

Internal Revenue Service

Department of the Treasury
TE/GE Exempt Organizations Examinations
1220 SW Third Avenue M/S O540
Portland, Oregon 97204

Release Number: **200836039**
Release Date: 9/5/08
Date: June 27, 2007
UIL Code: 501.03-01
ORG
ADDRESS

Taxpayer Identification Number:

Form:

Tax Year(s) Ended:

Person to Contact/ID Number:

Contact Numbers:

Telephone:

Fax:

Certified Mail - Return Receipt Requested

Dear

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

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

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

An Appeals officer will review your case. The Appeals office is independent of the Director, EO Examinations. The Appeals Office resolves most disputes informally and promptly. The enclosed Publication 3498, *The Examination Process*, and Publication 892, *Exempt Organizations Appeal Procedures for Unagreed Issues*, explain how to appeal an Internal Revenue Service (IRS) decision. Publication 3498 also includes information on your rights as a taxpayer and the IRS collection process.

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

If we do not hear from you within 30 days from the date of this letter, we will process your case based on the recommendations shown in the report of examination. If you do not protest this proposed determination within 30 days from the date of this letter, the IRS will consider it to be a failure to exhaust your available administrative remedies. Section 7428(b)(2) of the Code provides, in part: "A declaratory judgment or decree under this section shall not be issued in any proceeding unless the Tax Court, the Claims Court, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted its administrative remedies within the Internal Revenue Service." We will then issue a final revocation letter. We will also notify the appropriate state officials of the revocation in accordance with section 6104(c) of the Code.

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

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

Thank you for your cooperation.

Sincerely,

Marsha A. Ramirez
Director, EO Examinations

Enclosures:
Publication 892
Publication 3498
Report of Examination

Form 886A	Department of the Treasury - Internal Revenue Service Explanation of Items	Schedule No. or Exhibit
Name of Taxpayer ORG		Year/Period Ended 20XX12, 20XX12, 20XX12

LEGEND

ORG = Organization name XX = Date XYZ = State City = city
Motto = motto CO-1, CO-2, CO-3, CO-4, CO-5, CO-6, CO-7, CO-8, CO-9, CO-10,
CO-11, CO-12, CO-13, CO-14, CO-15 = 1st, 2nd, 3rd, 4th, 5th, 6th, 7th, 8th, 9th,
10th, 11th, 12th, 13th, 14th, & 15th companies Trustee = trustee Executive
Director = executive director car = car

Issue

Should ORG's tax-exempt status be revoked on the grounds that its net earnings inured to the benefit of its Executive Director?

Facts

ORG ("ORG") is a motto for children of low-income families, and is located in City, XYZ. ORG was incorporated in the State of XYZ on September 8, 19XX, and was granted tax-exempt status as a 501(c)(3) Public Charity on February 27, 19XX. It operates out of the basement of CO-1¹, and is certified by the State of XYZ to provide child care for up to 30 children ages 2- 5 years.

ORG's founder and Executive Director, Executive Director ("E.D.") represents the entirety of ORG's management. She hires and fires, writes and signs checks, accepts payment from parents, prepares and signs ORG's annual Forms 990, and administers payroll. There is no board of directors, and there has not been one since 20XX. Thus, E.D. also represents the closest thing there is to a governing body, and is the only person with apparent authority to legally bind ORG.

The Revenue Agent asked E.D. for a list of the children who received care from 20XX to 20XX. E.D. provided a list for each year, reflecting the following numbers of children cared for:

	<u>Full-time, Full-year</u>	<u>Part-time and/or Part-year</u>
20XX:		
20XX:		
20XX:		

The part-time numbers include "before-and-after" children. These were children who were old enough to attend elementary school and who would be watched for 1 to 2 hours before and 1 to 2 hours after school.

* * * *
¹ ORG is a tenant, and is otherwise unaffiliated with the

Form 886A	Department of the Treasury - Internal Revenue Service	Schedule No. or Exhibit
Explanation of Items		
Name of Taxpayer		Year/Period Ended
ORG		20XX12, 20XX12, 20XX12

During the years under examination, if parents and their children met certain criteria, they received assistance from the XYZ Department of Human Service (DHS). For each parent, DHS mailed a "voucher" to ORG, on which ORG indicated how many hours of child care were provided for the child or children, and what the total charge was. Once this voucher was returned to DHS, a check would be mailed to ORG for the amount charged, less any co-pay that had been determined for the parent. From 20XX through 20XX, ORG charged \$ per child per month for 80 hours of child care, and \$ per child per month for 160 hours or more of child care.

ORG's Forms 990-EZ for the years ended December 31, 20XX, 20XX, and 20XX report the following²:

	<u>20XX</u>	<u>20XX</u>	<u>20XX</u>
Contributions, gifts, grants			
Program service revenue			
Other revenue			
Total Revenue			
Grants and similar amounts paid			
Benefits paid to or for members			
Salaries, compensation, benefits			
Professional fees, contractors			
Occupancy, rent, utilities, maint.			
Printing, publications, postage			
Other expenses			
Total Expenses			
Excess or (deficit)			
Net assets – beginning of year			
Net assets – end of year			

The totals of deposits to ORG's bank account for each year were as follows:

20XX: \$
20XX: \$
20XX: \$

The totals of disbursements from ORG's bank account for each year were as follows:

* * * *

² The Forms 990-EZ, which were prepared by E.D., are not mathematically correct. The Agent asked during a May 31, 20XX interview if E.D. had any workpapers to show how she arrived at the figures on the 20XX Form 990-EZ. She did not (at that point, the Agent had not yet seen the 20XX Form 990-EZ).

Form 886A	Department of the Treasury - Internal Revenue Service Explanation of Items	Schedule No. or Exhibit
Name of Taxpayer ORG		Year/Period Ended 20XX12, 20XX12, 20XX12

20XX: \$
20XX: \$
20XX: \$

ORG was furnished Forms 1099 for payments from the XYZ DHS for each year as follows:

20XX: \$
20XX: \$
20XX: \$

From ORG's bank account each year, a number of checks were written and withdrawals were made to pay E.D.'s personal expenses. Checks were written and electronic fund transfers (EFTs) were made to CO-2 and to CO-3 for the mortgage on E.D.'s personal residence for about \$ per month. Checks were written and EFTs were made to CO-2 for E.D.'s 20XX Car for about \$ per month. During 20XX, checks were written to "CO-4", a local car dealership, for payment on E.D.'s 19XX Car for \$ per month. Each month from 20XX through 20XX, \$ in EFTs went to CO-5. The Agent confirmed during a February 13, 20XX interview with E.D. that she is the beneficiary of this CO-5 account. From 20XX through 20XX, payments were made to Trustee, the trustee in E.D.'s personal bankruptcy (discharged in 20XX), and to CO-6, E.D.'s bankruptcy lawyer. These payments totaled \$ over the three years. From 20XX through 20XX, checks were written and EFTs were made for utilities at E.D.'s personal residence (e.g. cable, electric, water, natural gas) totaling \$. During these years, a number of disbursements were also made for restaurants, hotels, car rentals, clothing retailers, pharmacies, and other non-motto expenses. Finally, a number of checks were written to "cash", to Executive Director and her husband, or did not otherwise specify a payee. These disbursements and all other identified disbursements made for E.D.'s personal expenses have been categorized and totaled below³:

	<u>20XX</u>	<u>20XX</u>	<u>20XX</u>
Mortgage – personal residence			
Car pmts, expenses – Car			
Car pmts, expenses - Car ⁴			
Personal bankruptcy costs			
Utilities – personal			
CO-5 retirement account			
E.D.'s Insurance policy ⁵			
* * * *			

³ The detail of the transactions comprising these amounts is attached at Schedules A, B, and C.

⁴ Payments to "CO-4", a car dealership, for E.D.'s 19XX Car.

Form 886A	Department of the Treasury - Internal Revenue Service Explanation of Items	Schedule No. or Exhibit
Name of Taxpayer ORG		Year/Period Ended 20XX12, 20XX12, 20XX12

Restaurants
Travel, gas stations⁶
Insurance – personal⁷
Misc. credit cards and loans⁸
Misc. retailers, other personal
expenses.⁹
Checks written to “Cash”, “Misc.”,
& other unspecified “Withdrawals”
Total

The Agent requested, in Information Document Requests (“IDRs”) #1 and #2, receipts and invoices to substantiate the disbursements made from ORG’s bank account from 20XX through 20XX. E.D. produced very little such substantiation.

The Agent conducted 3 interviews with E.D.; on January 31, 20XX, on February 13, 20XX, and on May 31, 20XX. Noteworthy statements made and answers given during these three interviews include the following:

January 31, 20XX

- When the Agent asked about ORG’s board of directors, E.D. replied that there hasn’t been a board of directors since 20XX and that the last board meeting was held in 20XX.
- When the Agent asked E.D. what her position in ORG is, she indicated that she is the “owner”.
- When the Agent asked if there was an auto available to any employee for use, including personal use, E.D. replied “no”.

February 13, 20XX

continued footnote

⁵ Since E.D. did not have any compensation reported for herself on either her W2 or the Form 990 beyond the \$, there was no *payroll* from which to deduct INSURANCE payments. The payments were made from ORG’s account irrespective of E.D.’s compensation.

⁶ Includes a number of purchases of gas in amounts of \$ and \$. Also includes hotels, car rentals, and \$ in 20XX to “CO-7” and “CO-8”.

⁷ Includes payments to Insurance which, according to a memo on check stub # is for the Car, Car, and a Car. ORG does not own any vehicles. Also includes payments to CO-9 and CO-10.

⁸ Payments on credit lines (CO-13, CO-14, CO-15). ORG has no such credit lines.

⁹ All other non-motto related disbursements (e.g. CO-10, CO-11, CO-12, etc)

Form 886A	Department of the Treasury - Internal Revenue Service	Schedule No. or Exhibit
Explanation of Items		
Name of Taxpayer	Year/Period Ended	
ORG	20XX12, 20XX12, 20XX12	

- When the Agent asked about the payments made to CO-2 and CO-3, E.D. acknowledged that these were for the mortgage on her house and the loan on her Car.
- E.D. acknowledged that the payments to CO-5 were for her retirement.
- The Agent pointed out that E.D. completed an CO-11 claim form in 20XX in which she stated that her salary was \$ per month, yet her 20XX W2 and the 20XX Form 990 stated that she only made \$ for the year. When asked to explain this, E.D. stated that her salary *used* to be \$ per month, but did not otherwise explain the discrepancy.

May 31, 20XX

- E.D. stated that she and her husband have their own personal bank account, aside from ORG's account:
- When asked if she sometimes deposits money *other than ORG's income* into ORG's account, she stated that she sometimes did. She estimated that this occurred about once a month in 20XX, but less often in 20XX and 20XX.
- The Agent pointed out that the amounts reported on the Forms 1099 from XYZ DHS for 20XX and 20XX were exactly the same as the amounts reported for Program Service Revenue on the Forms 990-EZ, and that this meant that no income from the parents was reported on the 990-EZs. When asked why this was so, E.D. offered no reason and expressed surprise when the Agent pointed out that the 20XX bank statements show over \$ in deposits for the year (whereas the 20XX Form 990-EZ shows only \$ in total revenue).
- When asked what other products she purchases at grocery stores besides food, E.D. replied that she purchases hand soaps, dishwashing liquid, rat traps, deodorizers, sprays, bleach, and other cleaning supplies.
- When asked whether she, at times, purchases food and other wares for herself and her family using ORG's bank account, E.D. replied that she has done so, but normally does not.
- When asked if there was ever an independent board of directors or governing body that documented its intent to compensate her any specified sum, E.D. said "no".

E.D. signed memoranda of contact from these three interviews, affirming these answers and statements, and affirming that a number of the expenditures she made from ORG's bank account were for her personal use or consumption, and not for ORG.

Form 886A	Department of the Treasury - Internal Revenue Service Explanation of Items	Schedule No. or Exhibit
Name of Taxpayer ORG		Year/Period Ended 20XX12, 20XX12, 20XX12

E.D.'s compensation was reported by ORG on Forms 990 and W2 for the years under examination as follows¹⁰:

	Forms 990	Forms W2
20XX		
20XX		
20XX		

A closing conference was held with E.D. June 4, 20XX.

Law

Internal Revenue Code

§501(c)(3) provides for exemption from Income Tax for 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 to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), 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 (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

§501(k) provides that, for purposes of subsection (c)(3), the term "educational purposes" includes the providing of care of children away from their homes if —

501(k)(1) substantially all of the care provided by the organization is for purposes of enabling individuals to be gainfully employed, and

501(k)(2) the services provided by the organization are available to the general public.

Treasury Regulations

* * * *

¹⁰ E.D. was not furnished a W2 for 20XX.

Form 886A	Department of the Treasury - Internal Revenue Service	Schedule No. or Exhibit
Explanation of Items		
Name of Taxpayer	Year/Period Ended	
ORG	20XX12, 20XX12, 20XX12	

§1.501(c)(3)-1(a)(1) of the Treasury Regulations provides that, in order to be exempt as an organization described in section 501(c)(3), an organization must be both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational test or the operational test, it is not exempt.

§1.501(c)(3)-1(c)(2) of the Treasury Regulations 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.

Government's Position

E.D. has benefited inappropriately from her position as Executive Director of ORG. As ORG has had no board of directors since 20XX, there has been no oversight of E.D.'s custody and use of ORG's assets. By writing checks directly from ORG's bank account and setting up electronic fund transfers (EFTs) to pay for such things as the mortgage on her and her husband's personal residence and the car payment on their Car, E.D. has effectively used ORG's bank account as her own personal bank account. In this respect, ORG's net earnings have inured to E.D.'s benefit.

The \$ of compensation reported on E.D.'s W2 and on the Form 990 for the 20XX year would not be a fair compensation for the Executive Director of any motto. It is worth noting then, that E.D. has indicated that she feels that her actions are at least partially justifiable in that she should receive *some* compensation for her work as Executive Director. However, it is inappropriate to bypass any sort of payroll system and to compensate one's self by paying for personal expenses from an employer's bank account. There are no controls to protect ORG's assets in such an arrangement. Moreover, this arrangement circumvents FICA and Federal Income Tax withholding. The summary in the Facts section of this report shows personal use of Motto money totaling \$, \$, and \$ for the years 20XX, 20XX, and 20XX, respectively. While these amounts may be a fair compensation for an Executive Director of a motto, they are not reported as such on E.D.'s W2s or on ORG's Forms 990. Furthermore, the manner in which E.D. received this money is more advantageous than being on a standard payroll, which would be subject to withholding and reporting requirements. Therefore, ORG's net earnings have inured, in substantial part, to E.D.'s benefit. This violates §1.501(c)(3)-1(c)(2) of the Treasury Regulations.

Taxpayer's Position

ORG has not yet indicated its position with respect to this report.

Conclusion

Form 886A	Department of the Treasury - Internal Revenue Service Explanation of Items	Schedule No. or Exhibit
Name of Taxpayer ORG		Year/Period Ended 20XX12, 20XX12, 20XX12

ORG's net earnings have inured to E.D.'s benefit. Rather than being paid an objectively determined level of compensation as an employee, E.D. used ORG's bank account and the funds in it as though they were her own. A breakdown of the percentage of ORG's funds that went to E.D., net of the amounts reported on her Forms W2 and the Forms 990, is presented below:

	Total Motto funds disbursed	Motto funds disbursed to pay E.D.'s expenses	% of disbursements that went to E.D.
20XX			
20XX			
20XX			

The above amounts and percentages represent a substantial amount of inurement. This violates §1.501(c)(3)-1(c)(2) of the Treasury Regulations, and warrants revocation of ORG's tax-exemption effective January 1, 20XX. Form 1120, U.S. Corporation Income Tax Return should be filed for 20XX, 20XX, 20XX, and each year thereafter as long as it remains subject to Federal Income Tax. If the proposed revocation becomes final, appropriate State officials will be notified of such action in accordance with §6104(c) of the Internal Revenue Code.



DEPARTMENT OF THE TREASURY

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

TAX EXEMPT AND GOVERNMENT ENTITIES DIVISION

May 21, 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:

CERTIFIED MAIL – RETURNED RECEIPTS

LAST DATE FOR FILING A PETITION
WITH THE TAX COURT: August 19, 20XX

Dear

This is a Final Adverse Determination Letter as to your exempt status under section 501(c)(3) of the Internal Revenue Code. Your exemption from Federal income tax under section 501(c)(3) of the code is hereby revoked effective January 1, 20XX.

Our adverse determination was made for the following reasons:

Organizations exempt from Federal income tax under section 501(c)(3) of the Code are required to operate exclusively for charitable, educational, or other exempt purposes. Organizations are not operated exclusively for exempt purposes if the net earnings of the organization inure in whole or in part to the benefit of private shareholders or individuals of the organization. See Treas. Reg. § 1.501(c)(3)-1(c)(2). During 20XX, 20XX, and 20XX we have determined your net earnings inured to the benefit of your founder and principal by regularly paying her personal expenses without contemporaneously recording the expenditures as salary or compensation. The funds inuring to your founder were substantial in comparison to your total expenditures and were multiple or repeated over a pattern of years. You have not implemented safeguards to prevent a recurrence of funds inuring to your founder. As such, you have not operated exclusively for exempt purposes and have operated for the benefit of the private interests of your founder in contravention of the requirements of Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii).

Contributions to your organization are no longer deductible under section 170 of the Internal Revenue Code. You are required to file Federal income tax returns on Form 1120. These returns should be filed with the appropriate Service Center for the year ending December 31, 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 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: Internal Revenue Service

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