Internal Revenue Service
Appeals Office
1352 Marrows Road, Suite 104
Newark, DE 19711-5445

Release Number **201015045**
Release Date: 4/16/10
Date: January 8, 2010

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B

UIL – 0501.32-00

Department of the Treasury

Person to Contact:

Employee ID Number:

Refer Reply to:
AP:FE:SAC:MF
In Re:
EO Revocation
Tax Period(s) Ended:

Form Required to be Filed:
1041
Employer Identification Number

Last Day to File a Petition with the United States Tax Court: APR 0 8 2010

CERTIFIED MAIL

Dear taxpayer:

This is a final adverse determination as to your exempt status under section 501(a) of the Internal Revenue Code. It is determined that you are no longer recognized as exempt from Federal income tax as an organization described in Section 501(c)(3) of the Internal Revenue Code, effective December 27, 1999.

Our adverse determination was made for the following reason(s):

> It was determined that your activities are not exclusively charitable and that assets of the organization have inured to the benefit of private individuals (i.e., your founders and/or officers) through the issuance of loans. Therefore, you are not operated exclusively for exempt purposes pursuant to section 501(c)(3) of the Internal Revenue Code.

Contributions to your organization are not deductible under code section 170 of the Internal Revenue Code.

You are required to file Federal income tax returns on the form indicated above. You should file these returns within 30 days from the date of this letter, unless a request for an extension of time is granted. File the returns in accordance with their instructions, and do not send them to this office. Processing of income tax returns and assessment of any taxes due will not be delayed because you have filed a petition for declaratory judgment under Code section 7428.

If you decide to contest this determination under the declaratory judgment provisions of Code section 7428, a petition to the United States Tax Court, the United States Court of Claims, or the

district court of the United States for the District of Columbia must be filed within 90 days from the date this determination was mailed to you. Contact the clerk of the appropriate court for rules for filing petitions for declaratory judgment. To secure a petition form from the United States Tax Court, write to the United States Tax Court, 400 Second Street, N.W., Washington, D.C. 20217.

You also have the right to contact the office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, formal appeals process, etc. The Taxpayer Advocate is not able to reverse legally correct tax determinations, nor extend the time fixed by law that you have to file a petition in 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. If you want Taxpayer Advocate assistance, please contact the Taxpayer Advocate for the IRS office that issued this letter. See the enclosed Notice 1214, *Helpful Contacts for Your "Notice of Deficiency"*, for Taxpayer Advocate telephone numbers and addresses.

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

CHARLES FISHER
TEAM MANAGER

Enclosures:
Notice 1214

DEPARTMENT OF THE TREASURY
Internal Revenue Service

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

September 27, 2007

Legend
ORG= Name of organization
EIN= EIN of organization
NN= Name of individual

ORG

Taxpayer Identification Number:
EIN
Form:

Tax Year(s) Ended:
June xx, 200X and 200X
Person to Contact/ID Number:

Contact Numbers:
Telephone:
Fax:

Certified Mail - Return Receipt Requested

Dear NN;

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

Legend

ORG= Name of organization
NN= Name of individual
RR= Related organization
UR= Unrelated organization
x= Amount
X= Year
EIN= EIN of the organization
FN= Family name

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

FACTS:

On December x, 199X, ORG (the "Trust" or the "Foundation") was created via a Declaration of Trust (the "Declaration") entered into by NN and NN (each individual being a "Founder"), and NN (the "Trustee"). According to the Declaration, the Trust was created for the purpose of establishing an organization which is described in IRC § 501(c)(3) and IRC § 509(a)(3).

The Declaration provides that the Trust is irrevocable and the Founders expressly waive the right and the power to alter, amend, revoke or terminate the Trust or any of the terms thereof. Moreover, the Declaration provides that the Founders renounce any power to determine or control the income or principal of the Trust estate, and that the Founders renounce any interest, either vested or contingent, including any reversionary interest or possibility of reverter, in the income or principal of the Trust estate. However, the Declaration also states that, in the event the Trust does not obtain tax exempt status under sections 501(c)(3) and 509(a)(3), the assets of the Trust shall go to the FN as a contingent remainder.

The Declaration further provides that upon winding up and dissolution of the Trust, the assets shall be distributed to a non-profit fund, foundation, or corporation which is organized and operated exclusively for charitable, educational, religious and/or scientific purposes, and which has established its tax exempt status under section 501(c)(3). However, the Declaration also expressly provides that "[i]n the event the Trustee determines, in Trustee's sole and complete discretion, that the Trust Fund is too small to economically administer, then in such event the Trustee shall distribute the Trust Fund in its entirety outright and free of trust to such organization or organizations as described in Section 170(c)(2) of the [Internal Revenue] Code as the Trustee, in Trustee's sole and complete discretion, shall determine."

In addition, the Declaration provides that each year the Trustee shall distribute x% of the Foundation's net income to RR(RR), the named Primary Charity. The Declaration also provides that, in addition to the x% distribution to RR, each year the Trustee shall distribute a total of x% of the Trust's net income to one or more of the organizations listed on Schedule A to the

Declaration as determined by the Foundation's board of directors (the "Board") or, if the Board fails to timely act, in the sole and absolute discretion of the Trustee.

Schedule A to the Declaration lists x organizations, including RR. Some of these organizations are identified as "affiliated organizations," such as the UR and affiliated organizations. Moreover, some of the organizations listed on Schedule A (such as UR and UR) are not publicly supported charities described in IRC § 509(a)(1) or (a)(2).

With regard to the Board, the Declaration provides that it shall be the governing body of the Trust and that the members of the Board shall be determined as follows:

- x Board member shall be appointed by the Primary Charity;
- x Board members shall be from the class consisting of NN, and their descendants (the "FN")

During the years at issue, the Board consisted of the following persons: (1) NN; (2) NN (3) NN; (4) NN; and (5) NN. Moreover, pursuant to the Declaration, the Board has the power to remove the Trustee by giving written notice signed by two members of the Board, one of whom must be a member of the FN.

Finally, the Declaration expressly provides that the Trustee is required to render an accounting of the income and principal to the Board and RR, including a reporting of all receipts, disbursements and capital changes made by the Foundation.

On June x, 200X, based on the representations it made on its application for exemption, the Foundation was recognized by the Internal Revenue Service (the "Service") as exempt from Federal income tax under IRC § 501(a) as an organization described in section 501(c)(3). The determination letter also classified the Foundation as a supporting organization described in section 509(a)(3).

The Foundation's application for exemption (Form 1023) was filed with the Service on April x, 200X. The application contained financial information for the calendar year ending December x, 199X, and proposed budgets for the calendar years 200X and 200X. The application states that $x had been contributed to the Foundation during 199X, and projected that $x of contributions would be made to the Foundation for each of the years 200X and 200X. The application did not, however, contain any information regarding the Foundation making any purported loans to its Founders.

The Founders, who were the sole contributors to the Foundation, made the following contributions to the Foundation:

FYE	Amount
7/31/199X	$ x

7/31/200X	x
7/31/200X	x
7/31/200X	x
7/31/200X	x
7/31/200X	x
Total	$ x

According to the Foundation's tax returns on Form 990, the Foundation made the following purported loans to the Founders:

Purported Loans during FYE	Total Amount	FYE Balance
7/31/200X	$x	$x
7/31/200X	x	x
7/31/200X	x	x
7/31/200X	x	x
7/31/200X	x	x

The Founders began receiving the purported loans at issue in May of 200X, while the Foundation's application for exemption was pending. Each year they allegedly borrowed money from the Foundation as reported on the Foundation's Form 990. However, no written agreements or other documentation exists that memorialize these purported loans. Moreover, as evidenced by the Foundation's Forms 990 for the years at issue, the Founders have used most of the Foundation's assets for themselves and not for charitable activities or grants.

According to the Founders in response to questions raised in the current examination, the loans are purportedly secured by their home and "[a]ll of the loans are made with the same requirements for repayment. The loans will be repaid with x% interest beginning in September, 200X. The minimum payment will be $x per month until all the loans are paid off. Each loan is combined with the total loan, and therefore, extends the time until the total is paid off. No additional loans will be given after September, 200X." The Founders make these claims despite the fact that they are unable to produce any documentary evidence that supports the claims.

In addition, the Founders initially advised the Service in the current examination that the Foundation does not keep minutes of Board meetings and that the Foundation's Board does not have any formal meetings. In later correspondence, however, the Founders claim that "[w]hen ORG was formed, it was decided by a unanimous vote of the board, that the Foundation could make loans to NN at an interest of x%. These loans will be repaid beginning in September, 200X." However, the Founders have not produced any Board minutes that support this claim.

Although required to do so by the Declaration, other than the above self-serving statement of the Founders to the Service, there is no evidence that representatives of any of the supported organizations ever attended or participated in any meetings of the Board, or had any input or oversight on the investments of the Foundation. Furthermore, there is no evidence that any financial reports were made to any of the supported organizations

FN claim to have partly repaid the loans at issue. They claim to have made $x of payments on these purported loans since September 200X. However, the repayments have not been according to the terms of the loans as described above, since the repayments have not been on a monthly basis. Moreover, FN have not provided the Service with any evidence that shows that these repayments were not later retransferred back to them. FN provided some bank records that showed that monies were transferred from their personal account into the Foundation's bank account. However, complete bank records were not provided to the Service. The Service was therefore unable to verify that these monies were not re-transferred to or for the benefit of FN. Accordingly, to date, FN have not established that they have repaid any portion of the loans at issue.

Because the "loans" at issue are not memorialized and do not have the common characteristics of bona fide loans, the Service has determined that they are in fact transfers of the Foundation's assets. This determination is set forth in the discussion below.

The Foundation's Form 990 and its work papers for 200X and 200X reflect the following:

	TY200X	TY 200X	TY200X
Contributions	$x	x	$x
Dividends/Interest	x	x	x
Gain(Loss) on Sale of Assets	$x	$x	$x
Total Revenue	$x	$x	$x
Grants	$x	$x	$x
Legal Fees	$x	$x	$x
Accounting Fees	$x	$x	$x
Bank Charges	$x	$x	$x
Reimbursements	$x	$x	$x
Total Expenses	$x	$x	$x
Excess (Deficit) for Year	$x	$x	($x)

Balance Sheet (end of year)
The following are the Foundation's assets per its Forms 990.

	TY200X	TY 200X	TY200X
Cash	$x	$x	$x
Loans Receivable	x	x	x
Investments – Securities	x	x	x
Total Assets	$x	$x	$x

During the years at issue, the Foundation purported to make the following grants:

	200X-07
UR	x
Total	x

	200X-07
UR	x
Total	x

The grants to UR for the years 200X and 200X were made from FN' personal checking account. FN have provided evidence in the form of acknowledgement letters from RR showing that the payments from their checking account were made on behalf of the Foundation. According to FN, the $x grant to RR was made with money they reported on the Foundation's fiscal year ending July x, 200X Form 990 as having been borrowed from the Foundation in May 200X. The $x grant to RR was made in September 200X.

On April x, 200X, UR's tax exempt status was revoked effective January x, 200X.

LAW:

IRC § 501(c)(3) exempts from Federal income tax: corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda,

or otherwise attempting to influence legislation and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.

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

Treas. Reg. §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 term "private shareholder or individual" is defined in Treas. Reg. §1.503(a)-1(c) as "persons having a personal and private interest in the activities of the organization."

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

In Better Business Bureau v. United States, 326 U.S. 279 (1945), the United States Supreme Court held that regardless of the number of truly exempt purposes, the presence of a single substantial non-exempt purpose will preclude exemption under section 501(c)(3). See also American Campaign Academy v. Commissioner, 92 T.C. 1053, 1065-66 (1989) (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); Old Dominion Box Co. v. United States, 477 F.2d 340 (4th Cir. 1973) (operating for the benefit of private parties who are not members of a charitable class constitutes a substantial nonexempt purpose).

In Harding Hospital, Inc. v. United States, 505 F.2d 1068 (6th Cir. 1974), the court held that section 501(c)(3) imposes three requirements for exemption: (1) the entity must be organized and operated exclusively for charitable purposes; (2) no part of its net earnings may inure to the benefit of a private individual or shareholder; and (3) it cannot engage in certain lobbying and political activities. Moreover, the court stated that "net earnings," as used in section 501(c)(3), may include more than the term net profits as shown by the books of the organization or the difference between gross receipts and disbursements in dollars. "Earnings may inure to an individual in ways other than through the distribution of dividends. 6 Mertens, Law of Income

Taxation, §34.13, at 63 (1968 ed.). '[I]f a particular individual or a limited number of individuals reap commercial benefits from the operation of the instrumentality, though they do not do so by direct acquisition or payment over to them of its earnings, the earnings may nevertheless 'inure' to their 'benefit' within the intendment of such phrasing so as to destroy the exempt status.' Id. At 63-64."

In Western Catholic Church v. Commissioner, 73 T.C. 196 (1979), aff'd, 631 F.2d 736 (7th Cir. 1980), the Tax Court held that when an organization's investments are dictated in part by the needs of private interests, it cannot be said that the organization was operated exclusively for the public benefit.

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

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

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

In Vinikoor v Commissioner, T.C. Memo. 1998-152, the Tax Court held that the determination of whether a transfer was a loan, made with a real expectation of repayment and an intention to enforce the debt, depends on all the facts and circumstances, including whether: (1) there was a promissory note or other evidence of indebtedness; (2) interest was charged; (3) there was security or collateral; (4) there was a fixed maturity date; (5) a demand for repayment was made; (6) any actual repayment was made; (7) the transferee had the ability to repay; (8) any records

maintained by the transferor and/or the transferee reflected the transaction as a loan; and (9) the manner in which the transaction was reported for Federal tax purposes is consistent with a loan.

GOVERNMENT'S POSITION:

The IRC § 501(c)(3) tax exempt status of ORG (the "Foundation") should be revoked because it is not operated exclusively for tax exempt charitable purposes. More than an insubstantial part of the Foundation's operation is to serve the financial needs of its founders, NN and NN.

There is no evidence that the loans at issue have benefited the Foundation in any manner. Since repayment of the loans was not purportedly required until September 200X, the Foundation was not receiving any income from the loans to make grants to its supported organizations. Moreover, there is no credible evidence that the terms of the "loans" to FN were considered by the entire board of directors (the "Board") or that the purported loans were reviewed by anyone acting in the interests of charity. Although FN have provided the Internal Revenue Service with a statement, dated May x, 200X, stating the Board approved the loans when the Foundation was formed, this approval is not documented in any minutes of the Board. There is also no evidence that the Foundation made any attempts at collection when FN failed to repay the "loans" according to their purported terms. There is no evidence that an independent third party lender would have made a loan on these terms – undocumented, unsecured and at a x% interest rate with interest not being charged or collected.

FN claim to have partly repaid the loans, but not as scheduled. The purported repayments did not start in September 200X as they claim the loans required but, instead, began in November 200X. In addition, FN have not complied with the purported term of the "loans" that payments are to be monthly. Instead, FN have haphazardly paid when they wanted in various amounts.

FN claim to have made six repayments in the total amount of $x. However, FN have not provided evidence that shows that the amounts they claim to have repaid were not retransferred back to them at some later date. Accordingly, to date, FN have not established that they have repaid any portion of the loans.

In addition, the transactions at issue do not in fact appear to be bona fide loans. The transactions fail to meet most of the characteristics required for them to be bona fide loans as set forth in the Miller v Commissioner, T.C. Memo. 1998-152. The purported loans are not evidenced by any type of note, there is no amortization schedule, or a set schedule of regular or minimum payments. Although FN claim that the "loans" are at x% interest, the Foundation's tax returns fail to report any increase in the loan amounts based on the accrual of interest. In addition, although FN claim that the "loans" are secured by their home, they have not produced any mortgage or deed of trust that supports this claim. In fact, as evidenced by the various statements

FN have made to the Service during this examination, the "loans" do not have a fixed maturity date for repayment since "[e]ach loan is combined with the total loan, and therefore, extends the time until the total is paid off." Accordingly, the transactions at issue do not qualify as loans but, instead, appear to be transfers of the Foundation's assets to FN.

Moreover, in making these undocumented and unsecured "loans," it does not appear that any attempt was made by the Board or the Trustee to ensure the Foundation's assets or income was protected. In fact, the transactions at issue involved almost all of the assets of the Foundation and, since no payments on the purported loans were due until September 200X, the "loans" deprived the Foundation of assets that could generate income for grants to its supported organizations. Accordingly, these loans were detrimental to the Foundation's exempt purpose.

As illustrated in the following Table, most of the assets of the Foundation are reported on its Form 990 as receivables from NN and NN.

	200X	**200X**	**2003**	**200X**
Loaned to Founder				
Total assets				
Loans as a percent of assets				
Charitable grants as a percent of assets				

*At the end of each of these years there was either no grants given or below x% of the total assets.

The Foundation is controlled by NN and it has been primarily operated as a source of funding for NN and NN. FN are able to use the Foundation's funds as if the funds were their own, which is detrimental to the Foundation. While the Foundation has distributed $x to UR, the Foundation transferred a much larger amount of its funds to FN. Accordingly, it is operated for a substantial non-exempt purpose. See Revenue Ruling 67-5, 1967-1 C.B. 123.

A charity's assets are required to be irrevocably dedicated to charitable purposes. Treas. Reg. § 1.501(c)(3)-1(b)(4). The inurement prohibition serves to prevent the individuals who operate the charity from siphoning off any of a charity's income or assets for personal use. By transferring the assets back to FN, purportedly as loans but as loans that do not require payments for a substantial period of time and/or loans that FN do not comply with the terms of, the Foundation breached the dedication requirement and its assets have inured to the benefit of FN.

Although the inurement prohibition is stated in terms of net earnings, it applies to any of a charity's assets that serve the interests of its private shareholders. Harding Hospital, Inc. v. United States, 505 F.2d 1068, 1072 (6th Cir. 1974). The transfer of funds directly to FN serves the financial interests of FN. Facts that show a charity's investments are decided in part by the needs of private interests indicate the charity may not be operated exclusively for exempt purposes. Western Catholic Church v. Commissioner, 73 T.C. 196 (1979), aff'd, 631 F.2d 736 (7th Cir. 1980). 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, 73 T.C. at 214.

The Foundation's assets have inured to the benefit of FN. The very presence of a private source of loan credit may amount to inurement. Founding Church of Scientology v. United States, 412 F.2d 1197 (Ct. Cl. 1969). The "loans" at issue promote private rather than charitable purposes. Id. Accordingly, the exempt status of the Foundation should be revoked because it is operated for substantial non-exempt purposes.

TAXPAYER'S POSITION:
Taxpayer's is position unknown.

CONCLUSION:

Accordingly, the IRC § 501(c)(3) exempt status of ORG (the "Foundation") should be revoked, effective December x, 199X, because it does not operate exclusively for exempt purposes. The Foundation's assets inured to, and it served the private interests of, its creators. The Foundation transferred most of its assets to its founders, FN. Therefore, the Foundation failed to operate exclusively for exempt purposes. Retroactive revocation is appropriate because the Foundation's operations were materially different from the representations that it made in its application for exemption. It did not state in its application that almost all of its assets would be transferred to its Founders.

Form 1041 U.S. Income Tax Return for Estates and Trusts should be filed for tax years ending July x, 200X, 200X, 200X and 200X. Subsequent returns are due no later than the xth day of the xth month following the close of the trust's accounting period.

Returns should be sent to the following mailing address:

ALTERNATIVE ISSUE: Whether ORG should be reclassified as a private foundation.

FACTS: See Facts under Primary Issue.

LAW:

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

> (1) *In general.* —An organization is organized exclusively for one or more of the purposes specified in section 509(a)(3)(A) only if its articles of organization (as defined in §1.501(c)(3)-1(b)(2)):
>
> > (i) Limit the purposes of such organization to one or more of the purposes set forth in section 509(a)(3)(A);
> > (ii) Do not expressly empower the organization to engage in activities which are not in furtherance of the purposes referred to in subdivision (i) of this subparagraph;
> > (iii) State the specified publicly supported organizations on whose behalf such organization is to be operated (within the meaning of paragraph (d) of this section); and
> > (iv) Do not expressly empower the organization to operate to support or benefit any organization other than the specified publicly supported organizations referred to in subdivision (iii) of this subparagraph.

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

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

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

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

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

(i) The supporting organization will be responsive to the needs or demands of one or more publicly supported organizations; and

(ii) The supporting organization will constitute an integral part of, or maintain a significant involvement in, the operations of one or more publicly supported organizations.

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

Treas. Reg. §1.509(a)-4(g)(1) provides guidance on the meaning of "operated, supervised, or controlled by" as follows:

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

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

demonstrated that the purposes of the former organizations are carried out by benefiting the latter organizations.

Treas. Reg. §1.509(a)-4(h) provides guidance on the meaning of "supervised or controlled in connection with" as follows:

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

(2) A supporting organization will not be considered to be "supervised or controlled in connection with" one or more publicly supported organizations if such organization merely makes payments (mandatory or discretionary) to one or more named publicly supported organizations, even if the obligation to make payments to the named beneficiaries is enforceable under state law by such beneficiaries and the supporting organization's governing instrument contains provisions whose effect is described in section 508(e)(1)(A) and (B). Such arrangements do not provide a sufficient "connection" between the payor organization and the needs and requirements of the publicly supported organization to constitute supervisions or control in connection with such organizations.

Treas. Reg. §1.509(a)-4(i) provides guidance on the meaning of "operated in connection with" as follows:

(1) *General rule*

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

....

(2) *Responsiveness test*

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

to meet this test, either subdivision (ii) or subdivision (iii) of this subparagraph must be satisfied.

(ii)

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

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

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

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

(iii)

(a) The supporting organization is a charitable trust under State law;
(b) Each specified publicly supported organization is a named beneficiary under such charitable trust's governing instrument; and
(c) The beneficiary organization has the power to enforce the trust and compel an accounting under State law.

(3) *Integral part test; general rule*

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

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

organization, would normally be engaged in by the publicly supported organizations themselves.

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

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

....

(d) All pertinent factors, including the number of beneficiaries, the length and nature of the relationship between the beneficiary and supporting organization and the purpose to which the funds are put (as illustrated by subdivision (iii)*(b)* and *(c)* of this subparagraph), will be considered in determining whether the amount of support received by a publicly supported beneficiary organization is sufficient to insure the attentiveness of such organization to the operations of the supporting organization. Normally the attentiveness of a beneficiary organization is motivated by reason of the amounts received from the supporting organization.

Thus, the more substantial the amount involved, in terms of a percentage of the publicly supported organization's total support the greater the likelihood that the required degree of attentiveness will be present. However, in determining whether the amount received from the supporting organization is sufficient to insure the attentiveness of the beneficiary organization to the operations of the supporting organization (including attentiveness to the nature and yield of such supporting organization's investments), evidence of actual attentiveness by the beneficiary organization is of almost equal importance. An example of acceptable evidence of actual attentiveness is the imposition of a requirement that the supporting organization furnish reports at least annually for taxable years beginning after December 31, 1971, to the beneficiary organization to assist such beneficiary organization in insuring that the supporting organization has invested its endowment in assets productive of a reasonable rate of return (taking appreciation into account) and has not engaged in any activity which would give rise to liability for a tax imposed under sections 4941, 4943, 4944, or 4945 if such organization were a private foundation. The imposition of such requirement within 120 days after October 16, 1972, will be deemed to have retroactive effect to January 1, 1970, for purposes of determining whether a supporting organization has met the requirements of this subdivision for its first two taxable years beginning after December 31, 1969. The imposition of such requirement is, however, merely one of the factors in determining whether a supporting organization is complying with this subdivision and the absence of such requirement will not preclude an organization from classification as a supporting organization based on other factors.

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

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

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

(1) *In general.* —Under the provisions of section 509(a)(3)(C) a supporting organization may not be controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more publicly supported organizations. If a person who is a disqualified person with respect to a supporting organization, such as a substantial contributor to the supporting organization, is appointed or designated as a foundation manager of the supporting organization by a publicly supported beneficiary organization to serve as the representative of such publicly supported organization, then for purposes of this paragraph such person will be regarded as a disqualified person, rather than as a representative of the publicly supported organization. An organization will be considered "controlled", for purposes of section 509(a)(3)(C), if the disqualified persons, by aggregating their votes or positions of authority, may require such organization to perform any act which significantly affects its operations or may prevent such organization from performing such act. This includes, but is not limited to, the right of any substantial contributor or his spouse to designate annually the recipients, from among the publicly supported organizations of the income attributable to his contribution to the supporting organization. Except as provided in subparagraph (2) of this paragraph, a supporting organization will be considered to be controlled directly or indirectly by one or more disqualified persons if the voting power of such persons is 50 percent or more of the total voting power of the organization's governing body or if one or more of the total voting power of the organization's governing body or if one or more of such persons have the right to exercise veto power over the actions of the organization. Thus, if the governing body of a foundation is composed of five trustees, none of whom has a veto power over the actions of the foundation, and no more than two trustees are at any time disqualified persons, such foundation will not be considered to be controlled directly or indirectly by one or more disqualified persons by reason of this fact alone. However, all pertinent facts and circumstances including the nature, diversity, and income yield of an organization's holdings, the length of time particular stocks, securities, or other assets are retained, and its manner of exercising its voting rights with respect to stocks in which members of its governing body also have some interest, will be taken into consideration in determining whether a disqualified person does in fact indirectly control an organization.

GOVERNMENT'S POSITION:

If its exempt status is not revoked, ORG (the "Foundation") should be reclassified as a private foundation.

Due to Congressional concerns about wide-spread abuses of their tax-exempt status by private foundations, private foundations were defined and subjected to significant regulations and controls by the Tax Reform Act of 1969. The definition of a private foundation is intentionally inclusive so that all organizations exempted from tax by IRC § 501(c)(3) are private foundations except for those specified in IRC § 509(a)(1) through (4). Roe Foundation Charitable Trust v. Commissioner, T.C. Memo. 1989-566; Quarrie Charitable Fund v. Commissioner, 603 F.2d 1274, 1277 (7th Cir. 1979). The Foundation currently is excepted from private foundation status because it is currently classified as a supporting organization which is described in section 509(a)(3).

Public charities (organizations described in section 501(c)(3) that meet the requirement of section 509(a)(1) or (2)) are excepted from private foundation status on the theory that their exposure to public scrutiny and their dependence on public support keep them from the abuses to which private foundations are subject. Supporting organizations are similarly excepted from private foundation status. Supporting organizations are excepted if they are subject to the scrutiny of public charities that provide sufficient oversight to keep supporting organizations from the types of abuses to which private foundations are prone. Quarrie, 603 F.2d at 1277-78.

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

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

Overall, these tests are meant to ensure that a supporting organization is responsive to the needs of a public charity and intimately involved in its operations, 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.

Organizational and Operational Tests

The Foundation is not organized to benefit one or more specified publicly supported organizations. Pursuant to Treas. Reg. § 1.509(a)-4(c)(1)(iii) and (iv), an organization's governing instrument must state the specified publicly supported organization(s) on whose behalf the organization is to be operated and cannot expressly empower the organization to support or benefit any organizations other than the specified publicly supported organization(s). The

dissolution clause of the Foundation's Declaration of Trust (the "Declaration") allows distributions to organizations other than the specified publicly supported organizations upon termination of the Foundation and the Declaration's final distribution clause expressly empowers the Trustee (in his sole and complete discretion) to distribute trust assets to any organization described in IRC § 170(c)(2). Furthermore, the Trustee can determine in his sole and complete discretion that the Trust Fund is to small to economically administer and distribute the Trust Fund outright to any section 170(c)(2) organization he determines. Accordingly, the possible beneficiaries are not limited to the RR("RR") or to the organizations specified on Schedule A of the Declaration and, therefore, the organizational test is not met. See Quarrie, supra (holding that the organizational test was not satisfied where the trustee had the power to substitute beneficiaries when, in the judgment of the trustee, the uses of the named beneficiaries became unnecessary, undesirable, impracticable, impossible or no longer adapted to the needs of the public).

In addition, the operational test set forth in Treas. Reg. § 1.509(a)-4(e)(1) is not satisfied. A supporting organization will be regarded as "operated exclusively" to support a specified publicly supported organization(s) only if it engages in activities which support or benefit the specified publicly supported organizations(s). The Foundation has served the private interests of the Founders, NN, by transferring almost all of its assets to the Founders.

Relationship Test

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

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

In the present case, while the facts indicate that there was no substantial control or direction over the policies or activities of the Foundation by RR or any other named supported organization, on

paper the requirements to satisfy the first relationship have been met. Of the five board members, three are appointed by the Primary Charity, RR

Disqualified Person Control Test

Treas. Reg. § 1.509(a)-4(j)(1) provides that for purposes of section 509(a)(3)(C), an organization will be considered "controlled" if the person, by reason of his position or authority, may require the organization to perform any act which significantly affects its operations or prevents such organization from performing such act. All facts and circumstances are taken into consideration in determining whether a disqualified person controls an organization. Id. As Founders, substantial contributors, and/or officers of the Foundation, NN are disqualified persons. Other than the self-serving statements of the Founders, there is no evidence that the members of the Foundation's board of directors (the "Board") that were appointed by RR ever attended or participated in Board meetings or that any Board meetings were ever held to discuss the financial, operational and governance decisions of the Foundation. Rather, the evidence developed thus far indicates that if in fact any Board meeting were held to discuss such matters, the members of the Board deferred such decisions to the Founders. Accordingly, control and management of the Foundation was primarily vested with the Founders and not with the appointed directors Although there are three other individuals listed as members of the Board, there is no evidence indicating that these other Board members were involved in any way with the investment policies, activities and/or governance of the Foundation. Thus, the Foundation is controlled by disqualified persons within the meaning of Treas. Reg. § 1.509(a)-4(j)(1).

TAXPAYER'S POSITION:
Taxpayer's position is unknown.

CONCLUSION:

Accordingly, if its exempt status is not revoked, the Foundation should be reclassified as a private foundation because it does not qualify as a supporting organization under the requirements set forth in Treas. Reg. § 1.509(a)-4(c) through (j). Form 990-PF, Return of Private Foundation, should be filed for the tax years ending July x, 200X through July x, 200X. Subsequent returns are due no later than the xth day of the xth month following the close of the Foundation's accounting period.

Send your returns to the following address:

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

This determination is effective beginning December x, 199X. Retroactive reclassification is appropriate because the Foundation did not state in its application that it would operate primarily for the benefit of its Founders and that it would be controlled by its Founders.