

**DEPARTMENT OF THE TREASURY**

Internal Revenue Service  
TE/GE EO Examinations  
1100 Commerce Street  
Dallas, TX 75424

**TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION**

Number: **200740014**  
Release Date: 10/5/2007

July 11, 2007

UIL: 501.03-01

ORG

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 October 1, 19XX. You have agreed to this adverse determination, per signed Form 6018, on June 6, 20AA.

Our adverse determination was made for the following reasons:

1. ORG is not operated for an exclusive exempt purpose, as is required by IRC section 501(c)(3) and Treas. Reg. section 1.501(c)(3)-1(d).
2. A substantial part of the activities of ORG furthers private interests (monies returned to trustee) rather than public interests, which is prohibited by Treas. Reg. section 1.501(c)(3)-1(d)(1)(ii). The foundation failed to make financial distributions or provide any activity as a supporting organization to a specified organization.
3. The organization did not operate exclusively for exempt purposes because it was organized and operated for the benefit of private interests, rather than public interests and its net earnings and assets inured to the benefit of its creators, trustees and directors., which is prohibited by IRC section 501(c)(3).

Please refer to the attached Form 886-A which sets forth the facts, law, and analysis upon which this final adverse determination is based.

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 1041.

These returns should be filed with the appropriate Service Center for the year ending December 31, 20YY, 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:

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

Attachment:  
Form 886-A  
Publication 892  
Form 4621-A



TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

DEPARTMENT OF THE TREASURY  
Internal Revenue Service

March 23, 2007

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.

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:

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

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service <b>Explanation of Items</b>	Schedule No. or Exhibit
<b>Name of Taxpayer</b> <b>ORG Foundation</b>		<b>Year/Period Ended</b>

**LEGEND:**

ORG - Name of Organization      XYZ - Name of CRT  
 XYZ - Name of Tenant            Trusteel - Founder, Trusteel  
 Lesseel - Name of Tenant        BW - Name of County  
 Statel - Purchase State          State2 - Org State  
 Other Bd Members - Other Board Members  
 DEF - Name of Trust

**PRIMARY ISSUE**

Whether the IRC § 501(c)(3) tax exempt status of the ORG Foundation should be revoked because it is not operated exclusively for tax exempt purposes.

**FACTS**

In December of 19WW, Trusteel purchased real property in Statel subject to a lease to the lessee, also known as ABC, hereinafter referred to as "ABC." The monthly lease income was \$ .

Trusteel (Founder) created the ORG Foundation (Foundation) via a Declaration of Trust (Declaration) dated October 1, 19WW. He is listed in the Declaration as both its Founder and Trustee and he executed the Declaration as both Founder and Trustee. He is also one of the five members of the Board of Directors of the Foundation.

The Declaration provides that the trust was created for the purpose of establishing an organization which is described in IRC §§ 501(c)(3) and 509(a)(3). The Declaration provides that the Founder renounces any power to determine or control, by alteration, amendment, revocation, termination or otherwise, the income or principal of the trust estate and that the Founder renounces any interest, either vested or contingent, including any reversionary interest or possibility of reverter, in the income or principal of the trust estate.

The Declaration further provides that each year the Trustee shall distribute 35% of the net income of the trust to the DEF (DEF), the named Primary Charity. In addition to this distribution, each year the Trustee shall distribute a total of 50% of the net income to one or more identified charitable organizations or to the Primary Charity as directed by a majority of the Board of Directors (the "Board"). Schedule A of the Declaration lists

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thirty-one (31) additional charities including DEF. Schedule A is attached as Exhibit 1.

The Declaration provides that the Board shall contain 5 members, be the governing body of the trust, and that the members of the Board shall be determined as follows:

- One Board member shall be appointed by the Primary Charity or its designated agent.
- Two Board members shall be from the class consisting of Trusteell, Trusteel2 and the descendants of Trusteell.
- Other Board members shall be appointed by a majority vote of the remaining members of the Board. Initially, they are Other board members.

The Declaration provides that upon winding up and dissolution of the trust, the assets shall be distributed to a non-profit fund, foundation or corporation, which is organized and operated exclusively for charitable, educational, religious, and/or scientific purposes and which has established its tax exempt status under § 501(c)(3).

On December 23, 19WW, the Founder signed an Irrevocable Unitrust Agreement creating the XYZ Charitable Remainder Trust (XYZ CRT). The real property the Founder purchased in State 1 was contributed to the XYZ CRT.

On December 23, 19WW, on behalf of the Foundation, the Founder signed Form 1023 (Application for Recognition of Exemption under Section 501(c)(3) of the Internal Revenue Code) seeking recognition of the Foundation as exempt from tax pursuant to section 501(a) as an organization described in section 501(c)(3) and classification as a supporting organization pursuant to section 509(a)(3).

Form 1023, Part II, item 1 states "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

("DEF"), the "Primary Charity," carry out its purposes and perform its functions." In Part II, item 2, Form 1023 states "The organization's principal financial support will be contributions by Trusteell."

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Based on the representations in the application, the Internal Revenue Service (IRS) issued a determination letter dated March 23, 20XX . This letter states that "...you are exempt from Federal income tax under section 501(a) of the Internal Revenue Code (Code) as an organization described in section 501(c)(3)." The letter further states "We have further determined that you are not a private foundation within the meaning of section 509(a) of the Code, because you are an organization described in section 509(a)(3)."

On December 28, 20XX , the Founder filed a "Verified Petition to Terminate Charitable Remainder Trust and Reverse Transactions" (Petition) in the Third Judicial District of BW County, State of State2 .

Paragraph 11 of the Petition explains the flow of funds. The paragraph states in part that "Beginning as of January, 20XX and continuing through to the present...":

- a. Each month the monthly rent payment from ABC has been paid directly to the XYZ CRT .
- b. The Trustee of the XYZ CRT , (Trustee11) then paid the amount of the monthly rental payment to the Founder (Trustee11) of the ORG Foundation.
- c. The Founder then contributed the amount of the monthly rental payment to the Foundation.
- d. Upon receipt of the money, the Foundation paid that monthly rental payment back to the Founder.

Paragraph 13 of the Petition states "In addition to contributing the amount of each Monthly Rental payment to the Foundation, Petitioner made an initial contribution of \$ ."

Paragraph 14 of the Petition states the Founder "...is and has been the sole contributor of funds and/or assets to the Foundation and the XYZ CRT ."

Paragraph 17 of the Petition states the Founder "...seeks to terminate the XYZ CRT and to undo and reverse the transfers made between himself, the (ORG) Foundation and/or the XYZ CRT , but does not seek termination of the (ORG) Foundation."

On December 28, 20XX , an "Order Approving Termination of Charitable Trust and Reversal of Transfers" (Order) was filed in the Third Judicial District Court of BW County, State of State2 . The Order terminated the XYZ CRT and stated that "The Trustee

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of the Foundation" (Trusteel) "...is hereby authorized and directed to return to Petitioner" (Trusteel) "all contributions made by Petitioner to the Foundation, including the amount of all monthly rental payments and Petitioner's initial contribution of \$ ."

The Foundation filed a Form 990 (Return of Organization Exempt from Income Tax) for calendar year ending (CYE) 19WW. The Form 990 reports the receipt of \$ in "Direct Public Support" in cash, but does not reveal the contributor. It also reports assets as of 12/31/19WW totaling \$ and \$ in distributions for charitable purposes.

The Foundation filed Form 990 for CYE 12/31/20XX on May 15, 20YY. The Form reported \$ in assets as of 01/01/20XX and 12/31/XX. The Form also reported \$ in revenue, expenses and grants for a charitable purpose.

Both Forms 990 list Trusteel as Trustee and one of the five members of the Board of Directors. Forms 990 were not filed for any year subsequent to CYE 12/31/20XX .

Explaining the amount reported as assets as of January 1, 20XX , in an undated letter, , Power of Attorney (POA) representing the Foundation, states that the Founder made contributions "...which in total exceed the \$ returned to him from the terminated foundation pursuant to the court order."

The Founder's Schedules A (Form 1040) for CYE 12/31/19WW shows the Founder claimed a charitable contribution deduction totaling \$ . However, in 20YY the Founder amended his Form 1040 return for 19WW to eliminate the claimed charitable contribution deduction.

### LAW

Code section 501(c)(3) exempts from federal income tax organizations organized and operated exclusively for charitable, educational, and other exempt purposes, provided that no part of the organization's net earnings inures to the benefit of any private shareholder or individual.

Regulations section 1.501(c)(3)-1(a)(1) provides that in order to be exempt as an organization described in section 501(c)(3) of the Code, the organization must be one that is both organized and



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operated exclusively for one or more of the purposes specified in that section.

Regulation section 1.501(c)(3)-1(c)(1) provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Regulation section 1.501(c)(3)-1(c)(2) provides that 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. The words "private shareholder or individual" refer to persons having a personal and private interest in the activities of the organization. The term "Private shareholder or individual" is defined in regulation section 1.501(a)-1(c).

Regulation section 1.501(c)(3)-1(d)(1)(ii) provides an organization is not organized or operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. Thus, to meet the requirement of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

The presence of a single substantial nonexempt purpose can destroy the exemption regardless of the number or importance of exempt purposes. Better Business Bureau v. United States, 326 U.S. 279, 283, 90 L. Ed. 67, 66 S. Ct. 112 (1945); American Campaign Academy v. Commissioner, 92 T.C. 1053, 1065 (1989); see also Old Dominion Box Co., Inc. v. United States, 477 F.2d. 340 (4<sup>th</sup> Cir. 1973) ("operating for the benefit of private parties who are not members of a charitable class constitutes a substantial nonexempt purpose"). When an organization operates for the benefit of private interests, such as designated individuals, the creator or his family, or persons directly or indirectly controlled by such private interests, the organization by definition does not operate exclusively for exempt purposes. American Campaign Academy v. Commissioner, supra at 1065-66.

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In Church of World Peace, Inc. v. Commissioner, T.C. Memo. 1994-87, aff'd, 75 A.F.T.R.2d (RIA) 2082 (10<sup>th</sup> Cir. 1995), the Tax Court held that a church did not operate exclusively for religious purposes because the church facilitated a circular tax-avoidance scheme. The facts showed that individuals made tax-deductible contributions to the church. The court found that the church then returned the money to the individuals claiming that the payments were for housing allowances and reimbursement of expenses. The court further found that such payments were in fact unrelated to the church's operations.

In New Faith, Inc. v. Commissioner, T.C. Memo 1992-601, the court stated that an organization must substantiate its alleged charitable activities with specific documentation in the form of checks, invoices, receipts, contemporaneous journals, and other documentation.

In Revenue Ruling 67-5, 1967-1 C.B. 123, it was held that a foundation controlled by the creator's family was operated to enable the creator and his family to engage in financial activities which were beneficial to them, but detrimental to the foundation. It was further held that the foundation was operated for a substantial non-exempt purpose and served the private interests of the creator and his family. Therefore, the foundation was not entitled to exemption from Federal income tax under section 501(c)(3).

#### **GOVERNMENT'S POSITION**

The IRC § 501(c)(3) tax exempt status of the ORG Foundation should be revoked because it is not operated exclusively for exempt purposes. The assets and income inured to the benefit of its Founder, Trusteel.

The Founder contributed \$ \_\_\_\_\_ to the Foundation in 19WW. However, by Order dated December 28, 20XX, \$ \_\_\_\_\_ was paid to the Founder. Form 990 for CYE 20XX did not reveal this. As of January 1, 20XX, there were \$ \_\_\_\_\_ in assets and Form 990 did not report these assets. Form 990, or an attachment thereto, did not disclose how the \$ \_\_\_\_\_ of assets were disposed.

The Foundation never operated as a charitable entity: 1) the flow of funds produced an undeserved charitable contribution deduction; 2) the flow of funds did not provide income to the Foundation for use in a charitable purpose; and 3) the money

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initially contributed to the Foundation, and the monthly rental payments from ABC, inured to the Founder.

The flow of funds, as stated in the Petition, generated an undeserved charitable contribution deduction for the Founder. The Founder made an initial \$ "contribution" to the Foundation. Then the monthly rental income flowed back to the Founder in a circular scheme as follows. First, ABC pays its monthly rent of \$ to the XYZ CRT . From the XYZ CRT , the funds go to the Founder, who in turn "contributes" the money to the Foundation. The funds then flow back to the Founder from the Foundation. As a result of the Petition, the Founder received back all funds "contributed," including the rental income. This is inurement. The Foundation has operated as a tax avoidance device.

The flow of funds did not provide income to the Foundation for use in the pursuit of its charitable goals, because the rental receipts remained in the Founder's possession. The rental income from ABC remained under the control of the Founder. It is a convoluted flow of funds, obfuscating a rental payment directly from ABC to the Founder.

The return of \$ from the Foundation to the Founder is inurement prohibited under Code section 501(c)(3). An organization is described in section 501(c)(3) only if no part of its net earnings inures to the benefit of any private shareholder. The inurement prohibition is designed to insure that charitable assets are dedicated to exclusively furthering public purposes. An organization is not operated exclusively for exempt purposes if its net earnings inure to the benefit of private shareholders or individuals.

A gift to a charitable organization must be a voluntary transfer of money or property without the receipt of adequate consideration, made with charitable intent. Hernandez v. Commissioner, 490 U.S. 680, 690 (1980). To claim a deduction under section 170, a donor must surrender dominion and control over the gift. United States v. Estate Preservation Services, 202 F.3d 1093, 1101 (9<sup>th</sup> Cir. 20XX ). Trusteel transferred assets to the Foundation and claimed a deduction under section 170. A charity's assets are required to be irrevocably dedicated to charitable purposes. Treas. Reg. § 1.501(c)(3)-1(b)(4). The inurement prohibition serves to prevent the individuals who operate the charity from siphoning off any of a charity's income or assets for personal use. By transferring its assets for the

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benefit of Trusteel, the Foundation breached the dedication requirement and its net earnings have inured to the benefit of Trusteel.

Although the inurement prohibition is stated in terms of net earnings, it applies to any of a charity's assets that serve the interests of its private shareholders. Harding Hospital, Inc. v. United States, 505 F.2d 1068, 1072 (6<sup>th</sup> Cir. 1974). The transfer of its funds to Trusteel per his request in the Petition, served the financial interest of Trusteel.

The Government's position is that the Foundation never operated as a tax exempt entity described in IRC § 501(c)(3) and was never intended to do so. The purpose of the Foundation was to provide a charitable contribution deduction for the Founder while sheltering the rental income that flowed from ABC to the Founder.

The State of State2 Court transferred the Foundation's assets to the Founder. The Founder received \$ because of the Order dated December 28, 20XX. This \$ remains in the possession of the Founder.

The Founder experienced tax benefits when he donated \$ to the Foundation. These benefits were reversed when he amended his Form 1040 for the CYE 19WW and paid the additional income taxes.

The Government's position is to revoke the Foundation's exempt status effective October 1, 19WW, because: 1) the Foundation never had an exclusively charitable purpose and its assets inured to the Founder; and 2) the flow of funds was a subterfuge intended to shelter the rental income paid to the Founder from ABC.

#### **TAXPAYER'S POSITION**

The taxpayer agrees the Foundation's exempt status should be revoked with an effective date of March 23, 20XX.

#### **CONCLUSION**

The tax exempt status of the Foundation should be revoked effective October 1, 19WW, because it was not operated exclusively for tax exempt purposes. More than an insubstantial purpose of the Foundation was to serve the needs of its Founder.

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Additionally, the assets/net income of the Foundation inured to the benefit of the Founder.

Retroactive revocation is appropriate because the Foundation did not report in its exemption application that it would be acting as a conduit for the rental income from ABC to flow to the Founder and because it did not report that the Founder's "contributions" would be returned to the Founder.

Form 1041 U.S. Income Tax Return for Estates and Trusts should be filed for tax years ending December 31, 20XX, 20YY, 20YY, 20WW, and 20QQ. Subsequent returns are due no later than the 15<sup>th</sup> day of the 4<sup>th</sup> month following the close of the trust's accounting period.

Returns should be sent to the following mailing address:

Internal Revenue Service Center  
, State2

For tax year ending December 31, 20RR Form 1041 is due April 15, 20SS, and should be sent to the following address:

Internal Revenue Service Center  
, State2

**ALTERNATIVE ISSUE**

Whether the Foundation should be reclassified as a private foundation, if its tax exempt status is not revoked?

**FACTS**

See prior Facts, as well as the following.

The Founder is a Trustee and Director of the Foundation. He is also a disqualified person because he is the sole contributor of \$ to the Foundation.

The determination letter, dated March 23, 20XX, states in part that, "If your sources of support, or your purposes, character, or method of operation change, please let us know so we can consider the effect of the change on your exempt status and foundation status."

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The Foundation did not make any distributions supporting a charitable entity described in 509(a)(1) or 509(a)(2) or perform charitable activities of any kind from its date of inception on October 1, 19WW to the end of the examination period.

**LAW**

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 of the purposes specified in section 509(a)(3)(A) only if its articles of organization (as defined in §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 to 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 (hereinafter 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

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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 an individual rather than to an organization the same standard shall be applied as in §53.4945-4(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 is 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 section 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

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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 in order 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)(B) 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 supporting organizations 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



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publicly supported organization, as described in paragraph (i) of this section.

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 organizations have a significant voice in the

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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

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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 such program or activity is a substantial one.

....

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

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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 give rise to liability for a tax imposed under sections 4941, 4943, 4944, or 4945 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 requirements 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.

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Rev. Rul. 76-208, 1976-1 C.B. 161, held that a charitable trust described in section 501(c)(3) did not satisfy the "substantially all" requirement of the integral part test set forth in section 1.509(a)-4(i)(3)(iii)(A) of the regulations and was therefore not a supporting organization. The trust instrument provided that 75 percent of the trust income was to be distributed annually to a specified church with the remaining 25 percent to accumulate until the original corpus doubled, at which time the entire annual income was to be distributed to the church. The Service also stated that for purposes of the integral part test, the term "substantially all" means 85 percent or more.

Income Tax Regulations section 1.509(a)-4(j) regarding control by disqualified persons 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 as 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

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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 of 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 persons, 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 its manner of 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

As set forth above, it is the government's primary position that the tax exempt status of the ORG Foundation (the "Foundation") should be revoked. Alternatively, the Foundation should be reclassified as a private foundation.

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 is intentionally inclusive so that all organizations exempted from tax by IRC § 501(c)(3) are private foundations except for those specified in IRC § 509(a)(1) through(4). Roe Foundation Charitable Trust v. Commissioner, T.C. Memo. 1989-566; Quarrie Charitable Fund v. Commissioner, 603 F.2d 1274, 1277 (7<sup>th</sup> Cir. 1979). The Foundation currently is excepted from private foundation status because it is currently classified as an organization described in section 509(a)(3) which defines supporting organizations.

Public charities (organizations described in section 501(c)(3) that meet the requirement of sections 509(a)(1) or (2)) are excepted from private foundation status on the theory that their

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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. Supporting organizations are excepted if they are subject to the scrutiny of public charities that provide sufficient oversight to keep supporting organizations from the types of abuses to which private foundations are prone. Quarrie, 603 F.2d at 1277-78.

To be classified as a section 509(a)(3) supporting organization, the Foundation must meet all three of the following tests:

- 1) Organizational and Operational Tests under section 509(a)(3)(A).
- 2) Relationship Test under section 509(a)(3)(B).
- 3) Lack of Disqualified Person Control Test under 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 motivated to be attentive to the operations of the supporting organization and that it is not controlled, directly or indirectly, by disqualified persons. The Foundation has not established that it has met any of these tests.

#### **Organizational and Operational Tests**

The Foundation is not organized to benefit one or more specified publicly supported organizations. Pursuant to Treas. Reg. § 1.509(a)-4(c)(1)(iii) and (iv), 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 organization(s). The Foundation's dissolution clause allows distributions to organizations other than the specified publicly supported organizations upon termination of the Organization. The possible beneficiaries are not limited to the

or to the organizations specified on Schedule A of the Foundation's Declaration of Trust. Therefore, the organizational test is not met. See Quarrie, supra (holding that the organizational test was not satisfied where the trustee had the

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power to substitute beneficiaries when, in the judgment of the trustee, the uses of the named beneficiaries became unnecessary, undesirable, impracticable, impossible or no longer adapted to the needs of the public).

Moreover, the operational test set forth in Treas. Reg. § 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 organizations(s). As was discussed under the Primary Issue above, the Foundation has served private interests and its assets inured to the benefit of Trusteel. Therefore, it has not established that it operated exclusively for the benefit of the publicly supported organizations.

#### **Relationship Test**

As set forth in Treas. Reg. § 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 a 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 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 is established by the fact that there is 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, only one of the five members of the board is appointed by the supported organization. Thus, the requirements to satisfy one of the first two types of



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relationship cannot be satisfied.

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" tests. 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 indication that the board member appointed by the supported organization had any input into the investment policies of the Foundation or into the timing of grants or the selection of recipients. No grants were made to any public charity including DEF. All assets were transferred to Trusteel.

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 Declaration states that the trustee shall distribute 35% of the net income of this trust to the primary charity. The Declaration further states that "a total of 50% of the net income shall be distributed to one or more of the organizations listed on Schedule A.". There are thirty-two (32) organizations listed on Schedule A that the Foundation can select as grant recipients. Only one, DEF, is entitled to receive a specified portion of the Foundation's net income. The Foundation is not required to make any specified distributions to any of the other organizations. Therefore, the Foundation has not established that any of these organizations are beneficiaries to the trust or that they have the power to enforce the trust under state law.

Therefore, the Foundation does not meet either of the "responsiveness" tests.

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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 motivated to attend 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. Treas. Reg § 1.509(a)-4(i) (3) (i). In order to meet the integral part test, either Treas. Reg. § 1.509-4(i) (3) (ii) or (iii) must be satisfied.

Treas. Reg. § 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 the publicly supported organizations would otherwise conduct themselves as opposed to simply making grants to the publicly supported organizations. Compare to Treas. Reg. § 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 Memorial Fund v. Commissioner, T.C. Memo. 20YY-300. The Foundation does not meet this test because organizations, it did not perform any activities for or on behalf of the publicly supported organizations that they would conduct themselves.

Because the Foundation did not perform any activities for or on behalf of publicly supported organizations, the applicable rules for satisfying the integral part test are in Treas. Reg. § 1.509(a)-4(i) (3) (iii). This section of the regulation has the following 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 Organization does not meet the

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second requirement. Because it has not met the second requirement, it cannot meet the third requirement.

The Foundation had no income. Therefore, the first requirement is not applicable

Treas. Reg. § 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 such attentiveness. Treas. Reg. § 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, Treas. Reg. § 1.509(a)-4(i)(3)(d) provides that "[a]ll 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.

The Foundation made no grants to DEF or any other public charity. Obviously, a grant of -0- is not enough to ensure attentiveness to the Foundation. There are no indicia of attentiveness like board representation or provision of financial statements.

In addition, the facts and circumstances show that the support is not sufficient to ensure that the supported organization is attentive to the operations of the Foundation. Trusteel filed a Petition in state court to transfer all of the assets of the Foundation to himself. The rental income from ABC flowed through the CRT, to the Foundation and back to Trusteel. No board member opposed these actions. Thus, DEF was not attentive to the Foundation's operations. See Treas. Reg. § 1.509(a)-4(i)(3)(iii).

#### **Disqualified Person Control Test**

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Treas. Reg. § 1.509(a)-4(j)(1) provides that for purposes of section 509(a)(3)(C), an organization will be considered "controlled" if the person, by reason of his position or authority, may require the organization to perform any act which significantly affects its operations or prevents such organization from performing such act. All facts and circumstances are taken into consideration in determining whether a disqualified person controls an organization. Id. Trusteel is a disqualified person because he was a substantial contributor to the Foundation. There is no indication that any representatives of any of the organizations named in the Declaration of Trust had any input into the operations of the Foundation.

Additionally, there is no evidence that any of the supported organizations are attentive to the operations of the Foundation. There is no indication that board member opposed Trusteel siphoning off the Foundation's assets for his own benefit. This prevented the Foundation from performing its stated exempt purpose.

Accordingly, the Foundation should be reclassified as a private foundation because it does not qualify as a supporting organization under the requirements set forth in Treas. Reg. § 1.509(a)-4(c) through (j).

### **TAXPAYER'S POSITION**

The Taxpayer does not agree that the foundation status should be modified to a private foundation. The taxpayer's position is that the Foundation should be revoked.

All of the Founder's efforts to withdraw himself from the Foundation were done in good faith and did not result in any monetary benefit to himself. This is true because the Founder amended his Form 1040 for CYE 19WW and paid additional income tax, thereby eliminating any monetary benefit to himself.

The Taxpayer does not agree with foundation modification, but revocation of exempt status retroactive to March 23, 20XX .

### **CONCLUSION**

If its exempt status is not revoked, the Foundation should be reclassified as a private foundation because it does not qualify

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as a supporting organization under the requirements set forth in Treas. Reg. § 1.509(a)-4(c) through (j).

This modification of private foundation status is effective beginning October 1, 19WW. The Foundation represented in its exemption application that it would make grants to the Primary Charity and other charities listed on Schedule A. It did not. The Foundation represented that the Primary Charity would be attentive to its operations. It was not. The Foundation represented that it would not be controlled by disqualified persons. It was. Therefore, retroactive reclassification is applicable.

The effect of this determination will be that the Organization is required to file Form 990-PF Return of Private Foundation. Form 990-PF should be filed for tax years ending December 31, 20XX, 20YY, 20YY, 20PP, 20QQ, 20RR and 20SS. Subsequent returns are due no later than the 15<sup>th</sup> day of the 5<sup>th</sup> month following the close of the Foundation's accounting period. For tax year ending December 31, 20SS, Form 990 PF is due May 15, 20TT.

Send your returns to the following mailing address:

**Note:**

Form 990-PF is required for each tax year until Private Foundation status is terminated under IRC 507.