



DEPARTMENT OF THE TREASURY

INTERNAL REVENUE SERVICE

TE/GE: EO Examination

625 Fulton Street, Room 503

Brooklyn, NY 11201

**TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION**

Date: November 16, 2007

Number: 200817048

Release Date: 4/25/2008

UIL: 501.03-01

Legend:

ORG = Organization name Address = address XX = Date

**ORG
ADDRESS**

Taxpayer Identification Number:

Person to Contact:

Identification Number

Contact Telephone Number:

**LAST DATE FOR FILING A PLEADING
WITH THE TAX COURT, THE CLAIMS
COURT, OR THE UNITED STATES
DISTRICT COURT FOR THE DISTRICT
OF COLUMBIA:**

Dear :

This is a final determination regarding your exempt status under section 501(c)(3) of the Internal Revenue Code (IRC). Recognition of your exemption from Federal income tax as an organization described in Internal Revenue Code section 501(c)(3) is retroactively revoked to October 15, 19XX because it is determined that you are not operated exclusively for an exempt purpose.

IRC 501(c)(3) exempts from taxation organizations which are organized and operated exclusively for charitable or educational purposes, no part of the net earnings of which inure 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 do not participate in, or intervene in, any political campaign on behalf of (or in opposition to) any candidate for public office.

We have determined that you are not operating exclusively for charitable or educational purposes. Our examination reveals that you did not operate exclusively for exempt purposes because your assets inured to, and it served the private interests of your creators and other disqualified persons.

We are revoking your exemption from Federal income tax as an organization described

in section 501(c)(3) of the Internal Revenue Code effective October 15, 19XX.

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 all years beginning January 1, 19XX.

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 file a pleading seeking a declaratory judgment in the United States Tax Court, the United States Court of Federal Claims, or the United States District Court for the District of Columbia before the 91st day after the date this final determination was mailed to you. Please contact the clerk of the appropriate court for rules regarding filing pleadings for declaratory judgments and refer to the enclosed Publication 892. You may write to these courts at the following addresses:

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 too-free 1-877-777-4778 and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate.

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

Enclosure:
Publication 892



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
Internal Revenue Service

ORG
ADDRESS

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 an adjustment of your organization's exempt status is necessary.

If you do not agree with our position you may appeal your case. The enclosed Publication 3498, *The Examination Process*, explains how to appeal an Internal Revenue Service (IRS) decision. Publication 3498 also includes information on your rights as a taxpayer and the IRS collection process.

If you request a conference, we will forward your written statement of protest to the Appeals Office and they will contact you. For your convenience, an envelope is enclosed.

If you and Appeals do not agree on some or all of the issues after your Appeals conference, or if you do not request an Appeals conference, you may file suit in United States Tax Court, the United States Court of Federal Claims, or United States District Court, after satisfying procedural and jurisdictional requirements as described in Publication 3498.

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

If you accept our findings, please sign and return the enclosed Form 6018, *Consent to Proposed Adverse Action*. We will then send you a final letter modifying or revoking exempt status. If we do not hear from you within 30 days from the date of this letter, we will process your case on the basis of the recommendations shown in the report of examination and this letter will become final. In that event, you will be required to file Federal income tax returns for the tax period(s) shown above. File these returns with the Ogden Service Center within 60 days from the date of this letter, unless a request for an extension of time is granted. File returns for later tax years with the appropriate service center indicated in the instructions for those returns.

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,

M. Pembroke
Internal Revenue Agent

Enclosures:
Publication 892
Publication 3498
Form 6018
Report of Examination
Envelope

Form 886A	Department of the Treasury - Internal Revenue Service Explanation of Items	Schedule No. or Exhibit
Name of Taxpayer ORG		Year/Period Ended 12/31/XX-12/31/XX

LEGEND:

ORG = Organization name XX = Date Founders = founders City = City
 XYZ = State Director -1, -2, & -3 = 1st, 2nd, & 3rd directors Co-1 thru
 Co-16 = Companies 1st, 2nd, 3rd, 4th, 5th, 6th, 7th, 8th, 9th, 10th, 11th, 12th, 13th,
 14th, 15th & 16th companies FM-1 & FM-21 = Family members 1 & 2

Primary Issue:

1) Whether the IRS Section 501(c)(3) tax exempt status of ORG should be revoked because the Foundation did not have an exclusively exempt purpose and the Foundation's income inured to private shareholders and individuals.

Facts:

During 19XX, Founders became clients of CO-1 (CO-1) in association with CO-2 (CO-2), both corporations with domestic subsidiary units in City, XYZ, with the purpose to:

- “1) Reduce or eliminate income and capital gains taxes while providing annual income to maintain your current standard of living.
- 2) Organize business entities to protect your retirement assets from frivolous litigation and predatory taxation.
- 3) Organize an estate for generational transfer that will be free from estate taxation.”

A plan was devised, dated September 15, 19XX, which the Founders were advised to implement by following specific step by step instructions provided by CO-1. This plan involved the creation of domestic corporations, complex trusts, living trusts, a charitable foundation, partnerships (including a family limited partnership), a domestic entity for the repatriation of foreign funds, foreign corporations and several foreign bank accounts. Founders played active roles in the formation and implementation of this plan. Noteworthy is the cover page of the “Analysis and Recommendations” prepared for Founders by CO-2, dated September 15, 19XX, which contained the following language: “It is strongly recommended that upon implementation of a master plan, this document be sent offshore to the administrative offices of the individual named below, or to the offshore offices of CO-1, or destroyed.”

The charitable vehicle recommended by CO-1 was a supporting organization described in section 501(c)(3) and section 509(a)(3) of the Internal Revenue Code. As described by CO-1, the purpose of the supporting organization was to accept appreciated assets so as to create a tax deduction for the donor and eliminate capital gains tax. In turn, the supporting organization could then loan the assets to controlled domestic and foreign corporations “for a minimal market rate of around 6%”, providing the donors capital for domestic investments and a foreign “tax-free environment” suitable for repatriation of assets.

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ORG ("Foundation") was created on October 15, 19XX, via a Declaration of Trust (Declaration) by and between Founders (Founder) and Founder (Trustee) of City, XYZ. Pursuant to the Declaration, the Foundation was established for the purpose of establishing an organization which is described in Section 501(c)(3) and Section 509(a)(3) of the Internal Revenue Code. Founder-1, Director-1, Director-2 and Director-3 were listed as directors of the Foundation.

The Declaration provides that the Founder renounces any power to determine or control, by alternation, amendment, revocation, termination or otherwise, the income or principal of the Foundation 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 Foundation estate.

Required distributions: Declaration Section 2.2.1 and 2.2.2

Each year, the Trustee shall distribute percent (%) of the net income of the Trust to the CO-2. Net income shall be determined pursuant to the XYZ Revised Uniform Principal and Income Act, section 22-3-1.

Trustee shall also distribute percent (%) of the net income to one or more of the section 501(c)(3) organizations listed on Schedule A, or to CO-2, as is directed by the Board in writing signed by at least three members of the Board. About 100 organizations are listed on Schedule A.

Discretionary distributions: Declaration Section 2.2.3

In addition to the Required Distributions under Sections 2.2.1 and 2.2.2, the Trustee may make such discretionary distributions of the income in excess of Eighty-five (85%) of the net income and principal of the Foundation to one or more of the organizations listed in Schedule A or to CO-2 as is directed by the Board in writing signed by at least three (3) board members.

Final distribution: Declaration Section 2.4

In the event the Trustee determines, in Trustee's sole and complete discretion, that the Foundation is too small to economically administer, then the Trustee shall distribute the Foundation Fund in its entirety outright and free of trust to such organization or organizations as described in Section 170(c)(2) of the Code as the Trustee, in Trustee's total and complete discretion shall determine.

Dissolution: Declaration Section 2.5

Upon winding up and dissolution of this Foundation, after paying or adequately providing for the debts and obligations of the Foundation, the remaining assets shall be distributed to a non-profit

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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 Section 501(c)(3) of the Code.

In the event that the Foundation does not obtain tax exempt status under Sections 501(c)(3) and 509(a)(3) of the Code, the assets of the Foundation shall go to the Founders, as defined herein, as a contingent remainder.

Bond and Compensation: Declaration Section 2.9

The Trustee shall not be required to furnish any bond or surety. The Trustee shall be entitled to a reasonable fee for Trustee's services commensurate with fees charged by corporate trustees in XYZ for similar services.

Liability of Trustee: Declaration Section 2.10

Trustee shall not be answerable for loss in investments made in good faith. Trustee shall not be answerable for any action taken in good faith.

The Board: Declaration Section 3.1.1, 3.1.2, 3.1.3

The Board shall be the body that has the authority, power and discretion as described herein. The Board shall consist of five (5) members. The members of the Board shall be determined as follows: One (1) Board member appointed by CO-2 or its designated agent. Two (2) Board members shall be from the class consisting of Founders and each of their descendants (The Founders). Remaining member (2) shall be appointed by a majority vote of the remaining members of the Board. Initial remaining members shall be Director-1 and Director-2, the latter associated with CO-1.

Factual Background Regarding Specific Income, Assets and Liabilities

The Foundation filed Form 1023 in April 19XX. Based on its representations on the Form 1023, on June 19, 19XX, the Foundation was granted exemption from federal income tax under section 501(a) of the Internal Revenue Code as an organization described in section 501(c)(3). The Foundation was classified as not a private foundation within the meaning of section 509(a) of the Code, because it is described in section 509(a)(3).

Subsequent to the creation of the trust and prior to the Foundation receiving tax exemption from the Service, other ORG "master plan" entities previously described were created. Whether as a result of haste or by actual design, ORG assets which were supposed to have been transferred into the possession of the Foundation as contributions were never legally or physically moved into the Foundation. Most of the ORG's assets, in fact, were transferred to the various other

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entities created. This non transference "oversight" resulted in the misrepresentation of the Foundation's income, assets and liabilities on its Forms 990 from the initial filing in 19XX through 20XX.

CO-5 Note Receivable:

Founder sold his "CO-3" to CO-5 Inc. on July 27, 19XX for \$. Of this amount, \$ was in cash and \$ in the form of a note receivable at 8.5% for 72 months, with monthly payments of \$ payable to Founder. On December 26, 19XX, as step #11 in CO-1's plan for ORG implementation, a \$ CD stemming from the CO-3 sale with a value of \$ was cashed in and the resulting funds deposited in CO-4 – one of the "other" entities created by the Founders, CO-1 and CO-2.

On February 28, 19XX, Founder "assigned all right, title and interest in the Bill of Sale and Purchase Agreement dated July 26, 19XX to ORG". The only asset of the CO-3 sale left to be affected by this assignment was the note receivable with a value of \$ at the time of transfer and a year end value of \$ (\$ per Form 990).

From the time of assignment, the Foundation received \$ per month until the bankruptcy of CO-5 in 20XX. The last payment was received in July, 20XX and the balance owed of \$ was written off on the Foundation's 20XX Form 990.

CO-8 Insurance Policy Payable:

Founder took out a \$ whole life insurance policy on October 11, 19XX with the beneficiary being Founder-1, his wife. Per step #12 of CO-1's "master plan", the Founders personally took out a \$ loan on the policy on January 15, 19XX. Bills for the interest were sent in the name of Founder-1. Per a CO-1 memo, the money was deposited directly into CO-4 account on January 22, 19XX.

The Foundation carried the loan on its Form 990 balance sheet as a liability from 19XX until 20XX, when the loan was paid off with personal funds per Founder-1. The Foundation made interest payments on the loan in the amounts of \$ on December 4, 19XX; \$ on September 25, 20XX; and \$ on November 28, 20XX (actually repaid CO-4 which originally made the payment on October 12, 20XX).

CO-6 Loan Payable and CO-7 Note Receivable:

On January 28, 19XX, Founders received a promissory note from their daughter FM-1 and her husband FM-2 in the amount of \$ ostensibly for the purchase of an CO-7 in City, XYZ. Per Founder's response to a CO-1 inquiry, Founders made two additional loans to FM-1 and FM-2 on November 25, 19XX in the amounts of \$ and \$. On December 9, 19XX, Founders took out a personal loan in the amount of \$ for 20 years from CO-6, using the CO-7 and another piece of property they owned as collateral for the loan. As part of the CO-1 strategy, the Foundation paid the \$ monthly loan payment to CO-6 from September 19XX until the property was sold on September 26, 20XX. FM-1 and FM-2 made payments to Founders on their loans from 19XX until 19XX – no payments were made after that time until the property was sold.

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The Foundation carried the CO-6 loan on its Form 990 balance sheet as a liability, and the CO-7 note receivable as an asset on its balance sheet from 19XX until 20XX when the property was sold. This was done in spite of the fact that all of the loans were personal loans of Founders, the property in question (CO-7) was in the FM-1&2 and ORG's names, and no note receivable to nor payable by the Foundation was ever found (per the ORG's responses to IDR #'s 1 and 2 dated April 22, 20XX and July 1, 20XX respectively). Per the records of CO-4, the CO-7 note receivable was also carried on their books. The Foundation made payments on Founders's personal loan with CO-6 in the years 19XX and 20XX in the amounts of \$ and \$, respectively, and received no reciprocal income benefit. The property was sold in September 20XX with \$ in proceeds. Of these proceeds, \$ went to the retirement of the CO-6 loan; \$ went to settlement costs; \$ went to the FM-1&2; and the balance went to Founders.

Summary of the Foundation's Financial Activity Since Inception in 19XX Relating To Accounting Practices, Charitable Intent, Form 990 Reporting Accuracy, Inurement and Private Benefit is as follows:

19XX Form 990

- 1) The \$ cash contribution, as reflected on line 1d of Part 1, never occurred. This money was actually deposited in the account of CO-4, another of the entities created in accordance with the "master plan" and owned by Founders.
- 2) The \$ in noncash contributions, reflected on line 1d of Part 1 also, could only be verified to the extent of \$ (\$ represented by the CO-5 note receivable and \$ in stock). The balance of \$ claimed as a contribution did not exist as an asset of the Foundation – these funds were actually the property of other entities created in the "plan".
- 3) The charitable deduction of \$ taken by the Founders on their personal 19XX Form 1040 could therefore only be verified to the amount of \$.
- 4) Interest income of \$ reflected on line 4 of Part 1 could not be verified based on available information. The Foundation also reported dividend income of \$.
- 5) Total assets reported on line 59 of Part IV of \$ were overstated by \$. This is partially due to the fact that the \$ reported as savings and temporary cash investments did not exist – these assets belonged to CO-4 with no related obligation to the Foundation (Founder-1 indicated in her response to IDR # 2 that the Foundation had no information relative to the \$ savings and temporary cash investments for this year or any other year – "all handled by CO-1"). The balance of the \$ discrepancy was due to the inclusion of a note receivable of \$ from CO-7 when no note to the Foundation existed.
- 6) The Foundation, in actuality, had no liabilities but Founder chose to list \$ on Form 990. This number was comprised of the \$ CO-8 loan and the balance of the CO-6 loan, both of which were personal liabilities of Founders.

19XX Form 990

- 1) The misrepresentation of assets and liabilities was carried over.
- 2) The Foundation paid CO-6 \$ for the benefit of Founders on their personal loan.

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- 3) The Foundation paid CO-8 \$ for the benefit of Founders on their personal policy loan.
- 4) The Foundation made grants to charity in the amount of \$, all to the CO-2.
- 5) The Foundation reported interest and dividend income in the amount of \$.

20XX Form 990

- 1) The misrepresentation of assets and liabilities continued.
- 2) The Foundation paid \$ to CO-6 for the benefit of Founders on their personal loan.
- 3) The Foundation paid CO-8 \$ for the benefit of Founders on their personal policy loan.
- 4) The Foundation paid \$ in charitable grants, to CO-2, and \$ to CO-9 and paid \$ for Founder to travel to with CO-10.
- 5) The Foundation reported interest and dividend income in the amount of \$. In addition, the Foundation reported a net loss of \$ for sale of assets.

20XX Form 990

- 1) The misrepresentation of assets and liabilities continued.
- 2) The Foundation paid CO-4 \$ to reimburse CO-4 for its payment to CO-8 for the benefit of Founders on their personal policy loan.
- 3) The Foundation paid \$ in charitable grants, to CO-11 and paid \$ for a trip to XYZ for Founder with CO-12.
- 4) The Foundation reported \$ in dividend income.

20XX Form 990

- 1) The misrepresentation of assets and liabilities continued.
- 2) The Foundation made grants to charities in the amount of \$ as follows: \$ to CO-12, \$ to CO-15, \$ to CO-13, \$ to CO-14.
- 3) The Foundation reported interest and dividend income in the amount of \$.

20XX Form 990

- 1) The misrepresentation of assets and liabilities ceased.
- 2) The Foundation made grants to charities in the amount of \$ as follows: \$ to CO-2, \$ to CO-16. \$ to CO-9, \$ to CO-14.
- 3) The Foundation reported interest and dividend income in the amount of \$ and revenue from a settlement in the amount of \$.

Law:

IRC § 501(c)(3) 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

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(including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.

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.

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.

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 section 501(c)(3).

In Founding Church of Scientology v. U.S., 412 F. 2d 1197 (Ct. Cl. 1969) the court stated that loans to an organization's founder or substantial contributor can constitute inurement that is prohibited under section 501(c)(3). In that case, the church made loans to its founder and his family and failed to produce documentation that demonstrated that the loans were advantageous to the church. The church also failed to produce documentation to show that the loans were repaid. Significantly, the court stated that "the very existence of private source of loan credit from an organization's earnings may itself amount to inurement of benefit."

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).

GOVERNMENTS POSITION:

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In order to qualify for exemption under IRC 501(c)(3) of the Internal Revenue Code, an organization must be organized and operated exclusively for charitable purposes. An organization is not organized or operated exclusively for one or more of the purposes specified in subdivision (i) of this subparagraph unless it serves a public rather than a private interest. 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 designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests. The burden of proof is upon the organization to establish that it is not organized or operated for the benefit of private interests.

ORG is not operated exclusively for a public charitable purpose, but rather for the private interest of the creators of the Foundation.

The Founders were active participants in the creation and implementation of the "master plan," a part of which was the creation of ORG. The Foundation never operated exclusively for exempt purposes. Its grants to other public charities were minimal at best. The Founders took a large personal charitable contribution deduction in 19XX for a contribution to the Foundation, much of which was never actually made. The Founders spent significant sums of Foundation funds for their own personal benefit while acting in the capacities of sole trustee, board member, and in actuality the only functioning officials of the Foundation. They initially and continuously misrepresented the financial status of the Foundation to the public as well as to the Internal Revenue Service. In essence, the Foundation was created in conjunction with numerous other entities to serve as a financial vehicle for the interests and benefit of Founders.

Specifically, as previously noted, Founders used \$ of the Foundation's assets to make payments on their personal \$ loan with CO-8, the proceeds of which were used by the Founders personally also. At the same time, the \$ loan was misleadingly carried on the Foundation's balance sheet as a liability. The Founders also used \$ of the Foundation's assets to make payments on a personal loan Founders had with CO-6, at the same time misleadingly recording this loan as liability on the Foundation's balance sheet and recording the CO-7 note receivable as an asset - neither of which was true.

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 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. See *United Cancer Council v. Commissioner*, 165 F3d 1173 (7th Cir. 19XX). By transferring its assets to or

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for the benefit of the Founders, for no consideration, the Foundation breached the dedication requirement and its net earnings have inured to the benefit of the Founders.

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 Foundation has operated since inception primarily for the benefit of its creators and their family.

CONCLUSION:

For these reasons, it is the government's position that the ORG does not qualify for exemption under Internal Revenue Code section 501(a) as an organization described in section 501(c)(3) and its exempt status should be revoked effective October 15, 19XX, because it did not operate exclusively for exempt purposes and because its assets inured to, and it served the private interests of, its creators and other disqualified persons. The Foundation's operations were materially different from the representations that it made in its application for exemption. It did not disclose in its exemption application that it would transfer its assets to and for the benefit of its founders. Thus, retroactive revocation is appropriate.

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

Returns should be sent to the following mailing address:

Internal Revenue Service

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

Internal Revenue Service Center
Ogden, UT

ALTERNATIVE POSITION:

Whether ORG should be reclassified as a private foundation?

Facts:

The Declaration of Trust provides that each year the Trustee shall distribute % of the adjusted net income of ORG (Foundation) to the CO-2 (Primary Charity). The Declaration also provides that the Board of Directors (the "Board") shall consist of five members, including one member appointed by the Primary Charity.

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There is no evidence that representatives of the Primary Charity ever attended or participated in any meetings of the Board of the Foundation. There is no evidence that any financial reporting's were made to the Primary Charity.

The gross revenue of the CO-2, the supported organization that is the Primary Charity, is as follows:

19XX \$
19XX
20XX
20XX
20XX

The Foundation made grants to the CO-2, the supported organization that is the primary charity, as follows:

19XX \$
19XX
20XX
20XX None
20XX None
20XX

Law:

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

Section 509(a)(3) provides that the term "private foundation" does not include an organization that is organized, and at all times thereafter is operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified organizations described in section 509(a)(1) or (2) if the organization is operated, supervised, or controlled by or in connection directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more organizations described in section 509(a)(1) or (2).

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

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

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

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

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

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

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fund raising dinners, and unrelated trade or business to raise funds for the publicly supported organizations, or for the permissible beneficiaries.

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

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

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

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

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

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

(4) General description of relationships.—In the case of supporting organizations which are “operated, supervised, or controlled by” one or more publicly supported organizations, the distinguishing feature of this type of relationship is the presence of a substantial degree of direction by the publicly supported organizations over the conduct of the supporting organization, as described in paragraph (g) of this section. In the case of the supporting organization which are “supervised or controlled in connection with” one or more publicly supported organizations, the distinguishing feature is the presence of common supervision or control among the governing bodies of all organizations involved, such as the presence of common directors, as described in paragraph (h) of this section. In the case of a supporting organization, which is “operated in connection with” one or more publicly supported organizations, the distinguishing feature is that the supporting organization is responsive to,

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and significantly involved in the operations of, the publicly supported organization, as described in paragraph (i) of this section.

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

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

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

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

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

(2) A supporting organization will not be considered to be “supervised or controlled in connection with” one or more publicly supported organizations if such organization merely makes payments (mandatory or discretionary) to one or more named publicly supported organizations, even if the obligation to make payments to the named beneficiaries is enforceable under state law by such beneficiaries and the supporting organization’s governing instrument contains provisions whose effect is described in section 508(e)(1)(A) and (B).

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Such arrangements do not provide a sufficient "connection" between the payor organization and the needs and requirements of the publicly supported organization to constitute supervisions or control in connection with such organizations.

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

(1) General rule

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

(2) Responsiveness test

(i) For purposes of this paragraph, a supporting organization will be considered to meet the "responsiveness test" if the organization is responsive to the needs or demands of the publicly supported organizations within the meaning of this subparagraph. In order to meet this test, either subdivision (ii) or subdivision (iii) of this subparagraph must be satisfied.

(ii)

(a) One or more officers, directors, or trustees of the supporting organization are elected or appointed by the officers, directors, trustees, or membership of the publicly supported organizations;

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

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

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

(iii)

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

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

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

(3) Integral part test; general rule

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

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

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

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

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

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

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

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

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

(1) In general.—Under the provisions of section 509(a)(3)(C) a supporting organization may not be controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more publicly supported organizations. If a person who is a disqualified person with respect to a supporting organization, such as a substantial contributor to the supporting organization, is appointed or designated as a foundation manager of the supporting organization by a publicly supported beneficiary organization to serve as the representative of such publicly supported organization, then for purposes of this paragraph such person will be regarded as a disqualified person, rather than as a representative of the publicly supported organization. An organization will be considered “controlled”, for purposes of section 509(a)(3)(C), if the disqualified persons, by aggregating their votes or positions of authority, may require such organization to perform any act which significantly affects its operations or may prevent such organization from performing such act. This includes, but is not limited to, the right of any substantial contributor or his spouse to designate annually the recipients, from among the publicly supported organizations of the income attributable to his contribution to the supporting organization. Except 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 such persons have the right to exercise veto power over the actions of the organization. Thus, if the governing body of a foundation is composed of five trustees, none of whom has a veto power over the actions of the foundation, and no more than two trustees are at any time disqualified person, such foundation will not be considered to be controlled directly or indirectly by one or more disqualified persons by reason of this fact alone. However, all pertinent facts and circumstances including the nature, diversity, and income yield of an organization’s holdings, the length of time particular stocks, securities, or other assets are retained, and the manner in exercising its voting rights with respect to stocks in which members of its governing body also have some interest, will be taken into consideration in determining whether a disqualified person does in fact indirectly control an organization.

GOVERNMENT’S POSITION:

It is the government’s position that ORG’s exempt status should be revoked. Alternatively, it 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 was

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intentionally inclusive so that all organizations exempted from tax by section 501(c)(3) are private foundations except for those specified in section 509(a)(1) through (4). Roe Foundation Charitable Trust v. Commission, T.C. Memo. 1989-566, 58 T.C.M. (CCH) 402, 404 (1989); Quarrie Charitable Fund v. Commissioner, 603 F.2d 1274, 1277 (7th Cir. 1979). Based on the representations made in its application for exemption, the Foundation received a determination letter from the Service that classified it as a supporting organization described in section 509(a)(3), rather than as a private foundation. The Foundation, however, has never met the requirements for supporting organization classification.

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

IRC section 509(a)(3) organizations must meet all three of the following tests:

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

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

Organizational and Operational Tests

The Foundation does not meet the organizational test, because the Foundation is not organized to benefit one or more publicly supported organizations. Pursuant to Treas. Reg. section 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 organization 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 Foundation. The possible beneficiaries are not limited to the CO-2 or the organizations specified in Schedule A of the Organization'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 power to substitute beneficiaries when, in the judgment

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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. section 1.509(a)-4(e)(1) is not satisfied. A supporting organization will be regarded as "operated exclusively" to support a specified publicly supported organization(s) only if it engages in activities which support or benefit the specified publicly supported organization(s). As was discussed under the Primary Issue above, the Foundation has served private interests and has made payments for the benefit of Founders. Therefore, it has not established that it operated exclusively for the benefit of the publicly supported organization.

The operational test requires the Foundation to exclusively engage in activities that benefit specified publicly supported organizations. In this case the Foundation has made distributions to entities not specified in the Declaration of Trust. In 20XX and 20XX, it made grants to CO-9. In 20XX, it made a grant to CO-11. In 20XX, it made grants to CO-12, CO-15, and CO-13. In 20XX, it also made a grant to CO-16. None of these organizations are listed in its Declaration of Trust or on Schedule A. These grants violate the operational test set forth at Treas. Reg. section 1.509(a)-4(e)(1).

Relationship Test under IRC section 509(a)(3)(B).

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

"Operated, supervised or controlled by" and "supervised or controlled in connection with"

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 by or elected by the governing body, members of the governing body, officers acting in their official capacity or the membership of the publicly supported organization. The "supervised or controlled in connection with" relationship requires common supervision or control by the persons supervising or controlling both the supporting and the publicly supported organizations, i.e., that control or management of the supporting organization is vested in the same persons that control or manage the publicly supported organization.

In the present case, the facts indicate that there was no substantial control or direction over the policies or activities of ORG by the specified publicly supported organization, the CO-2

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Supported Organization. Pursuant to the Declaration of Trust, the specified publicly supported organization could only appoint one member of the five member board. The majority of the members of the governing body (Board of Trustees) consisted of the family members (Founders, Founders), Director-1 and Director-2 (appointed by the Founders). Thus, ORG fails to meet either the "operated, supervised, or controlled by" or the "supervised or controlled in connection with" tests required by IRC 509(a)(3)(B).

"Operated in connection with"

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 (1) the "responsiveness" test, and (2) the "integral part" test. Neither of these tests has been met in this case.

Responsiveness test. ORG does not satisfy the responsiveness test. In order to meet the responsiveness test, either Treas. Reg. § 1.509(a)-4(i)(2)(ii) or (iii) must be satisfied. Income Tax Regulations section 1.509(a)-4(i)(2)(ii) requires a supporting organization to demonstrate that one or more of the officers, director or trustees of the supporting organizations either (a) be appointed or elected by specified representatives of the publicly supported organizations or (b) be members of the governing body of the publicly supported organizations or (c) maintain a close and continuous working relationship with the officers, directors or trustees of the publicly supported organizations. There is no evidence that the officers, directors or trustees of ORG satisfy any of these relationships. Even if such a relationship existed, by virtue of the relationship the officers, directors or trustees of the publicly supported organizations would have to have a significant voice in the investment policies of the supporting organization, the timing of grants, the manner of making grants, the selection of recipients by the supporting organization and in otherwise directing the use of the income or assets of the supporting organization. There is no evidence that the CO-2 Supported Organization has a significant voice in ORG's operations. The board did not exercise oversight – it did not realize that assets reported on the Form 990 did not belong to ORG, it did not assure grants were only made to specified public charities, it did not oversee ORG's operations to prevent its income and assets from benefiting disqualified persons. In short, the board acted as a rubber stamp for actions taken by the Founders and appeared to have no role other than responding to a fax from the Founders and signing the minutes.

If this test is not met, there is a second way to satisfy the responsiveness test that is set forth in Income Tax Regulations section 1.509(a)-4(i)(2)(iii). The second method requires that (a) the supporting organization be a charitable trust under state law; (b) each specific publicly supported organization be a named beneficiary under the trust's governing instrument; and (c) the beneficiary organization have the power to enforce the trust and compel an accounting

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under state law. The Declaration of Trust requires the trustee to distribute % of the net income of the trust to the CO-2 and a total of % of the net income to one or more of the organizations listed on Schedule A. There are over 100 organizations listed on Schedule A that the trustee can select as grant recipients. Only the CO-2 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. Thus this test is also not satisfied by ORG.

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

Integral Part Test: Activities. 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. The Foundation does not meet this test because, while it made some grants to publicly supported organizations, it did not perform any activities for or on behalf of the publicly supported organizations.

Because the Trust did not perform any activities for or on behalf of publicly supported organizations that the publicly supported organizations would otherwise perform themselves, 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. None of these requirements has been satisfied in the instant case.

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(1) Integral part test: "Substantially all" requirement. The supporting organization must pay substantially all of its income to or for the use of one or more publicly supported organizations. Rev. Rul. 76-208, 1976-1 C.B. 161 holds that "substantially all" in this context means at least 85% of the organization's income. 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.

Generally, income for purpose of applying the 85 percent test is reduced by related expenses and excludes contributions received and long-term gains. Also, consistent with section 53.4942(a)-(3)(e) of the private foundation excise tax regulations, a supporting organization may carryover excess distributions for five years following the year in which the excess distribution was made.

The year 19XX was the first year of ORG. During the year 19XX, ORG had net income of \$. Of this amount, grants of \$ were made (all to the Primary Charity) or 73% of net income. In 19XX, the Foundation had net income of \$. No recipients of grants were identified on the 19XX Form 990, though the Foundation claimed to have made a grant of \$, which its checkbook identified as a grant to the Primary Charity. This grant constituted 4% of the Foundation's net income. Therefore, the Foundation did not meet the requirement that "substantially all" of its income be paid to or for the use of one or more publicly supported organizations, because it failed to meet the 85 percent requirement.

(2) Integral part test: Attentiveness requirement. Income Tax Regulations section 1.509(a)-4(i)(3)(iii)(a) provides that the amount of support received by a publicly supported organization must represent a sufficient part of the organization's total support so as to insure its attentiveness. Income Tax Regulations section 1.509(a)-4(i)(3)(iii)(b) provides that a supporting organization can meet the attentiveness requirement, even where the amount of support received by the publicly supported organization does not represent a sufficient part of the publicly supported organization's total support, if it can be demonstrated that support is earmarked for a substantial program of the publicly supported organization that would be interrupted without the supporting organization's support. And finally, Income Tax Regulations section 1.509(a)-4(i)(3)(d) provides that "all pertinent factors...will be considered in determining whether the amount of support received by a publicly supported organization is sufficient to insure the attentiveness of such organization to the operations of the supporting organization." However, the most important factor is the percentage of the publicly supported organization total support that is provided by the supporting organization. Evidence of actual attentiveness, however, is almost as important.

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Income Tax Regulations section 1.509(a)-4(i)(3)(iii)(c) contains examples of organizations that meet the attentiveness test that have the following common factors: 1) the supporting organization pays over all its income, 2) the supporting organization provides all funds for the specific project, and 3) the expense of conducting the program is substantial.

ORG made grants to the CO-2 Supported Organization, the primary charity, as follows:

19XX	\$
19XX	
20XX	
20XX	None
20XX	None
20XX	

The gross revenue of the CO-2, the Primary Charity, was as follows:

19XX	\$
19XX	
20XX	
20XX	
20XX	

In each of the years since its formation, the Foundation's grants amounted to less than .01% of the Primary Charity's total support and are insufficient to insure that the Primary Charity would be attentive to the Foundation's operations. The Foundation did not produce any evidence that shows that the Primary Charity would be attentive to its operations. Because this requirement was not satisfied, the third requirement, a substantial amount of the total support of the organization must go to those publicly supported organizations that meet the attentiveness test, cannot be satisfied.

Disqualified Person Control Test under IRC section 509(a)(3)(C).

Internal Revenue Code section 509(a)(3)(C) and Income Tax Regulations section 1.509(a)-4(j)(1) provides that a supporting organization may not be controlled, directly or indirectly, by disqualified person. The Founders were substantial contributors to ORG and are, therefore, disqualified persons to ORG. Their other family members are also disqualified persons. See section 4946. The Declaration of Trust provides that two board members shall be from the class consisting of Founders and each of their descendants (the "Founders"). One board member is appointed by the Primary Charity. The other board members are appointed by a majority vote so the Founders control the selection of the other two board members by virtue of their 2/3 vote. In addition, the Form 990 for 20XX shows a 7 member board, including the trustee. Of these seven members, four are Founders. Thus, the Founders had 50% or more of

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the total voting power over the Foundation. In addition, the Founders control over the Foundation is reflected by the Foundation's payment of their personal loans.

A review of all the facts and circumstances shows ORG failed the operational test and operational tests under Internal Revenue Code section 509(a)(3)(A). ORG fails the Relationship Test under Internal Revenue Code section 509(a)(3)(b) and the Lack of Disqualified Person Control Test under Internal Revenue Code section 509(a)(3)(C).

CONCLUSION:

Accordingly, if the Foundation's exempt status is not revoked, 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).

The modification of private foundation status is effective October 15, 19XX. Because the application did not disclose that the Primary Charity would not be involved with the activities of the Foundation, that grants would be made to other than specified public charities, that the Foundation would operate for the benefit of the Founders and that the Founders would control the Foundation's activities, retroactive re-classification is appropriate in this case.

The effect of this determination will be that the Foundation is required to file Form 990-PF Return of Private Foundation. Form 990-PF should be filed for tax years ending December 31, XX {Please insert all open years}. Subsequent returns are due no later than the 15th day of the 5th month following the close of the Foundation's accounting period. For tax year 20XX, Form 990-PF is due May 15, 20XX.

Send your returns to the following mailing address:

Internal Revenue Service

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