DEPARTMENT OF THE TREASURY
Internal Revenue Service
TE/GE EO Examinations
1100 Commerce Street
Dallas, TX 75424

TAX EXEMPT AND GOVERNMENT ENTITIES DIVISION

Number: **200817041**
Release Date: 4/25/2008

January 10, 2008

LEGEND
ORG = Organization name XX = Date Address = address

UIL:501.03-01

ORG
ADDRESS

Person to Contact:
Identification Number:
Contact Telephone Number:
In Reply Refer to: TE/GE Review Staff
EIN:

LAST DATE FOR FILING A PETITION
WITH THE TAX COURT:

CERTIFIED MAIL – RETURN RECEIPT

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 December 27, 20XX. You have agreed to this adverse determination, per signed Form 6018, on August 23, 20XX.

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).

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, 20XX, 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 91st 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: ( ) , or writing to:

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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
Internal Revenue Service
1100 Commerce Street
Dallas, TX 75242

August 20, 2007

Taxpayer Identification Number:

ORG

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 & 3498
Report of Examination
Form 6018-A

LEGEND
ORG = Organization name XX = Date XYZ = State City = city
Country = Country Founder = Founder Address = Address Promoter = Promoter BM-1-7 = 1st, 2nd, 3rd, 4th, 5th, 6th, 7th Board Members
CO-1 - 15 = 1st, 2nd, 3rd, 4th, 5th, 6th, 7th, 8th, 9th, 10th, 11th, 12th, 13th, 14th, 15th companies

ISSUE

Whether the ORG's ("ORG") tax exempt status should be revoked because it was not organized and operated exclusively for purposes described in section 501(c)(3) of the Internal Revenue Code.

FACTS

1. Entities participating in and/or created to implement the Master Financial Plan

a. Affiliated Entities of CO-1 – the Promoter

The promoter and all affiliated entities, listed below, have come under Federal investigation by the Securities and Exchange Commission ("SEC"), Federal Bureau of Investigation and the Internal Revenue Service ("Service") for promoting numerous tax shelter schemes involving offshore transactions, including the repatriation of funds in the form of tax-free "borrowing." The CO-1 entities are as follows:

(1) CO-1., ("CO-1" or "CO-1"), was a company, headquartered in Country. CO-1 claimed to be a leading firm in the business of providing tax reduction and asset protection through the establishment of offshore entities and accounts. It was organized as a parent company, charged with coordinating the actions of its subsidiaries, as well as CO-2, an affiliated law firm. As the parent, later references in this report to CO-1 or to CO-1 may also include CO-1, Inc.

(2) CO-1, Inc., ("CO-1"), was a XYZ corporation, incorporated in 19XX. CO-1's function was to provide the office space and the staff who provided services to CO-1 and its investors, and served as the office through which investors are solicited. CO-1 and CO-1's clients regularly purchased securities they promoted, including those issued by CO-4 and . CO-1 was located in City, XYZ.

(3) CO-3, (" "), was a entity that acted as an investment adviser and a "mutual fund company" for CO-1 investors. CO-3managed "mutual funds" that had been sold to CO-1 investors. It also maintained accounts with brokerage firms into which investor securities were placed.

(4) CO-4., ("CO-4"), was an entity organized under the laws of Country, a . CO-4 ostensibly acted as an issuer of many of the investment products (e.g., LOI insurance policies) sold to CO-1 investors. CO-4 also controlled the funds of CO-1 investors that were to be repatriated to those individuals from accounts located in the Country.

(5) CO-2, Ltd., ("CO-2"), was a entity and a State of XYZ limited liability company. CO-2 was an international legal firm that operated as CO-1's legal advisors. It also shared offices with CO-1 in Country, Country and CO-1 in City, XYZ. CO-2's legal tax opinion, supporting the legality of the Master Financial Plan, was used by CO-1 to solicit wealthy clients.

(6) CO-6, ("CO-6"), was an arm of CO-1 and was based in Country, Country. CO-6 was set up to receive wire transactions from investors at an account it established with the Bank . It was also used to facilitate the repatriation of client funds via an Equity Management Mortgage.

(7) CO-7 ("CO-7"), was a State of State Limited Liability Company used to facilitate the repatriation of client funds via an Equity Management Mortgage

b. Affiliated Entities of Founder – the Client

(1) ORG, ("ORG"), is a non-profit trust formed in the State of XYZ on December 27, 20XX. ORG is an integral component of Founder's Master Financial Plan designed for him by CO-1.

(2) CO-12, (CO-12) is a nationwide travel and vacation business. This business, located in City, XYZ, is owned and operated by Founder.

c. Supported Organizations – the entities ORG supports

(1) CO-8 is a community-based adult education and employment program in City, XYZ. It is a program of an IRC 501(c)(3) organization (CO-13, EIN). This program, CO-8, was named as the primary beneficiary.

(2) CO-9 was also named as a secondary beneficiary. This is a program of the CO-14, a City based charity. There is now a section 501(c)(3) organization named CO-9 located in City but it did not receive its ruling until 20XX.

(3) CO-10 is a church located at Address in City, XYZ. This church was also named as a secondary beneficiary.

(4) CO-11 is a program of CO-15, and is also named as a secondary beneficiary. This is an independent section 501(c)(3) organization affiliated with the Church.

2. Background

a. Promotion and Design of the Master Financial Plan

Per Founder, his first substantive contact with CO-1 occurred in October 20XX, when Promoter of CO-1 came to his office and explained CO-1's services. Founder was referred to Promoter by a business associate. Based on this information, Founder flew to XYZ in December of 20XX.

In December 20XX, Founder purchased from CO-1 a financial product called the Master Financial Plan. One aspect of this plan called for the creation of a Supporting Organization. CO-1 cites the objectives of a Supporting Organization as a vehicle which permits charitable

giving with up to 100% tax deductibility, a way to take advantage of the tax benefits of charitable giving while maintaining a high degree of ultimate control over the donated assets, and to create a conduit for tax-free investing offshore. Per CO-1, given the requirements and structure of a Supporting Organization, a secondary but very significant use of it can be to channel investment funds offshore where they can grow tax free. With the investment gains that accrue through a Supporting Organization, a donor will have additional sums to contribute to charity while substantially increasing his investment portfolio offshore. These investment gains are available to the donor through access to the offshore corporations that contract to manage the investments of the Supporting Organizations. Donations made to the Supporting Organization can provide the donor business entities with substantial tax deductions. As a Trustee of this charitable organization, the donor is able to influence the investment decisions of the supporting organization while directing the SO's charitable contributions. The donor would also be empowered to select the other Trustees, within IRS guidelines, and to help determine the SO's ongoing investment strategy. Per the Master Financial Plan, "You and a family member may sit on the Board of Trustees along with a representative of the primary charity and two friends". Reasonable compensation can be paid to board members and employees of the SO in consideration for these services. The SO has the ability to make tax free investments in domestic or offshore investments under the prudent businessman standard. Once gains have been captured by the Supporting Organization, the assets are then available for offshore investing or other business purposes.

Any funds left in the treasury of the SO may be invested in domestic or offshore securities thus producing investment income for the SO. In order to limit the amount of investment income credited directly to the SO, and consequently disbursed to primary and secondary beneficiaries, CO-1 recommends the use of two International Business Corporations (IBCs). This allows the investor to capture much of the investment income offshore, in a tax free environment. In this way the profits from investment activities can be transferred between domestic and foreign entities and between taxable and non-taxable entities to produce the most favorable tax consequences. Much of the Master Financial Plan that was sold to Founder was not implemented. While Founder did establish a Supporting Organization and engage in acts of self dealing, no evidence was uncovered that entailed offshore financial activity.

b. <u>SEC Description of the Master Financial Plan</u>

In its complaint against CO-1, the SEC stated that CO-1 offered a product known as a Master Financial Plan whose function is to provide a means by which the investor can invest cash and securities offshore, usually in the Country or another nation, and receive tax-free gains from the investment activity. The basic structure of the plan involves the transfer of an investor's income and/or assets into offshore entities established on behalf of the investor. These funds and assets are then used to purchase investment and other products offered by CO-1 and its affiliates. The Master Financial Plan also provides investors a means to repatriate assets through

transactions that hide the actual ownership of the assets, thereby enabling the investors to utilize the untaxed funds without paying tax obligations. For instance, in its sales manual, CO-1 states:

> *Once money is invested offshore, there are several ways to repatriate part or all of it. These include such non-taxable methods as with secured credit cards, personal or corporate loans, mortgages, personal withdrawals or through insurance policies. Capital can also be repatriated through taxable means such as through salaries or annuities.*

CO-1 promises its clients that, through the implementation of the Master Financial Plan, the clients will reduce their taxes by significant percentages, have their investments grow offshore in a tax free environment, and will be able to protect their assets from unwanted liabilities and encumbrances.

The SEC contends that the Master Financial Plan essentially establishes the framework through which the CO-1 investor invests and protects cash and assets, avoids payment of taxes and repatriates his or her funds.

c. Description of the Founder Master Financial Plan

CO-1 designed the Master Financial Plan to further the income tax reduction, asset protection and personal estate planning objectives of Founder. It involved the establishment of several offshore and domestic entities; the purchase of several insurance plans; and the execution of transactions through which Founder would invest his pre-tax income.

The types of entities employed by CO-1 included International Business Corporations (IBCs), Voluntary Employee Beneficiary Associations (VEBAs), Support Organizations (SOs), S Corporations (S Corps) and Limited Liability Companies (LLCs). The insurance arrangements included products such as Loss-of-Income (LOI) insurance policies and Foreign Variable Annuities ("VFA").

(1) Description of Component Entities

The following are descriptions of component entities from CO-1's sales literature:

(a) International Business Corporations

The SEC report stated that CO-1 sales literature described IBCs as corporations formed in a tax haven but not authorized to do business within that country. They are intended to be used as an investment or asset protection vehicle. The CO-1 investor transfers personal assets or an investment portfolio to the IBC.

CO-1 tells clients the offshore entities are not owned or controlled by the clients for tax purposes. Rather, nominee officers or directors act on behalf of the clients to control the entities and effect transactions. In fact, CO-1 personnel have authority to effect the transactions, retaining sole signatory authority over all accounts. Typically, in order to affect a transfer of funds, senior personnel at CO-4 or CO-3must authorize the transfer.

(b) Supporting Organizations

SOs are described as charitable organizations established for the benefit of an individual client. Among the stated benefits of an investor establishing an SO over using a domestic charitable organization is that investment funds transferred to the investor's personal SO can grow tax free. These investment gains are available to the donor/investor through access to the offshore corporations that manage the investments of the SO.

CO-1 stated that Founder, as ORG's trustee, was able to make investment decisions, including the ability to borrow indirectly from the contributed funds, and direct charitable contributions, giving Founder a high degree of control over the donated assets. In addition, salaries and other administrative expenses may be paid to Founder and/or his family members in the approximate amount of 25 percent of the ORG's gross income.

(c) Voluntary Employee Beneficiary Association

CO-1 defines a VEBA as an employee benefit program that permits employers to take tax deductions for certain employee benefits payments such as the payment of life, sick, accident, death or other benefits. The investment gains of these payments grow tax deferred. Under certain circumstances, the gains can be accessed tax-free; e.g., borrowing funds to pay for the children's college education through a VEBA trust.

(d) S-Corporation

The S-Corporation model is also used to implement the VEBA and requires at least two employees. Under the VEBA arrangement, the employees would join the union and the employer would contribute tax deductible premiums to the VEBA trust. If the insurance policy accumulates cash value, the trust that administers the arrangement can issue loans to participants if certain conditions are met, viz., (1) paying uninsured medical expenses; (2) paying for post-secondary education of dependents; and (3) unusual, unexpected hardship events. Although repayment is anticipated, any outstanding loan balances at death can be paid off by the death benefit.

(e) Limited Liability Company

A Limited Liability Company offers personal protection and tax savings but does not require the reporting and record keeping of a corporation per CO-1.

(2) Description of Insurance Products

The types of investment products sold by CO-1 include Loss of Income Policies ("LOI"), Equity Management Mortgages ("EMM") and Foreign Variable Annuities ("FVA").

A Loss of Income policy ("LOI") is an agreement between the CO-1 client and CO-4 whereby the client purchases a policy to insure against a future loss of income.

An LOI policy is usually purchased for coverage until the earlier of a specified term, such as 1 year, or the date of death of the insured. The insurance company typically holds the net premium in a separate account, along with the net premiums of other LOI insurance policies. Creditors cannot access policy reserves. The insurance company guarantees a fixed return on such

premiums. Most LOI policies provide that your premiums, plus a guaranteed return, will be paid back to the policy holder at the end of a specified period (usually 10 years).

The sales manual also states that investment decisions are made by the insurance company. The funds received by CO-4 for the sale of LOIs are pooled in an account at Barclays Bank maintained by CO-4 in the Country.

Per the SEC, in reality, LOIs are not purchased as insurance, but as a vehicle to make offshore and tax-free investments of funds which can be repatriated as desired by the investor. No CO-1 investor has ever filed a claim against an LOI for a loss of income. What, in fact, occurs is that the investor purchases the LOI from CO-4 and then borrows back a percentage of the premium through a note or investment contract, usually in the form of a "mortgage," called an Equity Management Mortgage or EMM.

The EMM is obtained through two affiliated entities of CO-1, CO-6 and CO-7, which act as the mortgagee. The investor's proceeds from the EMM are then placed in an IBC and invested offshore through , or repatriated by the investor. The net effect of the LOI/EMM transaction is that the investor (S-Corporation) is able to deduct the premium paid for the LOI, encumber his property through a mortgage to himself and deduct the interest payments to himself on the mortgage. The investor can then invest the proceeds from the mortgage offshore through an IBC, with CO-3managing the investment. The remainder of the premium left with CO-4 is then invested to provide the investor with a fixed rate of return over the ten-year life of the policy.

(a) Foreign Variable Annuities

The FVA is a variable annuity issued by CO-4. The investor purchases the FVA by transferring cash or securities to CO-4; CO-4 then pays the investor or his designees the principal and an agreed upon rate of return over the succeeding years. CO-1 markets the FVA as a means to repatriate a client's assets without tax consequences. With respect to FVAs the CO-1 sales manual states:

> You could purchase a Foreign Variable Annuity Contract between you and a Foreign Insurer. During the accumulation period of the Annuity Contract you could set aside money and have it grow on a tax-deferred basis [pending] withdrawal. At retirement, or another time selected by you, the payout period begins whereby the insurance company promises to pay a steady stream of income for a fixed period of time or for life.

d. Implementation of ORG

On or about December 27, 20XX, Founder established the ORG (ORG) in the form of an irrevocable trust. Pursuant to the Declaration of Trust, the trust was organized and operated exclusively to support or benefit one or more publicly supported organizations as defined by Treas. Reg. § 1.509(a)-4(b)(1).

ORG is a trust formed under XYZ law by Founder's execution of a written Declaration of Trust. Under ORG's Declaration of Trust, the purpose of ORG is to "support or benefit ... one or more publicly supported organizations." The Declaration of Trust names CO-8 as the primary program run by a charity to be supported by ORG. The Declaration of Trust also permits distributions to three other named charities/programs run by charities: CO-9, CO-10 and CO-11. The Declaration of Trust requires that 35% of ORG's net income be distributed each year to CO-8, as the primary charity named in the Declaration of Trust. In addition, the Declaration of Trust requires that another 50% of ORG's net income be distributed to one or more of the four charities listed in the Declaration of Trust, in any allocation determined by ORG's Board. There is no requirement that any named charity other than CO-8 be allocated any amount.

At the time of ORG's formation, the Board consisted of:

Founder, Trustee
BM-1, Founder's mother
BM-2, BM-2 is the child of Founder's first wife.
BM-3. Co-worker at Founder's prior place of employment
BM-4, Director of CO-8.

On December 29, 20XX, Founder donated real property to ORG. This property consisted of three furnished condominiums in City, XYZ, a beach resort. Founder claimed a charitable contribution deduction under IRC § 170 in the amount of $. Revenue generated from these rental units prior to their donation was $ per month per unit. (See analysis below)

Property	Appraised Value	Cost	Date Purchased	Rents Received 20XX
22-A	$	$	10/20/19XX	$
13-B	$	$	7/7/19XX	$
23-G	$	$	7/7/19XX	$
	$	$		$

After the units were donated to ORG, Founder began to engage in acts of self dealing. Founder engaged in acts that were a conflict of interest that benefited Founder at the expense of ORG. As the Trustee for ORG, Founder rented the three condominium units back to CO-12, a company engaged in the rental of vacation properties. Founder owns CO-12. This transaction was conducted without a Board meeting, without going to the open market to solicit competitive bids from disinterested parties, and without a lease. In January of 20XX, CO-12 deposited $ into the ORG's bank account. This represented $ per month for each unit, which is consistent with the revenue that these units earned in 20XX. In subsequent months, Founder, on behalf of CO-12, generally deposited $ per unit, or $ per month, into the ORG account. This is half of what these units commanded as rent in 20XX. From February 20XX to March 20XX, Founder on behalf of

CO-12 typically remitted only $ per month to ORG, although in June of 20XX he deposited $, in July of 20XX he deposited $, in March, June and August of 20XX he deposited $, and he made no deposits in October 20XX, April and July 20XX, and January 20XX (see bank schedule below for details).

BANK DEPOSIT ACTIVITY

20XX		20XX		20XX		20XX	
5-Jan	$	17-Jan	$	7-Jan	$	6-Feb	$
12-Feb	$	27-Feb	$	5-Feb	$	5-Mar	$
13-Mar	$	18-Mar	$	5-Mar	$		$
10-Apr	$	8-Apr	$	31-Mar	$		
6-May	$	10-May	$	2-May	$		
6-Jun	$	14-Jun	$	2-Jun	$		
11-Jun	$	8-Jul	$	30-Jun	$		
9-Jul	$	8-Jul	$	1-Aug	$		
7-Aug	$	7-Aug	$	29-Aug	$		
7-Sep	$	9-Sep	$	22-Sep	$		
9-Oct	$	30-Sep	$	31-Oct	$		
14-Nov	$	8-Nov	$	28-Nov	$		
12-Dec	$	18-Dec	$	31-Dec	$		
	$		$		$		

During this same time period, contrary to the Declaration of Trust and contrary to representations made to the IRS on the application for exemption (Form 1023), ECS) distributed $0 in grants to the charities listed in its Declaration of Trust. By engaging in these acts of self dealing, Founder enriched his company and thus himself at the expense of ORG.

ORG did not make grants to the supported organizations in 20XX, 20XX, or 20XX. Founder did not make a grant from ORG until after he was contacted by the Service on regarding issues related to his purchase of CO-1's Master Financial Plan. In April 20XX, CO-12 executed a lease with ORG. The terms of the lease called for CO-12 to lease the three units at $ per unit per month. At this same time ORG began making grants in accordance with the application for exemption filed in January 20XX. Monthly rental payments should have been $ for the period 20XX through March 20XX. Annual payments should have been $ for the 3 units. CO-12's underpayments began in February 20XX and continued through March 20XX. Total payments for this time period should have been $. Founder, through his vacation company CO-12, only remitted $. This difference of $ was never restored to ORG.

Founder's signature is on both the Declaration of Trust and the application for exemption. These documents plainly state that the net income of ORG will be distributed yearly to the named supported organizations. Founder had control of the finances of ORG. This is evidenced by the

expenditures made out of ORG's bank account. ORG never held a meeting of the Board until it began taking corrective measures subsequent to contact by the Service.

In early 20XX, Founder was contacted by the Service regarding his purchase of the abusive tax scheme sold by CO-1 and the propriety of his charitable contribution deduction. At that point, Founder took action to correct the abuses he had been engaging in. On April 14, 20XX the Board was reconstituted. Founder procured the resignations of BM-2 and BM-3 from the ORG. These Board members were replaced by BM-5 and BM-6. At this point, three of the five members of the Board were comprised of designees of the supported charities. Other business conducted at the Board meeting of April 14, 20XX was the decision to make grants to the named charities. It was resolved that the following grants be made:

Grant Recipient	Amount	Percentage
CO-8	$	35%
CO-10	$	45%
CO-11	$	15%
Total	**$**	**95%**

A review of ORG's bank statements indicate that these grants took place between April 14th and April 30, 20XX. Written leases were also drawn up between CO-12 and ORG in April 20XX. These leases called for each unit to be rented to CO-12 for $ per month. The leases were for the same amounts charged in 20XX. There is no evidence of what the fair market value rental rate would have been in 20XX. There was no indication that the units were offered to disinterested people on the open market. There was no attempt to correct the excess benefit received by Founder or CO-12.

e. Application for Exempt Status

In a letter dated January 17, 20XX, the CO-2, L.C. (an affiliated entity of CO-1) submitted an application for exemption for ORG. The letter of submission that accompanied the 1023 application was signed by BM-7, a principal of the CO-2. This letter contained the following representations:

1. ORG is to be operated in compliance with Section 509(a)(3) of the Internal Revenue Code
2. Funds will be invested by the Trustee.
3. 85% of the net income will be distributed to the named charitable organizations
4. At least 35% of net income will be distributed to CO-8.
5. At least 50% of net income will be distributed among the charities listed on Schedule A.

6. ORG should be considered as a non private foundation under Section (a)(3) of the Code.
7. The Declaration of Trust states that its purpose is to be organized and operated exclusively to carry out the purposes of one or more specified publicly supported organizations.
8. CO-8 will have a significant voice in the investment policies of the Support Trust.

This application for exemption was received by the Service on February 9, 20XX. Pursuant to the application, ORG's purpose is to distribute substantially all of its income to and for the use of various public charities and to help CO-8 (the Primary Charity) carry out its purposes and perform its functions. ORG's Board will assist in educating adults with learning disabilities, with a specific project of donating toward an Endowment Fund for adult literacy.

Each year at least 35 percent of the adjusted net income is to be distributed to the Primary Charity. ORG's Board, which includes a member appointed by the Primary Charity, will work with the governing body 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 85% of the adjusted net income of ORG will be distributed among designated public charities.

The initial board of directors is comprised of the following persons:

- Founder
- BM-1
- BM-2
- BM-3
- BM-4

The application states that ORG has a special relationship with the Primary Charity as one of the Board members is appointed by the Primary Charity. The Board controls the investment policy, the making of grants, and all other activities of ORG. In addition, the Primary Charity is entitled to periodic accountings. The Declaration of Trust requires these accountings to go to the Primary Charity, and local laws allow any beneficiary the right to inspect the records of the organization and demand an accounting at any time.

In addition to the Primary Charity (CO-8), ORG lists the following charities as supported organizations:

(1) CO-9

(2) CO-10

(3) CO-11

The Declaration of Trust does not provide for a majority of ORG's board to be elected or appointed by the supported organizations. Rather, section 3.1.1 of the Declaration of Trust

provides that only one member of the board of directors may be appointed by Primary Charity. There are no appointments from the secondary supported organizations.

Based on the information provided in the application, the Service issued a favorable determination letter to CSO on March 12, 20XX recognizing it as tax exempt under section 501(a) as an organization described in section 501(c)(3) and classifying it as a supporting organization described in section 509(a)(3).

e. **Form 990**

CO-1 prepared ORG's calendar year 20XX Form 990. The table below gives a history of ORG's filings and reported amounts of revenue and expenses on its Form 990:

	20XX	20XX	20XX	20XX	20XX
Revenue -					
Direct Public Support					
Interest on savings and temporary cash Investments					
Net Rental Income					
Total Revenue					
Expenses -					
Program Services					
Management and general					
Fundraising					
Payments to affiliates					
Total Expenses					
Excess or (deficit) for the year					
Nets assets at beginning of year					
Other changes in net assets					
Net assets at end of year					

No returns were filed for 20XX, 20XX, or 20XX. A return was filed in 20XX. In 20XX, ORG recognized $ in net rental revenue and distributed $ to the supported charities.

On its Form 990 for 20XX, ORG stated that its primary exempt purpose is to distribute substantially all of its income to and for the use of various public charities, including the Primary Charity. ORG did not make any grants in calendar year 20XX, 20XX, 20XX, or 20XX. When the Service contacted ORG in 20XX, Founder secured counsel and began to bring ORG into compliance.

LAW:

Internal Revenue Code ("IRC") section 501(c)(3) of the exempts from Federal income tax corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.

Treasury Regulation ("TR") 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.

TR 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.

TR 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.

In Better Business Bureau v. United States, 326 U.S. 279 (1945), the United States Supreme Court held that regardless of the number of truly exempt purposes, the presence of a single substantial non-exempt purpose will preclude exemption under IRC section 501(c)(3).

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 IRC section 501(c)(3).

TAXPAYER'S POSITION:

In late 20XX, in reliance on advice given by CO-1, Founder donated three vacation condominiums to the ORG, and caused the ORG to lease such condominiums to Founder's vacation travel business. The purpose of this arrangement was for the ORG to own appreciating

and income producing real property, which would provide funding for grants to be made by the ORG to the charities named in the ORG's Declaration of Trust.

In early 20XX, CO-1 was put into receivership by the Securities and Exchange Commission. Once that receivership occurred, Founder stopped getting advice from CO-1 and Founder did not know how to proceed with respect to the ORG and other matters involving CO-1. Founder continued with the rental arrangement and accumulated the rental income within the ORG pending further direction. At no time, either prior to the CO-1 receivership proceedings was filed or after, were any funds from the ORG lent or paid to Founder or used for his benefit, either directly or indirectly. Founder simply did not know how to proceed given the uncertainty caused by the CO-1 receivership.

Founder retained counsel in mid 20XX and asked counsel to evaluate the bona fides of the ORG and to advise Founder on how to proceed. As a result of that evaluation, in early 20XX, Founder and counsel determined that the ORG's Board should be reconstituted and should meet, and that the ORG should be administered as outlined in its Declaration of Trust.

In preparation for an ORG Board meeting, Founder obtained the resignations of BM-2 and BM-3 from the ORG Board, to make room on the Board for two additional persons who would be designees of the supported charities named in the ORG's Declaration of Trust. Those resignations were submitted and accepted by the reconstituted Board at a meeting of the ORG Board held on April 14, 20XX. At that meeting, two new Board members were elected by the Board to fill the vacancies.

At this meeting, the following grants were approved:

Grant Recipient	Amount	Percentage
CO-8		35%
CO-10		45%
CO-11		15%
Total		**95%**

These amounts were subsequently paid to these organizations. With these actions ORG was now in compliance with the Service's rules regarding supporting organizations. However, ORG is willing to close this case as an agreed revocation.

GOVERNMENT'S POSITION:

The Service is proposing to revoke the exempt status of the ORG, because ORG is not operated exclusively for exempt purposes as defined under IRC 501(c)(3).

An organization is not described in section 501(c)(3) if 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 (9th Cir. 20XX). Founder transferred assets to the ORG 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 use and benefit of Founder's business, ORG breached the dedication requirement and its net earnings have inured to the benefit of Founder's business.

The promotional materials of CO-1 contain little substance in describing supporting organizations, e.g., how such organizations are operated within the requirements of the Federal tax laws and regulations, charitable purpose and an understanding of the problems an SO seeks to address, recordkeeping and filing requirements, differences between supported organizations, etc. Moreover, the promotional materials do not contain any basic information on how to maintain the SO after it is created, e.g., achieving the mission, creating a business plan and budget, bookkeeping, accounting systems, setting up a bank account, etc. It was not until the Service contacted ORG that Founder sought guidance in how ORG should have operated form the beginning.

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. Founder's business, CO-12, paid less than market rent to ORG from 20XX through early 20XX. It has not been established that it is paying fair market rental since that time. In doing this, ORG breached the dedication requirement and its assets have inured to the benefit of Founder.

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 (6th Cir. 1974). The use of the charity's property for less than fair market rental served the financial interests of CO-12.

ORG was created and operated as part of a tax avoidance scheme. Tax avoidance schemes do not further an exempt purpose. Freedom Church of Revelation v. United States, 588 F. Supp 693, 696 (D.D.C.1984). ORG is operated to enable Founder to engage in financial activities which are beneficial to him and/or entities with whom he is transacting business, but detrimental to ORG. Accordingly, it is operated for a substantial non-exempt purpose. See Revenue Ruling 67-5.

CONCLUSION:

The exempt status of ORG should be revoked, effective December 27, 20XX (date of incorporation). The Service's examination shows that ORG was organized and operated as an integral component of an offshore tax avoidance and asset protection scheme that promised to reduce income taxes, obtain tax-free income from offshore investments, and provide asset protection from unwanted liabilities and encumbrances. This scheme benefited ORG's founder, Founder, and his business (CO-12), in violation of IRC 501(c)(3).

Accordingly, ORG's status as an organization described under IRC section 501(c)(3) should be revoked, effective December 27, 20XX, because it did not operate exclusively for exempt purposes because its assets inured to, and it benefited disqualified persons. Retroactive revocation is appropriate because ORG did not state in its application that it would rent its condominium units to the founder's business (CO-12) on terms more favorable than those an independent renter would pay.

ORG needs to file Forms 1041 for the tax years 20XX, 20XX, 20XX, 20XX, 20XX, and 20XX. The Forms 1041 should be mailed to the IRS at:

ALTERNATIVE ISSUE:

If its tax exempt status is not revoked, whether ORG should be reclassified as a private foundation?

FACTS:

See above

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

Income Tax Regulations section 1.509(a)-4(g)(1) provides guidance on the meaning of "operated, supervised, or controlled by" as follows:

(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 relationship 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 organizations 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 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 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.

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 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 POSITION:

As set forth above, it is the government's primary position that the tax exempt status of the ORG ("ORG") should be revoked. Alternatively, ORG should be reclassified as a private foundation effective December 27, 20XX.

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 (7th Cir. 1979). The CSO 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 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.

Section 509(a)(3) organizations 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.

Operational Test

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, ORG served private interests and its assets and income has benefited Founder and entities related to him. Therefore, ORG has not established that it operated exclusively for the benefit of the specified 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, the facts indicate that there was no substantial control or direction over the policies or activities of ORG by the Primary Charity. There is no evidence that the appointed representative of the Primary Charity ever attended any board meetings. A majority of ORG's governance is not appointed or elected by the specified publicly supported organizations. There is no common supervision or control by the same persons over ORG and the specified publicly supported charities. The requirements to satisfy one of the first two types of relationship have not been met.

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 ORG or into the timing of grants or the selection of recipients. There is no evidence that there were ever any board meetings. As previously stated, there is no evidence that a board member appointed by the Primary Charity ever attended or participated in a board meeting.

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 the trust to the Primary Charity. The Declaration further requires that a total of 50% of the net income shall be distributed to one or more of the secondary beneficiaries. There are three secondary beneficiaries that ORG can select as grant recipients. Only CO-8 is entitled to receive a specified portion of ORG's net income. ORG is not required to make any specified distributions to any of the other organizations. Therefore, ORG has not established that any of the three secondary beneficiary organizations are beneficiaries to the trust or that they have the power to enforce the trust under state law.

Therefore, ORG 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 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 benefit the publicly supported organizations 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. 20XX-300. ORG does not meet this test because it does not perform any activities for or on behalf of the publicly supported organizations. ORG was allegedly set up to make grants to publicly supported organizations but it did not do so.

Because the purpose of ORG was to make grants to 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. ORG does not any of these requirements.

All facts and circumstances are considered in determining whether the "substantially all" requirement is satisfied. Where there is a permanent accumulation of income, or where there is an accumulation of income for an extended period without apparent purpose, the "substantially all" requirement will not be met. While there is no absolute rule with respect to the timing of the distributions, in general a supporting organization will satisfy the "substantially all" requirement if it distributes 85 percent or more of its income to specified publicly supported organizations no later than the end of the year following the year the income is realized. ORG did not distribute any of its income to charities until notified that it was under examination in 20XX. There was no distribution of its net income in 20XX, 20XX, 20XX or 20XX. Therefore, the first requirement is not satisfied.

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 Primary Charity received no funding in 20XX, 20XX, 20XX, or 20XX. Obviously, providing no support is not an amount sufficient to ensure the Primary Charity's attentiveness to ORG's operations.

ORG did not produce any evidence that shows that the Primary Charity was attentive to its operations. There is no evidence that the individual who represented the Primary Charity on ORG's board ever attended or participated in any board meeting. There is no evidence that this

individual was involved in the decisions regarding investments and/or operations of ORG. Nor is there any evidence that the Primary Charity ever requested or received any financial reporting from ORG. Thus, it is apparent that the Primary Charity was not attentive to the operations of ORG.

Please note the discussion under the Control Test that shows that a disqualified person actually controlled ORG.

Control Test

As noted above, Founder is a disqualified person because he is a substantial contributor and board member of ORG. There is no evidence the board ever met until contacted by the Service. There are no minutes reflecting any board meetings prior to April 20XX. There is no evidence that ORG distributed any money to the Primary Charity in 20XX, 20XX, 20XX, or 20XX. There is no evidence the other board members objected or that the board member appointed by the Primary Charity acted to compel ORG to make distributions in accordance with the Trust.

Looking at all pertinent facts and circumstances, it is evident that a disqualified person controlled ORG.

CONCLUSION:

The operational test is not met because ORG operated for the private benefit of Founder's business. The relationship test is not satisfied. The control test is not met because the Founder made all of the decisions regarding the operations of ORG.

Accordingly, if its tax exempt status is not revoked, ORG should be reclassified as a private foundation because it does not qualify as a supporting organization under the requirements set forth in Treas. Reg. section 1.509(a)-4(c) through (j).

This modification of private foundation status is effective beginning December 27, 20XX, because the application did not disclose that there would be no grants to public charities and that ORG's income would be reduced so that Founder' business would benefit, that control would be held by Founder, and that no representative of a public charity would be involved in its operations..

Note:

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