



TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

DEPARTMENT OF THE TREASURY  
Internal Revenue Service  
TE/GE Division

December 7, 2006

Release Number: **200732019**

Release Date: 8/10/2007

UIL: 501.03-01

ORG

Taxpayer Identification Number:

Form:

990

Tax Year(s) Ended:

Person to Contact/ID Number:

Contact Numbers:

Telephone:

Fax:

Certified Mail - Return Receipt Requested

Dear \_\_\_\_\_ :

We have enclosed a copy of our report of examination explaining why we believe revocation of your exempt status under section 501(c)(3) of the Internal Revenue Code (Code) is necessary.

If you accept our findings, take no further action. We will issue a final revocation letter.

If you do not agree with our proposed revocation, you must submit to us a written request for Appeals Office consideration within 30 days from the date of this letter to protest our decision. Your protest should include a statement of the facts, the applicable law, and arguments in support of your position.

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. The enclosed Publication 3498, *The Examination Process*, and Publication 892, *Exempt Organizations 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.

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.

Letter 3618 (04-2002)  
Catalog Number 34809F

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 revocation letter. We will also notify the appropriate state officials of the revocation in accordance with section 6104(c) of the Code.

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:

Internal Revenue Service  
Office of the Taxpayer Advocate

Phone

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 892  
Publication 3498  
Report of Examination

Legend:  
ORG= Name of Organization  
NUM= EIN Number  
Date1 = Effective Date  
Date2= Year end after effective date

UIL: 501.03-01

ORG

Person to Contact:  
Identification Number:  
Contact Telephone Number:  
In Reply Refer to:  
EIN: NUM

LAST DATE FOR FILING A PETITION  
WITH THE TAX COURT: \_\_\_\_\_

Dear :

This is a Final Adverse Determination Letter as to your exempt status under section 501(c)(3) of the Internal Revenue Code. Your exemption from Federal income tax under section 501(c)(3) of the code is hereby revoked effective January 1, XXXX.

Our adverse determination was made for the following reasons:

Inurement and/or private benefit of an IRC Section 501(c)(3)'s assets in any form or amount is prohibited. The organization's assets inured to the benefit of the founder and president of the organization's private interests through payment of personal expenditures, undocumented loans, and payments of cash. Third parties were insiders and therefore received a private benefit. Inurement and/or private benefit is therefore a justifiable cause for revocation and it is hereby recommended that their exempt status should be revoked effective January 1, XXXX, in accordance with the Treasury Regulations and Rulings of the Court of Law.

You failed to meet the requirements of IRC section 501(c)(3) and Treas. Reg. section 1.501(c)(3) -1(d) in that you failed to establish that you were operated exclusively for an exempt purpose. Rather, you were operated for the benefit of private interests and a part of your net earnings inured to the benefit of your founder and board members.

Contributions to your organization are no longer deductible under section 170 of the Internal Revenue Code.

You are required to file Federal income tax returns on Form 1120. These returns should be filed with the appropriate Service Center for the year ending December 31, XXXX, and for all years thereafter.

Processing of income tax returns and assessment of any taxes due will not be delayed should a petition for declaratory judgment be filed under section 7428 of the Internal Revenue Code.

If you decide to contest this determination in court, you must initiate a suit for declaratory judgment in the United States Tax Court, the United States Claim Court or the District Court of the United States for the District of Columbia before the 91<sup>st</sup> day after the date this determination was mailed to you. Contact the clerk of the appropriate court for the rules for initiating suits for declaratory judgment.

You also have the right to contact the office of the Taxpayer Advocate. However, you should first contact the person whose name and telephone number are shown above since this person can access your tax information and can help you get answers.

You can call 1-877-777-4778 and ask for Taxpayer Advocate assistance. Or you can contact the Taxpayer Advocate from the site where the tax deficiency was determined by calling :

#### Local Taxpayer Advocate

Taxpayer Advocate assistance cannot be used as a substitute for established IRS procedures, formal appeals processes, etc. The Taxpayer Advocate is not able to reverse legal or technically correct tax determinations, nor extend the time fixed by law that you have to file a petition in the United States Tax 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.

We will notify the appropriate State Officials of this action, as required by section 6104(c) of the Internal Revenue Code.

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely yours,

Marsha A. Ramirez  
Director, EO Examinations

<b>Form 886-A</b>	<b>EXPLANATION OF ITEMS</b>	<b>Schedule or Exhibit No.</b>
<b>Name of Taxpayer: ORG</b>		<b>Year Ended</b>

**Legend:**

ORG= Name of Organization  
 NUM= EIN Number  
 Date1 = Effective Date  
 Date2= Year end after effective date  
 States – Organizing State of Inc

Primary TP – Name of President  
 Address1 – Place Business  
 Address2 – Second Office  
 Address3 - Related entity

**Issues:**

1. Whether the exempt status of a daycare, which provided childcare services allowing parents to be gainfully employed, should have their exempt status revoked effective Date1 due to the assets of the organization inuring to the benefit of private interest(s)?

**Facts:**

ORG (ORG Daycare) registered with the State of States as a Non Stock Corporation on May XXXX. The States Department of Financial Institutions lists Primary TP. as the registered agent of the organization. A review of the Form 1023, Application for Recognition of Exemption under 501(c)(3) of the Internal Revenue Code, filed by the taxpayer showed the following individuals as officers of the taxpayer: Primary TP., President, Primary Tp Sr., Vice President, Name of Officer, Secretary.

The taxpayer was granted tax exempt status under IRC Section 501(c)(3) on July XXXX. The effective date of exemption for the taxpayer was May of XXXX. The taxpayer had not filed a 990 Return from its inception until September 1, XXXX pursuant to the audit conducted. The examiner successfully solicited the 990 Returns for years - .

The examiner received limited records to substantiate the filed returns. The records although limited did bring the following to light:

- (1) Primary TP formed a for-profit day care ( - ORG Development), of which he was the sole owner (1120-S Filer). This entity became operational in late 2000.
- (2) The locations run by ORG Daycare and ORG Development per the licensing applications filed with the state were:
  - Address 1 - ORG Daycare
  - Address2I – ORG Daycare
  - Address3,- ORG Development (Original license lists ORG Daycare as the licensee. Primary TP indicated this site actually belonged to ORG Development. Organization later changed the license to reflect that this organization is ORG

Form 886-A	EXPLANATION OF ITEMS	Schedule or Exhibit No.
Name of Taxpayer: ORG		Year Ended

Development's. The revenues and expenses for this site were reported on ORG Development's 1120-S Returns.)

- o Address1 - ORG Development
  - o Address2- ORG Development
- (3) Revenues for the principal organizations per the records/returns are as follows (Years - ):
    - o ORG Daycare - ; ; ;
    - o ORG Developments - ; ; ;
  - (4) ORG Daycare paid the start-up costs of ORG Development locations during the year ending December . These start-up costs were detailed as loans in the general ledger from years - the present. In the years and no interest was calculated on the loans per the general ledger. The general ledger for years and reflects an interest rate of . No substantiation was provided evidencing these amounts as loans (loan agreement, payment schedule, fixed maturity day, collateral, etc...).
  - (5) ORG Developments from - the , ran both organizations out of the corporate office on Address3. Expenses for both entities were paid out of the corporate office and the revenues for both entities were controlled by the corporate office (ORG Development). ORG Development used the loan payable representing the amounts owed to ORG Daycare as a clearing account whereby revenues were charged against this account to increase ORG Development's liability to ORG Daycare and actual expenses incurred, overhead allocations and payroll allocations were charged against this account to reduce amounts owed to ORG Daycare. Overhead Expenditures were allocated between the two entities based on revenues. Payroll was allocated based on location. The difference between revenues and expenses represented the net increase/decrease to this account.

There were issues raised by the effect of the consolidation of the administration of the two organizations. The initial balance in this loan account represented funds paid out to start-up the for-profit locations. Its questionable why after the for-profit location was started, all the revenues and expenses for both entities flowed through it. As the non-profit location was reportedly the only profitable organization and as the non-profit entity was in existence longer it would follow that any consolidation of administration would have flowed through the non-profit.

Regardless of intent the initial paid out in start-up costs represents amounts purely paid out for the benefit of ORG Development. No loan contract or repayment schedule between ORG Daycare and ORG Development was provided

Form 886-A	EXPLANATION OF ITEMS	Schedule or Exhibit No.
Name of Taxpayer: ORG		Year Ended

during the examination for these payments. No evidence was shown that ORG Development provided collateral for the payments received. The subsequent allocations to this account from \_\_\_\_\_ onward can be looked at as separate inter-company transactions. The amount owed to ORG Daycare from \_\_\_\_\_ - \_\_\_\_\_ is listed as follows per the general ledger:

- o Year -
  - o Year -
  - o Year -
  - o Year - (After deducting reported liability ORG Daycare owes ORG Development for Payroll Taxes.)
- (6) Primary TP formed ORG Investments, Inc. (ORG Investments). ORG Investments owns rental property. In 2001 ORG Investments agreed to pay \_\_\_\_\_ to Sellers for property (land contract). In 2001, ORG Daycare paid \_\_\_\_\_. The general ledger reflected this as a loan to ORG Investments. In 2003 another \_\_\_\_\_ was allocated from ORG Daycare to ORG Investments per the general ledger. No payment activity or interest charges were shown in the general ledger. No loan contract or repayment schedule between ORG Daycare and ORG Investments was provided during the audit. No evidence was provided to show that ORG Investments provided collateral for the loans received. The gross amount loaned to ORG Investments from ORG Daycare is the \_\_\_\_\_ through \_\_\_\_\_ .( \_\_\_\_\_ + \_\_\_\_\_ ).
  - (7) General ledger detailed donations given to employees for at least \_\_\_\_\_ total.
    - o Emp1 -
    - o Emp2 -
    - o Emp3 -
    - o Primary TP-
  - (8) Loan of \_\_\_\_\_ made to Father, Sr. in 2000. The loan was wiped off the books at the end of 2000 with an adjusting entry. It's unclear how this money was paid back. No interest was charged on the loan disbursed to Father, Sr. per the general ledger. No loan contract or repayment schedule between Father, Sr. and ORG Daycare was presented during the audit.
  - (9) Various other employee advances and loans were issued to employees. It's unclear whether all of the loans were successfully paid back.
  - (10) Roughly \_\_\_\_\_ in reimbursements was made to Primary TP directly by ORG Daycare during the years \_\_\_\_\_ - \_\_\_\_\_. The reimbursements per the general ledger

Form 886-A	EXPLANATION OF ITEMS	Schedule or Exhibit No.
Name of Taxpayer: ORG		Year Ended

included travel expenditures (Education/Conferences), supplies, building repair expenses, automobile repairs, et cetera. No documentation was presented during the audit to substantiate that these were all legitimate expenses.

In a conversation with Primary TP, Jr., he indicated that ORG Daycare and ORG Developments went out of business as of . In regards to any loans made to employees he indicated that there may have been some type of basic document in some cases, but there were various verbal agreements made. He also indicated that one of their locations had been taken by the City (Imminent Domain) and his creditors got a letter about their stake in the asset.

**Primary TP, Jr.'s use of ORG Daycare's assets to fund his private interests is inurement. The presence of inurement at any level is a disqualifying factor to exemption.**

Law:

**Treasury Regulation Section 1.501(c)(3)-(1)(c)(2)**

(2) *Distribution of earnings.* —An organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals. For the definition of the words "private shareholder or individual", see paragraph (c) of §1.501(a)-1.

**Treasury Regulation Section 1.501(a)-(1)(c)**

(c) *"Private shareholder or individual" defined.* —The words "private shareholder or individual" in section 501 refer to persons having a personal and private interest in the activities of the organization.

**Orange County Agr. Soc., Inc. v. Commissioner, 893 F.2d 529, C.A.2, 1990, Jan 19, 1990.**

"The stipulated record indicates that Taxpayer made several interest-free loans to M-W without obtaining any written security or even any written evidence of indebtedness. While some loan repayments have been made, the repayments do not match the loan amounts, and the total amount loaned exceeds the total repaid. There is no evidence in the record indicating whether the full amounts Taxpayer loaned to M-W have been or will ever be repaid. The record also does not support Taxpayer's argument that some of the loans were in fact prepayment of rent. Courts have frequently held that loans extended on advantageous terms by an exempt organization to its founders or shareholders, or to an entity controlled by them, indicate private inurement in violation of section 501(c)(3):

Although control of financial decisions by individuals who appear to benefit personally from certain expenditures does not necessarily indicate inurement of benefit to private individuals, those factors coupled with little or no facts in the administrative record to indicate the

Form 886-A	EXPLANATION OF ITEMS	Schedule or Exhibit No.
Name of Taxpayer: ORG		Year Ended

reasonableness and appropriateness of the expenses are sufficient to convince us that there is indeed prohibitive private inurement.”

**Orange County Agr. Soc., Inc. v. Commissioner, 1988 WL 83923, Tax Court, 1988. Aug 16, 1988**

“Here, the Society did not charge interest on the loans it made to OCF and M-W; further, the repayment dates, if any, are unknown. The use of the Society's funds without interest constitutes a benefit to the borrowers (M-W and OCF), both of whom were owned by persons having a controlling interest in the Society. Thus, as a result of these loans, part of the Society's earnings inured to the benefit of private interests which is in contravention of section 501(c)(3). See Unitary Mission Church, supra; Western Catholic Church v. Commissioner, 73 T.C. 196, 211 (1979); Church in Boston v. Commissioner, 71 T.C. 102, 106-107 (1978). In summary, we hold that respondent properly revoked the Society's previously granted tax exemption.”

**Easter House v. U.S., 12 Cl.Ct. 476, Cl.Ct., 1987. (Jun 10, 1987)**

“A loan in excess of \$86,000 was made by plaintiff to the Tzyril Foundation. The record contains nothing concerning any terms or repayment schedule relative to this loan. However, plaintiff's 1983 financial statement does indicate that plaintiff planned to write off the Tzyril loan as a bad debt. The 1983 financial statement also showed a loan outstanding to Friends in the amount of \$75,000. The record shows that this loan to Friends was expressly made without any terms or repayment schedule. Finally a smaller loan for over \$6,000 was made by plaintiff to the Suko Corporation. From all indications in the record, this loan was repaid. Plaintiff claims that the Friends and Tzyril loans should not disqualify it from exempt status because they were made to organizations similar to itself for charitable purposes. There is absolutely no evidence in the record relative to the purposes of these loans. The loan to Suko was made to a for-profit corporation. Apparently the loan was not outstanding at the time of plaintiff's application. Nevertheless the fact that it was made shows that companies controlled by Kurtz had a source of loan credit in plaintiff. The existence of a source of credit is what is important.”

**Government's Position:**

Treasury Regulation 1.501(c)(3)-(1)(c)(2) indicates that an organization is not operated exclusively for exempt purposes if its net earnings inure to the benefit of private interests. Private interests as defined in Treasury Regulation 1.501(a)-(1)(c) refers to any individual having a personal or private interest in the activities of the organization.

In Orange County Agr. Soc. Inc. v. Commissioner and in Easter House v. U.S. it was ruled that loans extended on financial terms that are advantageous to an exempt organization's founders or shareholders represent a form of private inurement. In both these cases the exempt

Form 886-A	EXPLANATION OF ITEMS	Schedule or Exhibit No.
Name of Taxpayer: ORG		Year Ended

organizations in question had their tax-exempt status revoked. In terms of what constitutes an advantageous loan, the following was noted: infrequent loan payments, little or no interest charged, no collateral on the loan, absence of a loan document, doubt as to whether the funds were or will ever be repaid.

Primary TP was an individual having a personal/private interest in the activities of ORG Daycare as the organization's founder and President. The fact pattern as detailed indicates various forms of questionable benefits paid to him and other individuals including employees and other officers of the organization. Primary Tp, Jr.'s companies received hundreds of thousands of dollars in "loans". The substantiation provided during the examination testified to the fact that overall these "loans" were made without supporting loan documentation, there was no set repayment schedule/plan, no interest was charged in some cases (ORG Investments Loan, ORG Development Loan for a few of the years), no payments were made in some cases (ORG Investments Loan), payments that were made involved questionable allocations especially since the for-profit (ORG Development) maintained control over the tax-exempt organization's receipts and disbursements (ORG Development), there was no collateral backing up these loans, and as of the latest information received it is highly questionable that ORG Developments can/has repaid ORG Daycare. Also at the time the "loans" were being paid out to start-up Primary Tp, Jr.'s for-profit interests, ORG had unpaid employment taxes which continued to accrue and cause problems with the exempt daycare's ability to operate in later years (Collections was assigned the case.). An exempt organization is not allowed to provide financial benefits to outside private interests to its own detriment. Overall the "loan" transactions were structured in such a way that the tax-exempt organization's assets were lent out with little or no protection.

In addition to the "loans" various other forms of inurement as noted above included unsubstantiated expense reimbursements and donations to employees (instead of wages subject to employment taxes). As indicated in Treasury Regulation Section 1.501(c)(3)-(1)(c)(2), an organization is not operated exclusively for exempt purposes if it's net earnings inure in whole or part to private interests.

**Taxpayer's Position:**

Position not provided.

**Conclusion:**

**Inurement of an IRC Section 501(c)(3)'s assets in any form or amount is prohibited. As ORG's assets inured to the benefit of private interests, in various forms and amounts, it**

Form 886-A	EXPLANATION OF ITEMS	Schedule or Exhibit No.
Name of Taxpayer: ORG		Year Ended

is hereby recommended that their exempt status should be revoked effective January 1, 2000, in accordance with the Treasury Regulations and Rulings of the Court of Law.

(If the proposed revocation becomes final, the organization will be required to file income tax returns for the years ending January 1, 2000 forward; the appropriate State officials will also be notified in accordance with IRC Section 6104(c).)