

LEGEND

ORG = ORGANIZATION

XX = DATE

ADDRESS = ADDRESS

Release Number: **201007076**

Release Date:

Date: 11/25/09

UIL Code: 501.03-00

ORG

ADDRESS

Person to Contact:

Identification Number:

Contact Telephone Number: (

In Reply Refer to: TE/GE Review Staff

EIN:

LAST DATE FOR FILING A PETITION
WITH THE TAX COURT: _____

Dear :

This is a Final Adverse Determination Letter as to ORG' s exempt status under section 501(c)(3) of the Internal Revenue Code.

Our adverse determination was made for the following reasons:

The ORG has not been operating exclusively for exempt purposes within the meaning of Internal Revenue Code section 501(c)(3). You are also not a charitable organization within the meaning of Treasury Regulations section 1.501(c)(3)-1(d). You are not an organization which operates exclusively for one or more of the exempt purposes which would qualify it as an exempt organization. You operate substantially for a non-exempt purpose, for private benefit, and its earnings inure to the benefit of the founders of the organization.

Based upon these reasons, your IRC section 501(c)(3) tax exempt status is revoked effective March 19, 20XX. You have signed Form 6018, "Consent to Proposed Action", agreeing to the revocation of your exempt status under section 501(c)(3) of the Code.

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

You are required to file Form 1041, "US Income Tax Return for Estates and Trusts" for all open years with the appropriate Service Center indicated in the instructions for the return.

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 Advocates Office.

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,

Sunita B. Lough
Director, EO Examinations



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
Internal Revenue Service
1616 Capitol Av Ste Stop 4710 OMA
Omaha, NE 68102-4923

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.

Letter 3618 (04-2002)
Catalog Number 34809F

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

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

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,

Sunita Lough
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 December 31, 20XX December 31, 20XX

LEGEND

ORG - Organization name XX - Date FDN-1 = 1st Founder FDN-2 = 2nd Founder
 Founder family = founder family Founders = founders CO-1 thru CO-16 = 1st, 2nd, 3rd, 4th, 5th, 6th, 7th, 8th, 9th, 10th, 11th, 12th, 13th, 14th, 15th, 16th, 17th & 18th Companies BM-1 thru BM-7 = 1st, 2nd, 3rd, 4th, 5th, 6th & 7th Board Members ED = Executive Director

PRIMARY ISSUE:

Whether the ORG ("Organization") tax exempt status as an organization described in section 501(c)(3) of the Internal Revenue Code ("Code") should be retroactively revoked because it is not operated exclusively for tax exempt purposes and because its net earnings inured to the private benefit of FDN-1, a trustee, founder, board member and substantial contributor, and to FDN-2, a founder, board member and substantial contributor.

FACTS:

Organizing Document

The ORG (the "Organization") was created with a Declaration of Trust (Declaration) by FDN-1 and FDN-2, (each being a "Founder") on March 26, 19XX. The Trustee was FDN-1 ("Trustee"). The Declaration provides that the Organization was created for the purpose of establishing an organization which is described in Code section 501(c)(3) and section 509(a)(3). The Declaration provides that the Founder renounces any power to determine or control, by alteration, amendment, revocation, termination or otherwise, the income or principal of the trust estate and renounces any interest, either vested or contingent, including any reversionary interest or possibility of reverter, in the income or principal of the trust estate.

The Declaration further requires that each year the Trustee shall distribute 35% of the net income of the Organization to the CO-1, the named primary supported organization. In addition to this distribution, each year the Trustee shall distribute a total of 50% of the net income to one or more of the organizations listed on Schedule A. If the Board has not directed the Trustee as to which organizations should receive grants within 7 days prior to April 30 of the year after the income is earned, the Trustee shall determine the grant recipients.

Per the Declaration, distributions in excess of 85% of the Organization's net income must be authorized by at least three board members, in writing. Further, the primary supported organization can only be changed if the specified primary charity is not an organization to which supporting organizations can make distributions.

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There are 108 organizations listed on Schedule A. Some of the organizations include “affiliated organizations,” such as “CO-2 and affiliated organizations.”

The Declaration provides that the Board shall be the governing body of the Organization and that the members of the Board shall be determined as follows:

- One Board member shall be appointed by the CO-1 or its designated agent
- Two Board members shall be from the class consisting of FND-1 and FND-2 and their descendants (the Founder Family)
- The Other Members of the Board shall be appointed by a majority vote of the Board. The initial remaining Board members were BM-1 and BM-2
- The Founders appointed successor Other Members of the Board and they were BM-3 and BM-4 to replace BM-1 and BM-2.

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

The Declaration provides that if the Trustee determines the trust fund is too small to economically administer, the Trustee shall distribute the trust fund in its entirety outright and free of trust to such organizations described in section 170(c)(3) as the Trustee shall determine.

By letter dated March 19XX, the Organization was recognized by the Service as exempt from Federal income tax under section 501(a) as an organization described in section 501(c)(3) and classified as a supporting organization described in section 509(a)(3). The Service’s determination letter was based on the Organization’s representations concerning its proposed operation and the supporting documents it submitted during the application process. The Organization did not disclose during the application process that it would lend virtually all of its assets to disqualified persons and would not enforce the loan terms.

On July 1, 20XX, the Declaration of Trust was amended to provide that references to CO-1 are to be deleted and in its place CO-3 (an organization affiliated with CO-4) is to be substituted. It was signed by the following Board of Directors: FDN-1, FDN-2 and BM-2. BM-5, the person purportedly appointed by CO-1, did not sign the amended Declaration of Trust. There are no board minutes that reflect the board voted on the amendment. At the time of the amendment, the CO-1 was recognized as a public charity. It appears that the Organization could have continued to provide support to CO-1. Despite the July 1, 20XX amendment, the Organization continued to list the supported organization as the CO-1 on its Forms 990.

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An April 16, 20XX letter from CO-3 is addressed to the Founders personally and not to the Organization. The letter states that the donation upgraded the Founders' membership to CO-5 (\$) and they would receive exclusive benefits as a Legacy member.

A June 11, 20XX letter from the Organization's CPA firm states that all contributions to the Organization were made by FDN-1 and FDN-2.

Although its governing instrument and its application representations indicated that the Organization would not be controlled by disqualified persons, the Organization appears to have held only two Board meetings through November 20XX. No known Board meetings were held after November 14, 20XX.

Income and grants

The following income and grants were reported on the Organization's Forms 990:

	20XX	20XX	20XX	20XX
Income				
Interest				
Contributions				
Total				
Grants				
CO-1 (received \$ and \$ in 19XX and 19XX, respectively)				
CO-2 (CO-6)				
CO-3 (received \$ in 19XX)				
CO-7				
CO-8				
CO-9				
CO-10				
CO-11				
CO-12				
CO-13				
Total				

No grants were given in 20XX to the primary supported organization, CO-1. The Organization's 20XX trial balance shows \$ in grants not listed above paid to "other".

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More than 85% of the Organization's net income was granted to charities without approval of three members of the board of directors, in writing.

The Organization does not conduct any independent charitable activities, it only provides grants.

In 20XX, the Organization started giving grants to organizations that were not listed on Schedule A of its Declaration as supported organizations. It gave a total of \$ to CO-9, CO-11, CO-10, CO-12 and CO-14 (\$ in 20XX not listed above) organizations not listed on the Schedule A.

From inception, the Organization gave grants to CO-6, part of the CO-2 (CO-2). CO-2 is listed on Schedule A. The memo line on the checks for the grants frequently showed the grants were actually tithes.

Balance Sheet (end of year)

The following are the Organization's assets per its Forms 990:

	20XX	20XX	20XX	20XX
Cash				
Other notes and				
Loans receivable				

Loans

The Organization's Forms 990 show three loans. Per the Forms 990, all three loans were made to FDN-1 and FDN-2. There is written documentation to support the loans.

LOANS	
	Per Exam Form 990
20XX	
20XX	
20XX	
20XX	
20XX	

FIRST LOAN:

\$ Promissory Note
Stated 8% interest rate

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Loan date March 19, 20XX

Interest only until March 19, 20XX

Loan term: All principal and interest due in full on March 19, 20XX

Borrowers: FDN-1 and FDN-2

Lender: ORG(no signature for the Organization)

Security: March 19, 20XX Trust Deed on real property (no evidence of recording; signed by FDN-1 and FDN-2 as Trustees of the FND-1 and FDN-2 Trust; not signed on behalf of the Organization) and March 19, 20XX Quit-Claim Deed (no evidence of recording; not signed on behalf of the Organization)

Promissory Note replaced with Revised Promissory Note (Revolving Line of Credit) signed by FDN-1 and FDN-2 but not by the Organization for \$ at 5% effective January 1, 20XX; no maturity date;

A Trust Deed Note dated March 19, 20XX is signed by FDN-1 and FDN-2 as Trustees of the FND-1 and FDN-2 Trust as borrower; the lender is the FDN-1 and FDN-2

for a line of credit in the amount of \$, with 8% interest per annum and monthly interest-only payments until March 19, 20XX when all principal and interest becomes due. The document sets forth that it is secured by a Deed of Trust of even date. This document is not recorded. A Trust Deed dated March 19, 20XX was signed by FDN-1 and FDN-2, Trustees of the FND-1 and FDN-2 Trust. The Trust Deed names the FND-1 and FDN-2 Trust as Trustor, BM-2, a member of the CO-15, as Trustee, and the ORG as Beneficiary. The Trust Deed purports to secure real property for the trust deed note. The Founders' signatures were notarized on March 19, 20XX. There is no evidence that the Trust Deed was recorded. A Quit-Claim Deed from FDN-1 and FDN-2 individually to the "FND-1 and FDN-2 Trust" is dated March 19, 20XX. The Quit-Claim Deed is signed by FDN-1 and FDN-2 individually. There is no evidence that the Quit-Claim Deed was recorded.

A Memorandum of a ORG Board meeting apparently held on April 13, 20XX reflects that the Board members present, FDN-1, FDN-2, BM-5 (by conference call) and BM-2 BM-2, unanimously approved the \$ loan to FDN-1 and FDN-2 as a line of credit secured by a second trust deed on the Founders residence. Although the Memorandum contains signature lines for FDN-1 as Trustee and for all five board members, there is no evidence of any signature on the Memorandum.

Per the Organization, the loan was orally extended each year so long as all interest payments were made. Thus, the funds were not repaid.

SECOND LOAN:

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Name of Taxpayer ORG		Year/Period Ended December 31, 20XX December 31, 20XX

\$ Promissory Note

Stated 8% per annum interest rate

Loan date May 15, 20XX

Interest only payments of \$ starting June 15, 20XX and every 15th day of each month thereafter until May 15, 20XX

Loan term: All principal and interest due in full on May 15, 20XX

Borrowers: FDN-1 and FDN-2 (both signed)

Security: Trust deed on real property (no evidence of recording; signed by FDN-1 and FDN-2 as Trustees of the FND-1 and FDN-2 Trust)

Promissory Note replaced with Revised Promissory Note (Revolving Line of Credit) signed by FDN-1 and FDN-2 but not by the Organization for \$ at 5% effective January 1, 20XX; no maturity date

A Trust Deed Note dated May 15, 20XX is signed by FDN-1 and FDN-2 as Trustees of the FND-1 and FDN-2 Trust as borrower; the lender is the FDN-1 and FDN-2 for a line of credit in the amount of \$, with 8% interest per annum and monthly interest-only payments in the amount of \$ until May 15, 20XX when all principal and interest becomes due. The document sets forth that it is secured by a Deed of Trust of even date. This document is not recorded.

Per the Organization, the loan was orally extended each year so long as the interest was paid. The note reflects that the loan is secured by a Trust Deed. No Trust Deed secured this note.

THIRD LOAN:

\$ Promissory Note

Stated 8% per annum interest rate

Loan date October 15, 20XX

Interest only payments of \$ due on or before the 15th day of each month until May 15, 20XX.

Lender may demand repayment of all or a portion of the principal amount at any time. The entire amount outstanding shall become fully due and payable on the death of Seller. [The ORG explained in a June 11, 20XX response that the word "Seller" was mistakenly left in the document from a form document and that the word would be interpreted to mean the Foundation as lender.] No prepayment penalty.

Loan term: All principal and interest due in full on May 15, 20XX

Borrowers: FDN-1 and FDN-2 (both signed; no signature for the Organization)

Security: Trust deed on real property (no evidence of recording; signed by FDN-1 and FDN-2 as Trustees of the FND-1 and FDN-2 Trust)

Promissory Note (no evidence of recording) signed by FDN-1 and FDN-2 but not by the

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Organization replaced with Revised Promissory Note (Revolving Line of Credit) (no evidence of recording) for \$ at 5% effective January 1, 20XX, and no maturity date

Per the Organization, the loan was orally extended each year so long as the interest was paid.

Each of the \$, \$ and \$ Promissory Notes includes a footnote stating that they replace original Promissory Note referenced in the Trust Deed recorded September 6, 20XX, as Entry No. _____, and _____ respectively, with the CO-16, "which is now unable to be located." It is unclear whether the document(s) which cannot be located is the purportedly recorded Trust Deed, or the original Promissory Notes. The Trust Deed referenced only encompasses the \$ note. The spaces into which the maturity date and the due date for principal and interest are to be written are left blank. All three Revised Promissory Notes state they are effective January 1, 20XX, but there is no indication when they were actually signed. All three revised Promissory Notes are signed by FDN-1 and FDN-2 as borrowers. None of the three includes a signature on behalf of the FDN-1 and FDN-2

The Forms 990 for 20XX through 20XX did not provide any information about the loans. The Form 990 for 20XX reported the interest rate for all three notes to be 5%. The prime interest rate at the time was 5.25%. The mortgage interest rate at the time was 5.86%. The loans were secured by the real property for which the loans were taken; however, signatures, proper authorization from the Organization and recording are in question. The loans were reported on the Forms 990 as loans receivable rather than as receivables from officers, directors, etc.

Based on the documentation described above it appears that the Organization will continue to loan money to the Founders because they now have Revolving Lines of Credit without maturity dates. Correspondence from the Founders dated March 25, 20XX noted that all the notes were secured with a Trust Deed. Only one Trust Deed was provided. As discussed above, it only secures the \$ loan. There is no evidence that any of the loan documents were recorded.

Based on a review of the Organization's bank deposits, none of the loans were being repaid on a regular basis. It appears that several months go by without any payments. The Organization does not receive any penalty payments for late payments of loan amounts due. The correct amount of interest was paid without consideration of late payments by the end of the year but regular monthly interest payments were never made for the 20XX and 20XX time periods. The Form 990 for 20XX did not report any interest income. Instead it showed the interest payment as a principal payment of \$ and decreased the loan balance. The Form 990 for 20XX showed \$ for interest income and \$ was shown as a principal payment, again decreasing the

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loan balance. On June 11, 20XX, correspondence received from the Organization explained its error in 20XX and 20XX in applying interest payments to the principal. The Organization corrected the loan balance to the original amount of \$\$\$. The correspondence also stated the correct interest payments for both 20XX and 20XX was \$ and \$, respectively. Furthermore, the Founders made payments totaling \$ for 20XX and \$ for 20XX. The Organization had been advised by letter dated January 24, 20XX that it was under examination.

During the application process, the Organization did not disclose that Organization funds were going to be loaned to FDN-1 and FDN-2 or their trust. There is no evidence that any of the loan documents were recorded, or that the Organization properly authorized the loans.

At a minimum, the Organization transferred, purportedly as loans, \$\$\$ of its funds to FDN-1 and FDN-2 or their trust in 20XX, to be repaid in 20XX. Interest was paid annually but not in accordance with the loan terms. The loans were orally extended each year. The Organization erroneously applied interest payments to the principal balance in 20XX and in 20XX. The Organization entered into new loan agreements with the Founders dated January 1, 20XX, and reduced the interest rate on all three loans. It was represented that all three loans were secured but only the smallest loan was secured and recording of that secured interest is not established. Proper authorization of the loans by the Organization has not been established.

The Foundation's trial balances for each of the years 20XX through 20XX show the same amount in receivables, \$\$\$\$. This amount is the total principal amount of the three loans to the Founders.

Minutes

The Organization has minutes of the first meeting of the Board held on March 26, 19XX. These minutes pertain to how the Organization would operate. Item 12 says that "this Trust need not have any employees in the sense that no one will be carried on a payroll as such. That is to say, that this Trust need not withhold State or Federal income taxes or Social Security taxes. All its executives, agents or other employees, will be remunerated as consultants, receiving consultant fees on a contract basis, and any and all remuneration paid to them will be reported by this Trust at the year end on IRS Form 1099."

A Memorandum of a ORG Board April 13, 20XX meeting reflects that the Board members present, FDN-1, FDN-2, BM-5 (by conference call) and BM-2 BM-2, unanimously approved the \$ loan to FDN-1 and FDN-2. Although the Memorandum contains signature lines for FDN-1 as Trustee and for all five board members, there is no evidence of any signature on the Memorandum.

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A November 14, 20XX document, which appears to be in the nature of minutes of a ORG Board meeting, states that by majority vote BM-6 and BM-7 were instated as Board members. The document states that BM-2 resigned from the Board as a trustee in spring 20XX, and that BM-1 was removed as a trustee by majority vote effective July 20XX. Those signing the document are FDN-1, FDN-2 and ED. The three remaining Board members were FND-1 and FDN-2 and ED. ED is the Executive Director of the CO-3. No minutes of 20XX meetings were provided to explain or contemporaneously document the referenced spring 20XX or July 20XX actions.

A February 1, 20XX document on Organization letterhead states that BM-6 and BM-7 were appointed to the Board in November 20XX because "we needed to replace BM-1 and BM-2." The document states that "we changed our financial management services from CO-17 to CO-18." The document states that BM-6 and BM-7 are "trusted business friends" and that they are not affiliated with the new financial management services from CO-18. However, the Organization on its Forms 990 for 20XX and 20XX continued to reflect that its Board was composed of FDN-1 and FDN-2, BM-2 BM-2, BM-1 and BM-5.

These were the only minutes provided by the Organization.

Tithing

The Organization's 20XX General Ledger reflects entries for "tithing" as follows:

Date	Amount
2-15-20XX	\$
12-12-20XX	
12-12-20XX	
Total	\$

Checks for the above payments were written to CO-6 which is part of CO-2. The Organization asserts that these amounts were grants to the CO-3 in 20XX.

LAW - PRIMARY ISSUE:

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

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Treas. Reg. Section 1.501(c)(3)-1(a)(1) provides that in order to be exempt as an organization described in Code section 501(c)(3), the organization must be one that is both organized and operated exclusively for one or more of the purposes specified in that section.

Treas. Reg. 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 Code 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.

Treas. Reg. section 1.501(c)(3)-1(c)(2) provides that an organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals. The words "private shareholder or individual" refer to persons having a personal and private interest in the activities of the organization. The term "private shareholder or individual" is defined in Treas. Reg. section 1.501(a)-1(c).

Treas. Reg. section 1.501(a)-1(c) defines "private shareholder or individual" for purposes of section 501 as "persons having a personal and private interest in the activities of the organization."

Treas. Reg. section 1.501(c)(3)-1(d)(1)(ii) provides that an organization is not organized or operated exclusively for exempt purposes unless it serves a public rather than a private interest. 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. An organization does not serve a public rather than a private interest within the meaning of Treas. Reg. section 1.501(c)(3)-1(d)(1) if any of its assets or earnings inure to the benefit of any insiders (or disqualified persons).

Treas. Reg. section 1.6033-2(i)(2) provides that, "[e]very organization which is exempt from tax, whether or not it is required to file an annual information return, shall submit such additional information as may be required by the Internal Revenue Service for the purpose in inquiring into its exempt status and administering the provisions of subchapter F (section 501 and following), chapter 1 of subtitle A of the Code...."

In Better Business Bureau v. United States, 326 U.S. 279 (1945), the Supreme Court stated that an organization is considered to be "operated exclusively" for exempt purposes if it engages primarily in activities which accomplish one or more exempt purposes. The presence of a single noncharitable purpose, if more than insubstantial in nature, will preclude exemption under

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section 501(c)(3) of the Code regardless of the number or importance of the charitable purposes. See also, Church By Mail, Inc. v. Commissioner, 765 F.2d 1387 (9th Cir. 1985); Copyright Clearance Center v. Commissioner, 79 T.C. 793, 804 (1982).

Whether an organization satisfies the operational test is a question of fact to be resolved on the basis of all the evidence presented by the record. Church of Scientology of California v. Commissioner, 83 T.C. 381, 474 (1984), *aff'd*. 823 F.2d 1310 (9th Cir. 1987); Leon A. Beeghly Fund v. Commissioner, 35 T.C. 473, 518 (1960).

When an organization operates for the benefit of private interests, such as designated individuals, the creator or his family, or persons directly or indirectly controlled by such private interests, the organization by definition does not operate exclusively for exempt purposes. American Campaign Academy v. Commissioner, 92 T.C. 1053, 1065-66 (1989).

In Church of World Peace, Inc. v. Commissioner, T.C. Memo 1994-87, *aff'd*, 75 A.F.T.R.2d 2082 (10th Cir. 1995), the Tax Court held that a church did not operate exclusively for religious purposes because the church facilitated a circular tax-avoidance scheme. The facts showed that individuals made tax-deductible contributions to the church. The court found that the church then returned the money to the individuals without substantiating that the payments furthered any purpose described in 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). 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 Help the Children, Inc. v. Commissioner, 28 T.C. 1128 (1957), an organization operated bingo games. Its charitable function consisted of contributions to charitable institutions of amounts that were insubstantial when compared to gross receipts from the bingo games. The court held that the organization did not qualify for exemption under Code section 501(c)(3) because it did not operate any charitable institutions and its principal activity was the profitable operation of bingo games on a business or commercial basis.

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

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foundation did not operate a charitable program commensurate in scope with its financial resources, rather the foundation was only able to carry out minimal charitable activities. The Revenue Ruling stated 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 tax exemption under section 501(c)(3).

In Revenue Ruling 64-182, 1967 CB 186, a corporation organized exclusively for charitable purposes derived its income principally from the rental of space in a large commercial office building which it owns, maintains and operates. The charitable purposes of the corporation are carried out by aiding other charitable organizations, selected in the discretion of the governing body, through contributions and grants to such organizations for charitable purposes. The Revenue Ruling deemed the corporation to meet the primary purpose test of Treas. Reg. section 1.501(c)(3)-1(e)(1), and to be entitled to tax exemption as a corporation organized and operated exclusively for charitable purposes within the meaning of Code section 501(c)(3), because the organization through such contributions and grants carried on a charitable program commensurate in scope with its financial resources.

Effective date of revocation

An organization may ordinarily rely on a favorable determination of exempt status under Code section 501(a) or the corresponding provision of prior law received from the Internal Revenue Service. Treas. Reg. section 1.501(a)-1(a)(2).

A determination letter or ruling recognizing exemption may not be relied upon if there is a material change, inconsistent with exemption, in the character, the purpose, or the method of operation of the organization. A determination letter or ruling may be revoked retroactively if the organization omitted or misstated a material fact, or operated in a manner materially different from that originally represented. Where there is a material change, inconsistent with exemption, in the character, the purpose, or the method of operation of an organization, revocation or modification will ordinarily take effect as of the date of such material change. Treas. Reg. section 1.501(a)-1(a)(2); Rev. Proc. 2008-9; 2008-2 I.R.B. 258, section 12.01.

GOVERNMENT POSITION - PRIMARY ISSUE:

Analysis

The Organization was not operated exclusively for charitable purposes within the meaning of Code section 501(c)(3). The Organization violated Treas. Reg. sections 1.501(c)(3)-1)(c)(2) and 1.501(c)(3)-1(d)(1)(ii) by allowing FDN-1 and FDN-2, founders, board members and substantial

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contributors, to borrow a substantial amount of Organization assets without requiring repayment, with forgiveness of missed interest payments and with slightly below market rates.

Even though the Organization did make grants which furthered its exempt purpose, the amounts were insubstantial in comparison to the private use of the Organization's assets. The Organization was operated primarily to serve the private interests of FDN-1 and FDN-2 by allowing them to personally use more than an insubstantial amount of its assets for non-exempt purposes over a period of years. The Organization provided non-incidental benefits to FDN-1 and FDN-2 that served their private interests as opposed to charity. The Organization's assets inured to FDN-1 and FDN-2's benefit.

The Organization's income and grants totals from 20XX through 20XX are as follows:

	20XX	20XX	20XX	20XX
Income Total				
Grants Total				

During this same time period, the Organization continued loaning FDN-1 and FDN-2 \$ year to year. The Organization has not established that the loans were properly authorized. It appears that the loans were authorized, if at all, by a vote for which FDN-1 and FDN-2 constituted a majority. The loan documents do not appear to have been recorded. The loans were not repaid but rather were extended seriatim and orally until the loans were redrafted in 20XX at a reduced interest rate. When the Organization came under audit in 20XX, some loan repayment was made, for the first time, approximately five years after the original loan dates.

The Founders are not members of a charitable class and are not permissible beneficiaries of the Organization. The "loans" to FDN-1 and FDN-2, as evidenced by the inconsistent interest payments, put Organization assets at risk. There is no evidence that the loans were secured. The documents that purport to represent security on the "loans" were not recorded. Further, the Organization was not paid late fees when the Founders failed to make timely payments of interest. The loans benefited the Founders because it enabled them to claim a charitable contribution deduction and retain complete access to the funds that supported the deduction. Moreover, no evidence was supplied to show that the Founders could have secured similar loans on similar terms from an independent lender. The Organization engaged in operations which were beneficial to its founders and detrimental to it. FDN-1 and FDN-2 were able to claim a charitable contribution deduction, and subsequently use the funds for their personal benefit.

The loans were made at a slightly below market interest rate. However, even if the interest rate was reasonable, private benefit does not require that payments for goods or services be

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unreasonable or exceed fair market value where a private shareholder or individual benefits. In est. of Hawaii v. Commissioner, 71 T.C. 1067 (1979), the Tax Court stated, “[r]egardless of whether the payments made by petitioner to International were excessive, International and Est, Inc., benefited substantially from the operations of petitioner.”

Similarly, in Church by Mail v. Commissioner, 765 F. 2d 1387 (9th Cir. 1985), *aff’g* T.C. Memo. 1984-349, the Tax Court found it unnecessary to consider the reasonableness of payments made by the applicant to a business owned by its officers. The Ninth Circuit Court of Appeals, affirming the Tax Court’s decision, stated, “[t]he critical inquiry is not whether particular contractual payments to a related for-profit organization are reasonable or excessive, but instead whether the entire enterprise is carried on in such a manner that the [private party] benefits substantially from the operations of the Church.”

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). Even if the transaction is characterized as an investment, when a charity’s investments are decided in part by the needs of private interests, the charity is not operating exclusively for exempt purposes. Western Catholic Church v. Commissioner, 73 T.C. 196 (1979), *aff’d*, 631 F.2d 736 (7th Cir. 1980).

The Court in Orange Co. Agricultural Society, Inc. v. Commissioner, 893 F.2d 529 (2d Cir. 1990) found private inurement and private benefit when an exempt organization loaned money to a for-profit organization controlled by the exempt organization's largest shareholders. Although some loans were repaid, the total amount was not repaid.

In Easter House v. United States, 12 Cl. Ct. 476 (1987), *aff’d. without opinion*, 846 F.2d 78 (Fed. Cir. 1988), the Court found that the organization was not exempt because it provided a source of loans to other organizations that were non-exempt and all the organizations were controlled by the same person.

In John Marshall Law School v. United States, 228 Ct. Cl. 902 (1981), the Court upheld the revocation of an organization's tax exempt status based in part on interest-free loans from the organization to a founder. The Court noted that the lost interest provided benefit to the founder but provided no financial benefit to the organization, and that the unsecured notes subjected the organization to uncompensated risks for no business purpose. The Court also noted that the founder could not have received such interest-free unsecured loans from banks or other lending institutions.

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A charity's assets are required to be irrevocably dedicated to charitable purposes. Treas. Reg. section 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. The Organization's loans to FDN-1 and FDN-2 were not enforced. This breaches the requirement that the Organization's assets be dedicated to charitable use and instead allowed its assets to inure to the benefit of founders FDN-1 and FDN-2.

Further, the Founders may have been taking a charitable contribution deduction personally for grants made by the Organization as indicated by the April 16, 20XX letter from CO-3 addressed to the Founders personally, relating to the Organization's grant. This appears to be further use of charitable funds for private benefit.

Effective Date of Revocation

While revocation of a determination letter is generally not retroactive, revocation of a determination letter may be retroactive if the organization omitted or misstated a material fact or operated in a manner materially different from that originally represented. In cases where the organization omitted or misstated a material fact, revocation may be retroactive to all open years under the statute. In cases where revocation is due to a material change, inconsistent with exempt status, in the character, the purpose, or the method of operation, revocation will ordinarily take effect as of the date of the material change. In any event, revocation will ordinarily take effect no later than the time at which the organization received written notice that its exemption ruling or determination letter might be revoked. Rev. Proc. 2008-9, 2008-2 IRB 258.

In its application, the Organization did not disclose that it would loan substantial amounts of its assets to its founders. The Organization began entering into "loans" with its founders on March 19, 20XX. This constituted a change in its operations as represented in the Organization's application for exemption. The change in operations was material to its exemption because if disclosed the Service could have determined that a substantial part of the Organization's activities would serve its founders private interests and that its assets would inure to the benefit of its founders. Therefore retroactive revocation to the date the Organization's assets were first returned to its donors is appropriate. This determination is effective March 19, 20XX.

TAXPAYER'S POSITION - PRIMARY ISSUE:

Power of Attorney wants to read the Revenue's Agent Report .

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CONCLUSION - PRIMARY ISSUE:

The ORG tax exempt status under Code section 501(a) as an organization described in Code section 501(c)(3) should be retroactively revoked to March 19, 20XX, because the Organization was not operated exclusively for charitable purposes. The Organization served the private interests of FDN-1 and FDN-2 and its assets inured to their benefit.

Form 1041 U.S. Income Tax Return for Estates and Trusts should be filed for all prior open tax years. 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

ALTERNATE ISSUE:

In the alternative, whether the ORG should be reclassified as a private foundation because it is not a supporting organization as defined in section 509(a)(3).

LAW - ALTERNATE ISSUE:

Code section 509(a) provides that organizations described in section 501(c)(3) are private foundations unless they are described in section 509(a)(1)-(4).

Code section 509(a)(3) excepts from private foundation classification organizations that are: (A) organized, and at all times thereafter 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 subsections 509(a)(1) or 509(a)(2); (B) operated, supervised, or controlled by or in connection with one or more organizations described in subsections 509(a)(1) or 509(a)(2); and (C) not controlled directly or indirectly by one or more disqualified persons other than foundation managers and other than organizations described in subsections 509(a)(1) or 509(a)(2).

Treas. Reg. section 1.509(a)-4(c) regarding the organizational test a Code section 509(a)(3) organization must meet provides:

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

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

Treas. Reg. section 1.509(a)-4(e) regarding the operational test a Code section 509(a)(3) organization must meet provides:

(1) *Permissible beneficiaries.* —A supporting organization will be regarded as “operated exclusively” to support one or more specified publicly supported organizations (hereinafter referred to as the “operational test”) only if it engages solely in activities which support or benefit the specified publicly supported organizations. Such activities may include making payments to or for the use of, or providing services or facilities for, individual members of the charitable class benefited by the specified publicly supported organization. A supporting organization may also, for example, make a payment indirectly through another unrelated organization to a member of a charitable class benefited by a specified publicly supported organization, but only if such a payment constitutes a grant to an individual rather than a grant to an organization. In determining whether a grant is indirectly to an individual rather than to an organization the same standard shall be applied as in §53.4945-4(a)(4) of this chapter. Similarly, an organization will be regarded as “operated exclusively” to support or benefit one or more specified publicly supported organizations even if it supports or benefits an organization, other than a private foundation, which is described in section 501(c)(3) and is operated, supervised, or controlled directly by or in connection with such publicly supported organizations, or which is described in section 511(a)(2)(B). However, an organization will not be regarded as operated exclusively if any part of its activities is in furtherance of a purpose other than supporting or benefiting one or more specified publicly supported organizations.

(2) *Permissible activities.* —A supporting organization is not required to pay over its income to the publicly supported organizations in order to meet the operational test. It may satisfy the test by using its income to carry on an independent activity or program which

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supports or benefits the specified publicly supported organizations. All such support must, however, be limited to permissible beneficiaries in accordance with subparagraph (1) of this paragraph. The supporting organization may also engage in fund raising activities, such as solicitations, fund raising dinners, and unrelated trade or business to raise funds for the publicly supported organizations, or for the permissible beneficiaries.

Treas. Reg. section 1.509(a)-4(f) regarding the nature of relationships required for Code section 509(a)(3) organizations provides:

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

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

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

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

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

(4) *General description of relationships.* —In the case of supporting organizations which are “operated, supervised, or controlled by” one or more publicly supported organizations, the distinguishing feature of this type of relationship is the presence of a

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

Treas. Reg. 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

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

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

(iii)

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

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

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

(3) *Integral part test; general rule*

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

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

(iii)

(a) The supporting organization makes payments of substantially all of its income to or for the use of one or more publicly supported organizations, and the amount of support received by one or more of such publicly supported organizations is sufficient to insure the attentiveness of such organizations to the operations of the supporting organization. In addition, a substantial amount of the total support of the supporting organization must go to those publicly supported organizations

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which meet the attentiveness requirement of this subdivision with respect to such supporting organization. Except as provided in (b) of this subdivision, the amount of support received by a publicly supported organization must represent a sufficient part of the organization's total support so as to insure such attentiveness. In applying the preceding sentence, if such supporting organization makes payments to, or for the use of, a particular department or school of a university, hospital or church, the total support of the department or school shall be substituted for the total support of the beneficiary organization.

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

....

(d) All pertinent factors, including the number of beneficiaries, the length and nature of the relationship between the beneficiary and supporting organization and the purpose to which the funds are put (as illustrated by subdivision (iii)(b) and (c) of this subparagraph), will be considered in determining whether the amount of support received by a publicly supported beneficiary organization is sufficient to insure the attentiveness of such organization to the operations of the supporting organization. Normally the attentiveness of a beneficiary organization is motivated by reason of the amounts received from the supporting organization. Thus, the more substantial the amount involved, in terms of a percentage of the publicly supported organization's total support the greater the likelihood that the required degree of attentiveness will be present. However, in determining whether the amount received from the supporting organization is sufficient to insure the attentiveness of the beneficiary organization to the operations of the supporting organization (including attentiveness to the nature and yield of such supporting organization's investments), evidence of actual attentiveness by the beneficiary organization is of almost equal importance. An example of acceptable evidence of

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actual attentiveness is the imposition of a requirement that the supporting organization furnish reports at least annually for taxable years beginning after December 31, 1971, to the beneficiary organization to assist such beneficiary organization in insuring that the supporting organization has invested its endowment in assets productive of a reasonable rate of return (taking appreciation into account) and has not engaged in any activity which would give rise to liability for a tax imposed under sections 4941, 4943, 4944, or 4945 if such organization were a private foundation. The imposition of such requirement within 120 days after October 16, 1972, will be deemed to have retroactive effect to January 1, 1970, for purposes of determining whether a supporting organization has met the requirements of this subdivision for its first two taxable years beginning after December 31, 1969. The imposition of such requirement is, however, merely one of the factors in determining whether a supporting organization is complying with this subdivision and the absence of such requirement will not preclude an organization from classification as a supporting organization based on other factors.

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

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

Treas. Reg. section 1.509(a)-4(j)(1) regarding control by disqualified persons provides:

- (1) *In general.* —Under the provisions of section 509(a)(3)(C) a supporting organization may not be controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more publicly supported organizations. If a person who is a disqualified person with respect to a supporting organization, such as a substantial contributor to

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the supporting organization, is appointed or designated as a foundation manager of the supporting organization by a publicly supported beneficiary organization to serve as the representative of such publicly supported organization, then for purposes of this paragraph such person will be regarded as a disqualified person, rather than as a representative of the publicly supported organization. An organization will be considered “controlled”, for purposes of section 509(a)(3)(C), if the disqualified persons, by aggregating their votes or positions of authority, may require such organization to perform any act which significantly affects its operations or may prevent such organization from performing such act. This includes, but is not limited to, the right of any substantial contributor or his spouse to designate annually the recipients, from among the publicly supported organizations of the income attributable to his contribution to the supporting organization. Except as provided in subparagraph (2) of this paragraph, a supporting organization will be considered to be controlled directly or indirectly by one or more disqualified persons if the voting power of such persons is 50 percent or more of the total voting power of the organization's governing body or if one or more of the total voting power of the organization's governing body or if one or more of such persons have the right to exercise veto power over the actions of the organization. Thus, if the governing body of a foundation is composed of five trustees, none of whom has a veto power over the actions of the foundation, and no more than two trustees are at any time disqualified persons, such foundation will not be considered to be controlled directly or indirectly by one or more disqualified persons by reason of this fact alone. However, all pertinent facts and circumstances including the nature, diversity, and income yield of an organization's holdings, the length of time particular stocks, securities, or other assets are retained, and its manner of exercising its voting rights with respect to stocks in which members of its governing body also have some interest, will be taken into consideration in determining whether a disqualified person does in fact indirectly control an organization.

Code section 4946(a)(1)(A) states that the term “disqualified person” means, with respect to a private foundation, a person who is a substantial contributor to the foundation. Code section 4946(a)(1)(D) states that "disqualified person" includes the family member of another disqualified person.

Date of reclassification:

The revocation or modification of a determination letter or ruling recognizing exemption may be retroactive if the organization omitted or misstated a material fact, operated in a manner materially different from that originally represented. Where there is a material change,

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inconsistent with exemption, in the character, the purpose, or the method of operation of an organization, revocation or modification will ordinarily take effect as of the date of such material change. Rev. Proc. 2008-9; 2008-2 I.R.B. 258, section 12.01.

GOVERNMENT’S POSITION - ALTERNATE ISSUE:

It is the government’s position that, if the Organization's exempt status is not revoked, then the ORG should be reclassified from a supporting organization to a private foundation.

In general, private foundations receive their funding from one or just a few donors and their operations are controlled by those donors. Private foundations are subject to a regulatory scheme in Chapter 42, not applicable to public charities that was added to the Internal Revenue Code by the Tax Reform Act of 1969. The definition of a private foundation is intentionally inclusive so that all organizations exempted from tax by Code section 501(c)(3) are private foundations except for those specified in section 509(a)(1) through(4). Roe Foundation Charitable Trust v. Commissioner, T.C. Memo. 1989-566; Quarries Charitable Fund v. Commissioner, 603 F.2d 1274, 1277 (7th Cir. 1979). The Organization is currently classified as an organization described in section 509(a)(3), which defines supporting organizations, rather than a private foundation.

Code section 509(a)(3) provides an exception from private foundation status for organizations that support one or more section 509(a)(1) or (2) organizations (public charities). Public charities (organizations described in Code section 501(c)(3) that meet the requirement of sections 509(a)(1) or (2)) were excepted from the regulatory scheme that applies to private foundations on the theory that their exposure to public scrutiny and their dependence on public support keep them from the abuses to which private foundations were prone. Supporting organizations were excepted from the private foundation regulatory scheme on the theory that their close relationships with public charities would keep them from the potential abuses to which private foundations were prone. In other words, the regulatory scheme applicable to private foundations was not needed for supporting organizations because their relationships with public charities were supposed to provide sufficient oversight to keep supporting organizations from the types of abuses to which private foundations are prone. Quarrie Charitable Fund, 603 F.2d at 1277-78.

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

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

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

Organizational and Operational Tests

The Organization is not organized to benefit one or more specified 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 organizations other than the specified publicly supported organization(s). The Organization's dissolution clause allows distributions to organizations other than the specified publicly supported organizations upon termination of the Organization. The possible beneficiaries are not limited to the CO-1 or CO-3 or to the organizations specified on Schedule A of the Organization's Declaration of Trust. Furthermore, the Trustee has the power to determine when the trust corpus is too small to economically administer and distribute the assets to any section 170(c)(3) organization that he chooses. In Quarrie Charitable Fund v. Commissioner, 603 F.2d 1274 (7th Cir. 1979), the court held that substitution of a supporting organization's beneficiaries is permissible only if it is conditioned upon the occurrence of an event which is beyond the control of the supporting organization.

Further, the Declaration permits distributions to affiliated organizations of some of the public charities. These affiliated organizations may not be public charities. Therefore, the organizational test is not met.

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 organizations(s). On July 1, 20XX, there was an amendment to the Declaration of Trust and a new primary charity to be supported was specified. At the time of the amendment, the CO-1 was recognized as a public charity and it could be supported by a supporting organization. Therefore, the primary charity was changed without a showing that the change occurred for reasons that were beyond the Organization's control. This violated the operational test.

The Organization has served the private interests of the Founders by giving them loans/lines of credit, not requiring them to make interest payments in accordance with the terms thereof, and

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not requiring principal repayment. Therefore, the Organization has not established that it operated exclusively for the benefit of the publicly supported organizations.

In addition, the operational test is not satisfied because the Organization made distributions to organizations that were not specified in the original or the amended Declaration of Trust. These distributions are in violation of Treas. Reg. section 1.509(a)-4(e)(1). The Organization gave total grants of \$ to CO-14, CO-9, CO-10, CO-11 and the CO-12 from the years 20XX to 20XX. None of these organizations are listed on Schedule A of the Declaration. One of these organizations, the CO-12, is not a public charity.

Relationship Test

As set forth in Treas. Reg. 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.

The relationships “operated, supervised or controlled by” and “supervised or controlled in connection with” presuppose a substantial degree of direction over the policies, programs and activities of the supporting organization by a publicly supported organization. The “operated, supervised or controlled by” relationship is established by the fact that a majority of the officers, directors, or trustees of the supporting organization are appointed or elected by the governing body, members of the governing body, officers acting in their official capacity or the membership of the publicly supported organization. The “supervised or controlled in connection with” relationship is established by the fact that there is common supervision or control by the persons supervising or controlling both the supporting and the publicly supported organizations (*i.e.*; that control or management of the supporting organization is vested in the same persons that control or manage the publicly supported organization).

In the present case, only one of the five members of the board is appointed by the supported organization. The Organization cannot meet the requirements to satisfy one of the first two types of relationships because a majority of its control and supervisory personnel are not appointed by a supported organization nor is there common supervision and control by the same persons over the supporting and supported organizations.

Thus, the only relationship test the Organization can possibly meet to be a supporting organization is the “operated in connection with” test. This test requires that the Organization satisfy both a responsiveness test and an integral part test. Neither test has been met in this case.

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In order to meet the responsiveness test, either Treas. Reg. section 1.509(a)-4(i)(2)(ii) or (iii) must be satisfied. Treas. Reg. section 1.509(a)-4(i)(2)(ii) requires that the board member appointed by the supported organization have a significant voice in the operations of the supporting organization. The organization has established only two instances of board meetings from inception through November 20XX. There were no board minutes after November 20XX. There are five members of the board; two are from the family, two are trusted business associates of the founder and one is appointed by the supported organization. In the absence of any board meetings after November 14, 20XX, there is no indication that the member appointed by the supported organization had a voice in the Organization's investment policies, the timing of its grants or the selection of grant recipients. See Roe Foundation Charitable Trust v. Commissioner; 58 T.C. Memo. 402 (1989).

Prior to the enactment of the Pension Protection Act on August 17, 20XX, there was an alternative responsiveness test for charitable trusts. Under Treas. Reg. section 1.509(a)-4(i)(2)(iii), the supporting organization that was a charitable trust under state law could meet the responsiveness test if each of its publicly supported organizations were named as beneficiaries under the charitable trust's governing instrument and the beneficiary organizations had the power to enforce the trust and compel an accounting under state law. Treas. Reg. section 1.509(a)-4(i)(2)(iii). Section 2.2.1 of the Declaration states that the trustee shall distribute 35% of the net income of this trust to the primary charity. Section 2.2.2 states, "a total of 50% of the net income shall be distributed to one or more of the organizations listed on Schedule A". There are 108 organizations listed on Schedule A, including the primary charity. Only the primary charity is specifically named as entitled to receive a portion of the Organization's net income. The Organization is not required to make any payments to any specific charity among the other 107 organizations. There is no other evidence to establish that each publicly supported organization has the power to enforce the trust.

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

While the responsiveness test guarantees that the publicly supported organization can influence the activities of the supporting organization, the integral part test ensures that the publicly supported organization will be motivated to attend to the operations of the supporting organization. The integral part test is considered to have been satisfied if the supporting organization maintains a significant involvement in the operations of one or more publicly supported organizations and the publicly supported organizations are in turn dependent upon the supporting organization for the type of support which it provides. Treas. Reg. section 1.509(a)-4(i)(3)(i).

There are two ways to meet the integral part test. One is based on the nature of the activities

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the supporting organization engages in to support the supported organization. The alternate is based on the financial support the supporting organization provides the supported organization.

Treas. Reg. section 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. In contrast, Treas. Reg. section 1.509(a)-4(i)(3)(iii) sets forth the integral part test rules 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. 2002-300. The Organization does not meet the integral part 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 Organization did not perform any activities for or on behalf of publicly supported organizations aside from grants, the applicable rules for satisfying the integral part test are in Treas. Reg. section 1.509(a)-4(i)(3)(iii), which has the following three basic requirements: 1) payment of substantially all of its income to publicly supported organizations; 2) the amount received by one publicly supported organization must be sufficient to motivate it to pay attention to the operations of the supporting organization; and 3) a substantial amount of the total support of the organization must go to those publicly supported organizations that meet the attentiveness requirement. In the present situation, the Organization does not meet the second requirement so it cannot meet the third requirement.

Except as provided in Treas. Reg. section 1.509(a)-1(i)(3)(iii)(b), the amount of support received by a publicly supported organization must represent a sufficient part of the organization's total support so as to ensure its attentiveness to the operations of the supporting organization. Treas. Reg. section 1.509(a)-4(i)(3)(iii)(a). The regulations do not specify what percentage of a supported organization's support must be received from a supporting organization to meet the integral part test. The requirement is that facts and circumstances show that the support is sufficient to ensure that the supported organization is attentive to the operations of the supporting organization. Treas. Reg. section 1.509(a)-4(i)(3)(iii). Treas. Reg. 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

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is earmarked for a substantial program of the publicly supported organization that would be interrupted without the supporting organization's support. Treas. Reg. section 1.509(a)-4(i)(3)(d) provides that, "[a]ll pertinent factors...will be considered in determining whether the amount of support received by a publicly supported organization is sufficient to insure the attentiveness of such organization to the operations of the supporting organization." The Regulation notes the importance of the percentage of the income received from the supporting organization in determining if the publicly supported organization will have the requisite degree of attentiveness and concludes that evidence of actual attentiveness is almost as important.

19XX was the first year that the primary supported charity was the CO-1. CO-1 received \$, \$ and \$ in 19XX, 19XX and 20XX, respectively. In violation of its terms, the Declaration was amended on July 1, 20XX, to change the primary charity to CO-3. The grants to the CO-3 were \$, \$ and \$ in 19XX, 20XX and 20XX, respectively. The Organization was asked to provide the total amount of support for the 20XX and 20XX years of the CO-3. The Organization replied that it had no access to CO-3's records because it is a large organization. This demonstrates that the supported organization (CO-3) is not attentive to the operations of the Organization because the Organization was unable to procure information required to maintain its classification as a supporting organization. Further, a large organization implies a large amount of outside support as well. Failure to provide this requested information is indicative that it would be harmful to the Organization's position. See Wichita Terminal Elevator Co. v. Commissioner, 6 T.C. 1158 (1946), *aff'd*. 162 F.2d 513 (10th Cir. 1947). The Organization stated in its application that the CO-1's income in 19XX was The amounts the Organization granted to it are insufficient to cause the primary supported organization to be attentive to the Organization's operations.

There is no evidence that either of the primary beneficiaries--CO-1 or the CO-3-- was attentive to the operations of the FDN-1 and FDN-2. The fact that those primary supported organizations did not object to virtually all of the Organization's assets being loaned to disqualified persons and that neither of them made any attempt to have the loan terms complied with when payments were not made in conformity with the loan terms demonstrates that the primary supported organizations were not attentive to the operations of the Organization. Further, there is no evidence the change in the primary supported organization was considered or properly approved by the Board or that the CO-1 objected to the change or questioned why it was not receiving grants. acknowledged the grants to it as if they came directly from the Founders rather than from the Organization. Further, there were no Board meetings, meaning the supported organizations could not have been attentive to the Organization's operations.

Control Test

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FDN-1 and FDN-2, as the only contributors to the Organization, are substantial contributors and/or the spouse of a substantial contributor. As such, both FDN-1 and FDN-2 are disqualified persons pursuant to Code section 4946(a)(1)(A) and (D) and Treas. Reg. section 1.509(a)-4(j)(1). FDN-1 and FDN-2 as disqualified persons control the Organization.

When the primary supported organization was changed, only three Board members voted. Two of those Board members voting were FDN-1 and FDN-2. In addition, when two new Board members were instated in 20XX, only three Board members voted. Two of those Board members voting to add new Board members were FDN-1 and FDN-2. Pursuant to Treas. Reg. section 1.509(a)-4(j)(1), disqualified persons impermissibly controlled the Organization because FDN-1 and FDN-2, both disqualified persons, by aggregating their votes or positions of authority, could require such organization to perform any act which significantly affects its operation or may prevent such organization from performing such act. Further, control by a disqualified person 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. The Declaration provides that, if the board has not directed the Trustee as to which organizations should receive grants within 7 days prior to April 30 of the year after the income is earned, the Trustee shall determine the grant recipients. There is no evidence that the board directed the Trustee as to which organizations should receive grants. Further, in violation of the terms of the Declaration, grants in excess of 85% of the Organization's net income were made to charities without written approval by three board members. Thus, the right to determine recipients of the Organization's funds was with disqualified person FDN-1 as Trustee, contrary to the requirements of Treas. Reg. section 1.509(a)-4(j)(1).

Almost all of the Organization's assets have been transferred to disqualified persons FDN-1 and FDN-2. Their loans have not been paid in accordance with their terms, were orally extended and interest payments were applied to the principal balance. Treas. Reg. section 1.509(a)-4(j)(1) states that among the pertinent facts and circumstances to be considered are the nature of the organization's assets. Where almost all of the Organization's assets were under the control of disqualified persons, there is evidence of indirect control.

The Declaration provides that if the Trustee determines the trust fund is too small to economically administer, the Trustee shall distribute the trust fund in its entirety outright and free of trust to such organizations described in section 170(c)(3) as the Trustee shall determine. Trustee FDN-1 is a disqualified person and this provision therefore allows a disqualified person an impermissible level of control because FDN-1 can determine the trust is too small to economically administer and he can control the final distribution of trust assets.

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Based on the lack of Minutes of the Organization's Board meetings, there is no indication that any representatives of any of the organizations named in the Declaration have had any input into the Organization's operations since November 14, 20XX.

The ORG is not a supporting organization under Code section 509(a)(3) because it is controlled directly or indirectly by one or more disqualified persons.

Effective Date of Reclassification

Revocation of a determination letter may be retroactive if the organization omitted or misstated a material fact or operated in a manner materially different from that originally represented. Rev. Proc. 2008-9; 2008-2 I.R.B. 258, section 12.01.

In its application, the Organization did not state that it would make grants to organizations not specified in its Declaration, that it would not have a sufficient relationship with a supported organization and that a disqualified person would control it or borrow substantial amounts of its funds. Therefore retroactive reclassification is appropriate. This determination is effective July 1, 20XX, the date the Declaration was amended to substitute the primary charity.

TAXPAYER'S POSITION - ALTERNATE ISSUE:

Unknown.

CONCLUSION - ALTERNATE ISSUE:

Accordingly, the ORG should be reclassified as a private foundation retroactive to July 1, 20XX, because it does not qualify as a supporting organization under the requirements set forth in Treas. Reg. section 1.509(a)-4(c) through (j).

Form 990 PF Return of Private Foundation should be filed for all open tax years. Subsequent returns are due no later than the 15th day of the 5th month following the close of the Organization's accounting period. For tax year ending December 31, 20XX Form 990-PF is due May 15, 20XX.

Send your returns for open years prior to 20XX to the following mailing address:

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Note:

Form 990-PF is required for each tax year until private foundation status is terminated under IRC § 507.