(j).

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[2] The Trust document also ensures that the NN controls the board. The board can be reduced to x members. The trust document states the board will always be comprised of one person appointed by the primary supported organization and two persons from the ORG family. Thus, if reduced to a three member board, the NN will have voting control. Also, because the two remaining board members are appointed by a majority vote, the NN retain the ability to appoint these board members.

TAXPAYER'S POSITION:

IDR #9, question 7a. was sent to the ORG. The IDR asked the ORG to explain how it could meet the responsiveness test when it gave to an organization not named in Schedule A of its trust document and when it gave to an organization which was a private foundation."

In a letter dated April x, 200X, ORG responded:

> "The ORG meets the "responsiveness test." Initially, NN, Associate Director of Projects for the RR, is a member of the ORG Board. NN email confirms the level of his involvement in the ORG. This is the close working relationship that is required by the regulations.
>
> Further, the ORG, a charitable entity under ST law, has named RR as its designated beneficiary. Granted, a payment was made to an organization that was a private foundation at the time, but subsequently became a public charity. NN believed it was a public charity when the payment was made. Also, the ORG made a contribution to a charity other than RR. These payments were made in good faith, based on the mistaken belief by NN that they were allowable. This goes back to the quote from the federal judge on the complexity of the ORG regulations. The majority of payments, and all current payments, are going to the RR. NN believed, in good faith, that he could personally handle the operations and administration of the ORG with federal law. You and I, as tax professionals, may surely question his conclusion, but not his good faith."

Attached to IDR #9 were copies of the years 200X and 200X Forms 990 from the RR. Question 7b of the IDR asked the following: "Please explain how the ORG can meet the integral part test when it appears that the programs/projects supported by the ORG for the RR do not appear to be substantial programs/projects of the RR."

In a letter dated April x, 200X, ORG responded:

> "Section 1.509(a)-4(i)(3)(ii) of the regulations provides that the "integral part test" is met if the activities engaged in for or on behalf of the publicly supported organization are activities to perform the functions of, or to carry out the purposes of, such organizations and, but for the involvement of the supporting organization, would normally be engaged in by the publicly supported organization themselves. Here, the ORG meets this test by satisfying the "but for" prong. It has already been established that RR, through NN, made recommendations to the ORG of various projects that RR wanted funded. When the ORG Board selected these projects to fund, the ORG was then funding projects that would otherwise have been funded by the RR. So being, the ORG was substituting its funding for that of RR and, thus, relieving RR of the need to use its funds for these projects. See PLR 8725056.
>
> In addition, the ORG satisfies the "substantially all income" prong of the integral part test. As you noted, the ORG has paid x% of its annual net income to one or more supported charitable organizations. While the payments maybe small when compared to the total charitable contributions made to the RR, nonetheless, the

contributions fully fund the projects identified by RR. NN's statement confirms the level of his involvement with the ORG. Thus, RR, through the involvement of NN, has been sufficiently attentive to the operations of the ORG to satisfy this requirement as well. IRS Reg. 1.509[a]-4[i][3][iii][b]."

CONCLUSION:

A review of all the facts and circumstances shows ORG fails to satisfy the organizational and the operational tests under Internal Revenue Code section 509(a)(3)(A), fails the Relationship Test under Internal Revenue Code section 509(a)(3)(B), and fails the Lack of Disqualified Person Control Test under Internal Revenue Code section 509(a)(3)(C).

Therefore, ORG should be reclassified as an organization that is a private foundation as defined in section 509(a). The ORG cannot be classified as a supporting organization, because it has not established that it has met the requirements set forth in the Income Tax Regulations.

The proposed effective date of the reclassification from an organization with foundation status under section 509(a)(3) to an organization with private foundation status is July x, 200X, which was the first day of the ORG. The ORG is required to file Form 990-PF for the year ending December x, 200X, and all subsequent years.

The ORG remains recognized as exempt from federal taxation because it is described in Internal Revenue Code section 501(c)(3).

Returns should be sent to the following mailing address:

_____Internal Revenue Service!

Make check(s) or money order(s) payable to the United States Treasury.

Note: Form 990-PF is required for each year until private foundation status is terminated under I.R.C. § 507.