



DEPARTMENT OF THE TREASURY

INTERNAL REVENUE SERVICE

TE/GE: EO Examinations  
625 Fulton Street, Room 503  
Brooklyn, NY 11201

501.03-00

TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

January 12, 2010

Release Number: **201017079**  
Release Date: 4/30/10

LEGEND

ORG = ORGANIZATION NAME      XX = DATE  
ADDRESS = ADDRESS

ORG  
ADDRESS

Taxpayer Identification Number:  
Person to Contact:  
Identification Number:  
Contact Telephone Number:

LAST DATE FOR FILING A PLEADING  
WITH THE TAX COURT, THE CLAIMS,  
COURT, OR THE UNITED STATES  
DISTRICT COURT FOR THE DISTRICT  
OF COLUMBIA: April 12, 20XX

**CERTIFIED MAIL**

Dear

This is a final adverse determination regarding your exempt status under section 501(c)(3) of the Internal Revenue Code (the Code). Our favorable determination letter to you dated April 17, 19XX is hereby revoked and you are no longer exempt under section 501(a) of the Code effective January 1, 20XX.

The revocation of your exempt status was made for the following reason(s):

You are not operating exclusively for any charitable purpose, educational purpose, or any other exempt purpose. Our examination reveals that you are not engaged primarily in activities which accomplish charitable, educational or other exempt purposes as required by Treas. Reg. 1.501(c)(3)-1(c)(1). Your activities, including your financial transactions, more than insubstantially furthered non-exempt purposes. Moreover, you failed to establish that you were not operated for the benefit of private interest of your chairman and private shareholders or individuals, as required for continued recognition of exemption pursuant to Treas. Reg. 1.501(c)(3)-1(d)(1)(ii). Your income inured to the benefit of private shareholders and individuals.

Contributions to your organization are no longer deductible under IRC §170 after

January 1, 20XX.

You are required to file income tax returns on Form 1120. These returns should be filed with the appropriate Service Center for the tax year ending December 31, 20XX and for all tax years thereafter in accordance with the instructions of the return. You have filed taxable returns on Form 1120 for the years ended December 31, 20XX, December 31, 20XX, December 31, 20XX, December 31, 20XX, December 31, 20XX and December 31, 20XX with us.

Processing of income tax returns and assessments 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 under the declaratory judgment provisions of section 7428 of the Code, a petition to the United States Tax Court, the United States Claims Court, or the district court of the United States for the District of Columbia must be filed before the 91<sup>st</sup> Day after the date this determination was mailed to you. Please contact the clerk of the appropriate court for rules regarding filing petitions for declaratory judgments by referring to the enclosed Publication 892. You may write to these courts at the following addresses:

You also 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, and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate at:

We will notify the appropriate State Officials of this action, as required by Code section 6104(c). You should contact your State officials if you have any questions about how this final determination may affect your State responsibilities and requirements.

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

Sincerely,

Nanette M. Downing  
Acting Director, EO Examinations

Enclosure:  
Publication 892



TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

DEPARTMENT OF THE TREASURY

Internal Revenue Service  
9350 Flair Dr., 2nd Floor  
El Monte, CA 91732-2828

October 21, 2009

ORG  
ADDRESS

Taxpayer Identification Number:

Form:

Tax Year(s) Ended:

Person to Contact/ID Number:

Contact Numbers:

Telephone:

Fax:

Certified Mail - Return Receipt Requested

Dear

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

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

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

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

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

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

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

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

Thank you for your cooperation.

Sincerely,

Sunita B. Lough  
Director, EO Examinations

Enclosures:  
Publications 892 & 3498  
Report of Examination  
Form 6018

**EXPLANATION OF ITEMS**

Name of Organization/Taxpayer

Tax Identification Number

Year/Period ended

ORG

12/31/20XX, 20XX and 20XX

**LEGEND**

ORG = Organization name      XX = Date      Address - address      City - city      State = state  
state      President = president      Director = director      Secretary = secretary  
SCH-1 & SCH-2 = 1<sup>st</sup> & 2<sup>nd</sup> School      EMP-1, EMP-2, EMP-4, EMP-4, EMP-5, EMP-6, EMP-7, EMP-8  
& EMP-9 = 1<sup>st</sup>, 2<sup>nd</sup>, 3<sup>rd</sup>, 4<sup>th</sup>, 5<sup>th</sup>, 6<sup>th</sup>, 7<sup>th</sup>, 8<sup>th</sup>, & 9<sup>th</sup> EMPLOYEES      CO-1, CO-2, CO-3, CO-4,  
CO-5, CO-6, CO-7 & CO-8 = 1<sup>st</sup>, 2<sup>nd</sup>, 3<sup>rd</sup>, 4<sup>th</sup>, 5<sup>th</sup>, 6<sup>th</sup>, 7<sup>th</sup> & 8<sup>th</sup> COMPANIES

**ISSUE**

1. Whether the activities conducted by ORG (“ORG”) throughout the years of its existence were in compliance with the rules and regulations under the Internal Revenue Code (“the Code”) §501(c)(3).
2. Whether ORG’s net earnings inure to the benefit of its officers and board members within the meanings of the Income Tax Regulations (“the Regulation”) §1.501(c)(3)-1(c)(2).
3. Whether ORG complied with record keeping requirements as required under the Code §§ 6001 and 6033.

**FACTS**

**Organizational Information:**

ORG was incorporated on October 21, 19XX, in the State of State. The specific purpose of the organization, as stipulated by Article II of the Articles of Incorporation is “to engage in the solicitation, receipt and administration of property and from time to time to disburse such property and the income there from [sic] for activities related to the development of new housing, for low to moderate income families, or for other charitable purposes, in accordance with Section 501(c)(3) ...”

The Internal Revenue Service (“The Service”) received the Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue code*, signed by President, the President of ORG, on February 6, 19XX. Its intended purposes as described in the application were:

“(1) Rehabilitation of dilapidated single family dwellings

- (a) The organization will purchase dilapidated single family dwellings from the Department of Housing and Urban Development (“HUD”). The purchase of each unit will be financed through loans from HUD (approximately 85% of the purchase price) and loans (at market interest rates) from private investors, including President, the president of the organization (approximately 15% of the purchase price). The organization will then rehabilitate each unit so that it meets all applicable building codes and is suitable for marketing. All rehabilitation work will be done by local building contractors at prevailing rates. The rehabilitation of each unit will be financed through loans from HUD (approximately 85% of rehabilitation costs) and loans (at market interest rates) from private investors, including President, the president of the organization (approximately 15% of rehabilitation costs). This activity will consume about 50% of the organization’s time. This activity furthers the organization’s goal of

**EXPLANATION OF ITEMS**

Name of Organization/Taxpayer

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ORG

12/31/20XX, 20XX and 20XX

rehabilitating existing housing stock in depressed urban neighborhoods, thereby helping to halt the deterioration of such neighborhoods and contributing to their revitalization.

- (b) This activity will begin as soon as the organization locates a suitable property being offered for sale by HUD, and HUD determines that the organization is eligible to participate in its sale and loan programs.
  - (c) This activity will be conducted in depressed urban neighborhoods located within County. The organization's president, President, will handle all day to day tasks related to purchase, rehabilitation, and financing.
- (2) Sale of rehabilitated dwellings to low and moderate income families
- (a) The organization will sell the units it rehabilitates to low and moderate income families at market prices. The units will be marketed through periodicals and through local real estate agents who specialize in home for low and middle income buyers. The organization will provide education and advice to first-time homebuyers, especially with regard to available sources of financing. This activity will consume about 30% of the organization's time. This activity furthers the organization's goals of (i) assisting low and moderate income families to achieve the goal of home ownership and (ii) contributing to the stability and revitalization of depressed urban neighborhoods by helping families become "stakeholders" in those neighborhoods.
  - (b) This activity will begin as soon as the organization completes rehabilitation of its first property.
  - (c) This activity will be conducted in depressed urban neighborhoods located within County. The organization's president, President, and volunteers who support the organization's goals will handle all day to day tasks related to marketing and sales.
- (3) Development and support of after-school tutoring and sports programs for "at risk" high school and junior high school students
- (a) All profits from the sales of rehabilitated units will be used to finance after-school tutoring and sports programs for "at risk" high school and junior high school students. The organization will work with school district personnel and other non-profit organizations to strengthen existing programs and to develop new programs of this type. It is anticipated that most programs will recruit and compensate credentialed teachers and physical education instructors to provide students with academic tutoring and sports instruction after school hours. This activity will consume about 20% of the organization's time. This activity furthers the organization's goals of providing constructive activities for "at risk" youth which will encourage them to stay in school and which will counteract the negative influences which they encounter each day.

Form <b>886-A</b> (Rev. January 1994)	<b>EXPLANATION OF ITEMS</b>		Schedule number or exhibit
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- (b) This activity will begin as soon as the organization realizes a profit from the sale of rehabilitated units.
- (c) Initially, the organization will focus on developing and supporting programs at SCH-1, located in City, State, and SCH-2, located in City, State. The organization's president, President, and volunteers who support the organization's goals will handle all day to day tasks related to the development and support of these after-school programs."

In response to the Service's questioning about whether any contractors would be related in any way to the officers or directors, ORG stated "The contractors used in the rehabilitation of the dwellings will not be related to any of the officers or directors of the organization."

In response to the Service's requesting a list of steps taken to involve the community or the residents, ORG stated that it would "provide education and advice to local residents who would like to become home owners."

In response to the Service's questioning about what President would be doing for the estimated \$ annual compensation, ORG provided a list of matters President would be doing and stated "The president will spend in excess of 150 hours per unit conducting his duties. The basis of setting the compensation will be to provide "token" compensation for his services."

In response to the Service's request to adopt the safe harbor guidelines with a statement signed by two officers under the penalties of perjury, ORG made the following statement:

"ORG is very familiar with the Department of Housing and Urban Developments requirements for low income housing providers. We will comply with all safe harbor guidelines described on page 3 of your March 28 letter."

Three individuals, President as the President, Director as the Director, and Secretary as the Secretary and the Director, signed the safe harbor statement and the response letter without the penalty of perjury statement on April 9, 19XX.

A determination letter was issued on April 17, 19XX granting exemption status under the Code §501(c)(3) as an organization described under the Code §509(a)(2) with an advanced ruling period through December 31, 20XX. In a letter dated April 25, 20XX, the Service reaffirmed the exempt status of ORG as a publicly supported organization.

### Issue 1 – Operational Test

On April 21, 20XX, the Service initiated a review of the Forms 990, *Return of Organization Exempt From Income Tax*, and activities of ORG for the years ending December 31, 20XX through 20XX. ORG was involved in two separate but related activities: low-income-housing rental, and rehabilitating and selling of old homes purchased from HUD.

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ORG owned 6 properties in the beginning of 20XX and rented 5 of them out. ORG stated the units were rented to low-income tenants and provided rental agreements. A review of the 20 rental agreements indicated 75% of the tenants received Section 8 housing assistance from HUD. Each tenant would pay the same amount of rent regardless of the Section 8 assistance. For example, if the rent was \$ a month and the tenant received \$ in Section 8 voucher, than ORG would receive \$ from the Housing Authority of the County of County and this tenant would pay ORG the difference of \$ with his own money.

We visited the website of the Housing Authority of the County of County at website which provided information related to Section 8 program. To become a participating owner, all one need to do is to lease the rental unit to a Section 8 voucher-holder. There is no requirement that a participating owner/landlord has to be an exempt organization, nor does it have any special rules or regulations to follow.

ORG would not explain how this rental activity constituted a charitable activity.

The other activity ORG involved in was the purchasing, refurbishing and reselling HUD properties. This activity began in 19XX and reached its peek in 20XX and tapered off. By 20XX, ORG was no longer purchasing properties from HUD. However, ORG fixed-up and sold two of the 6 properties in 20XX. We searched the public records for property transactions by ORG. The HUD properties ORG sold to individuals are summarized in the table below:

Year	# of prop	Total sale	Total cost	Total Gross Gain	10% gain
19XX	5				
19XX	6				
19XX	28				
20XX	42				
20XX	70				
20XX	26				
20XX	2				
Total	179				

The “total gross gain” was mathematically determined by subtracting “total cost” from “total sale”. It doesn’t represent the actual gain, since the cost of refurbishing and the cost of sale were not accounted for. We understand that HUD allows for a 10% profit for these kinds of properties. With that in mind, we made a conservative estimate of a 10% gain, or \$ gain over 7 year period.

We reviewed Forms 990 for the years ending December 31, 19XX through 20XX. The sales of the properties were only in 19XX through 20XX, and they were reported on Forms 990 as follows:

## EXPLANATION OF ITEMS

Name of Organization/Taxpayer

Tax Identification Number

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ORG

12/31/20XX, 20XX and 20XX

Account Description	19XX12	20XX12	20XX12	20XX12	20XX12
Housing sales					
HUD discount					
<b>Total Income</b>					
1st time home buyer gift					
Acquisition costs					
broker commission					
buyer costs pd by seller					
carrying costs					
closing costs at Acq					
Development fees					
Rehab costs					
Sales Closing costs					
<b>Total Expenses</b>					
<b>Net Gain(loss)</b>					
<b>% of net Gain(loss)</b>					

Even though it appeared that ORG made little or no profits from these transactions, President received substantial compensations and benefits. The follow table is a summary of the expenses reported on Forms 990 and displays how the funds earned from the two activities were utilized for the years 19XX through 20XX.

Account Description	19XX12	20XX12	20XX12	20XX12	20XX12	20XX12	20XX12
Comp to officers, directors, etc.							
Pension plan contribution (n1)							
Health insurance							
Payroll Taxes							
<b>Total pymt to/for President</b>							
after school program							
Interest (n2)							
Professional Fees							
EE related expenses							
Office related expenses							
<b>Total Office/Administrative Expenses</b>							
<b>% paid to/for President</b>	<b>71.94%</b>	<b>71.57%</b>	<b>62.07%</b>	<b>62.93%</b>	<b>26.62%</b>	<b>14.28%</b>	<b>n/a</b>

n1 ORG was on cash basis. Therefore, when these amounts were contributed to the pension account is not know. We adjusted the expenses to reflect and correct this timing difference the best we could.

n2 Since it was not a part of the office or administrative expenses, the 20XX percentage computation did not include the \$ interest.

The table above indicates over 60% of the net revenues in 19XX through 20XX were paid to President in the forms of compensations and benefits, which was substantially higher than the \$ estimated annual compensation to him on Form 1023.

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In the Form 1023, ORG indicated it would be operating after-school programs for “at risk” school students. There was one expense named “after school program”. Our review of the financial records indicated for 20XX through 20XX the payments were for school/personal related expenses of the office manager’s daughter.

## Issue 2 – Net Earnings Inuring to the Benefit of Officers and Directors

### Issue 2, Category 1 – Office space and staffs utilized by related entities

In order to determine whether there were net earnings inuring to the benefit of its officers and board members, we need to look at how day-to-day matters were handled. For the 5 rental properties, ORG contracted a property management company to rent out each unit, collect rents, maintain the property, etc. At the end of each month, the property management company would produce a monthly statement that summarized the rent collected, expenses incurred, including its management fees, and paid the net amount to ORG. This property management company was also the contact person for the Section 8 assistance. In other words, ORG’s work related to the rental activities were to record net rental income, and pay some bills such as mortgages, property taxes and utilities. We wanted to review the exact responsibilities of the property management company, but ORG would not provide a copy.

During 20XX, ORG rebuilt/constructed properties and made the following payments:

Payee	Description/purpose	Total paid in 20XX	Recorded in 20XX
EMP-1	did handy-man work for rental properties		
EMP-2	ORG paid it directly for the work it did through EMP-3.		
EMP-3	Did construction work for ORG		

The works related to rebuilding/constructing were primarily, if not entirely, handled by EMP-3, an entity wholly owned by the husband of a director of ORG. ORG’s work for this activity was limited to issuing checks to EMP-3. ORG had no written contracts with EMP-3 nor did it receive bills and invoices. (See Issue 2, Category 2 for transactions with EMP-3.)

For the amount of work described above, ORG rented a space in City, State that appeared to be a 2-room apartment converted into office for over \$\$ per month. ORG hired a full-time office manager with compensation and benefits exceeding \$\$ per year. Since there were more works than the office manager could handle, ORG hired a part-time helper and paid her \$\$ in 20XX, \$\$ in 20XX, and \$\$ in 20XX. The payment to the part-time helper included \$\$ bonus each year, including 20XX, the year she was compensated by ORG for the first 2 months only.

A search of public records indicated several other entities were using the same Post Office Box and/or the office addresses. We asked ORG to identify its related entities and percentage of ownership by the officers and directors. ORG provided the ownership of President for each of the entities. The following table summarizes his ownership:

Entity Name	President ownership
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Tax Identification Number

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ORG

12/31/20XX, 20XX and 20XX

Address, City	owned 25% in the past
Address City	owned 25% in the past
CO-1	
CO-2	currently owns 50%
EMP-3, Inc	
CO-3	currently owns 100%
CO-4	
CO-5	currently owns 50%
CO-6	currently owns 50%

We searched the records within the Service and found that it confirmed the ownership stated above plus the ownership of EMP-4 as follows:

Entity Name	President	EMP-4
Address, City	owned 25%	<b>owned 25%</b>
Address City	owned 25%	<b>owned 25%</b>
CO-1		<b>President of this EO</b>
CO-2	owns 50%	<b>owns 50%</b>
EMP-3, Inc.		<b>owns 100%</b>
CO-3	owns 100%	
CO-4	<b>owns 100% through his wife</b>	
CO-5	owns 50%	<b>owns 50%</b>
CO-6	owns 50%	<b>owns 50%</b>

The ownership of EMP-4 is significant for our consideration because his ownerships represent the ownerships of the ORG's operating director, EMP-5.

We questioned whether ORG's employees provided any services to these related entities and ORG responded by stating:

In 20XX, EMP-6 [the office manager] and EMP-7 [the part-time helper] did handle general office work for some of the entities above. We are unable to provide an accurate percentage of the time spent. In the past, the majority of their time was spent on ORG matters. From 20XX to present, the time spent on ORG matters has reduced and time spent on other companies' matters has increased. In 20XX and 20XX, many of the office expenses paid by ORG were phased out and these expenses are now paid by other companies. ORG no longer pays for Health Insurance for President, payments to EMP-7, cell phone bills, telephone bills, P.O. Box rent, office rent, or office supplies.

This explains why the part-time employee received \$\$ bonus at the end of 20XX, even though she was not compensated by ORG for the last 10 months. She was doing the same thing she had been doing for the remaining 10 months for the same group of entities but paid by an entity other than ORG. The people in charge of ORG allowed other entities to utilize ORG in this manner because they were benefiting from such usage.

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We reviewed 3 phone bills from CO-7, and observed that there were 4 phone lines. In response to our question of who were the individuals using the phones, ORG stated “President and EMP-6 were two of the users. We have to check the other two numbers.” ORG did not provide the names of the other 2 users.

Beginning in the year 20XX, ORG borrowed funds from ORG to cover some of the office expenses. By early 20XX, the borrowed funds accumulated to over \$. President agreed to apply this loan as corrections toward office expenses inuring to the benefits of CO-5, CO8 and CO-3 during the years under examination totaling \$.

### Issue 2, Category 2 – Health Insurance for EMP-1’s Family

ORG had 2 full-time employees, President and the office manager. Since 5/1/XX, ORG provided health insurance coverage for the entire family of these 2 employees. However, beginning on 5/1/XX ORG also provided health insurance for EMP-4’s family at \$ per month. We questioned why ORG was paying for EMP-1’s family and the response was “It was agreed that ORG would pay the health insurance for EMP-4 from 5/1/XX. His insurance was paid for until 10/26/XX.” The coverage for EMP-1’s family continued through October 20XX. This represented a total benefit of \$ in 20XX and around \$ in 20XX.

EMP-1 agreed and utilized the loan from CO-5 to ORG as corrections for these excess benefit transactions.

### Issue 2, Category 3 – Properties transferred out of ORG

We observed several questionable property transactions from the public records. ORG quitclaimed 3 of the rental properties (Address property, the Address property, and the Address property) to President back in 20XX and remained under his name throughout these years. We questioned why this was the case. ORG’s response was “The properties were quitclaimed to President in order to obtain favorable financing terms from CO-8. The properties were supposed to be quitclaimed back to ORG on the same day as the closing of the loan. This is what was done with Address on 12/14/XX. The fact that this was not done on subsequent properties was an error. President has signed quitclaim deeds back to ORG. ORG has not recorded those deeds because it would trigger a reassessment of the property.”

The property records indicated that ORG quit claimed the Address property to President on 9/23/XX, who then quit claimed to CO-5 (“CO-5”) on the same day. ORG quit claimed the Address property to President on 9/20/XX, who then quit claimed to CO-5 on the same day. ORG quit claimed the Address property to President on 10/29/XX, who then quit claimed to CO-5 on 2/6/XX. We questioned what ORG received in exchanged for these properties and the response was “The properties were sold in 20XX for valuable consideration. The sales were recorded on the 20XX tax returns.” We questioned why rental incomes from the Address property and the Address property were recorded on ORG’s general ledger in January 20XX, and the response was “Rental income deposited in January 20XX would have been for November or December 20XX rents. Since ORG is on the cash accounting basis, the income was recorded in 20XX when the checks were received.” This response did not match the records, because one property was quitclaimed out of ORG in September 20XX and the other in October 20XX.

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ORG quit claimed the Address property to President on 9/23/XX, who then quit claimed to CO-5 on 10/31/XX. CO-5 then sold it to an individual on 9/5/XX for \$. We questioned what ORG received in exchange for this property, and the response was "The property was sold in 20XX for valuable consideration. The sale was recorded on the 20XX tax returns."

ORG quitclaimed the Address. property to CO-5 on 1/1/XX but did not record the quit claim until 6/17/XX. CO-5 then sold it to an individual on 9/12/XX for \$. We questioned what ORG received in exchange for this property, and the response was "The property was sold in 20XX for valuable consideration. The sale was recorded on the 20XX tax returns." We questioned why the recording of the quitclaim did not take place until 2 and ½ years later, and the response was "The property was sold on 12/26/20XX to CO-5. If the deed was not recorded until later, that was an error."

ORG quitclaimed the Address property to President on 7/12/XX. President then sold it to an individual on 8/6/XX for \$. We questioned what ORG received in exchange for this property, and the response was "The property was sold on 9/23/20XX for \$. The sale was recorded on the 20XX tax returns."

The transactions related to the Address. property were unusual, and we have to summarize it as follows:

- 8/3/XX – HUD sold it to CO-1, the 501(c)(3) organization with EMP-1 as its President, for \$.
- 12/21/XX – CO-1 sold it to President for \$.
- 12/29/XX – President quit claimed it to CO-5.
- 6/8/XX – CO-5 quit claimed it to CO-1.
- 12/27/XX – CO-1 quit claimed it back to CO-5.
- 10/17/XX – CO-5 quit claimed to ORG

We questioned what ORG paid for in exchange for this property, and the response was "ORG purchased the property for valuable consideration." We questioned how ORG was utilizing this property, and the response was "ORG is maintaining the property as low to moderate income housing." The general ledger for 20XX indicated that the rental income was recorded starting in November 20XX. The purchasing of the property was recorded on 1/3/XX with a journal entry offsetting "Loans-Mortgage" account for \$.

ORG stated there were no appraisals for any of these properties when they were transferred out of ORG. We requested documentations regarding discussions and approval of these transfers, and ORG's response was there were "no written minutes, memos, or emails" regarding these transfers. We requested ORG's general ledgers for 20XX and 20XX to understand how these property transactions were records. ORG chose not to provide them.

In September 20XX, President made corrections for these property transactions. ORG quitclaimed three properties at Address, Address, and Address to President for the purpose of getting a better mortgage rate. President transferred these properties back to ORG. We determined that the excess benefit amounts for the remaining 5 properties that went to him or CO-5 totaled to \$. The remaining balance of CO-5's loan to ORG in the amount of \$ was used to reduce these excess benefit amounts. The remaining excess benefit amounts of \$ plus applicable interest were given to an unrelated organization exempt under the IRC § 501(c)(3).

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**Facts Applicable to All Issues:**

**Board Members:**

Section 6.02 of the Bylaws stated that the authorized number of directors shall be five (5). The Form 1023 listed the following 5 individuals for officers, directors, trustees, etc. under #4 of Part II:

<u>Name</u>	<u>Title</u>	<u>Address</u>
President	President, Chairman, Director	Address, City State
CFO	Chief financial Officer, Director	Address, City State
EMP-4	Secretary, Director	Address, City State
EMP-8	Director	Address, City State
Director	Director	Address, City State

An analysis of Forms 990, for the calendar years 19XX through 20XX indicated there were only 4 officers or directors. These officers and directors remained the same throughout the seven years. In other words, ORG failed to comply with its own bylaws since 19XX. The table below indicated that President was the only one receiving compensations.

Name	Title		19XX12	20XX12	20XX12	20XX12	20XX12	20XX12	20XX12
President, President	Chairman	Comp							
		Pension							
		Total							
EMP-5	Secretary		none	none	none	none	none	none	
CFO	Oper. Dir.		none	none	none	none	none	none	
EMP-9	Director		none	none	none	none	none	none	

**Minutes of Meetings:**

In response to our request for the minutes of the meetings of the governing body, including committee meetings, ORG provided the minutes of annual meetings dated 12/19/XX, 12/16/XX, and 12/15/XX. All three minutes have the following statements except as indicated:

Minutes of Annual Meetings of Both Shareholders and Directors of

ORG

**We, the undersigned, being all of the shareholders, directors, and the secretary of the Corporation, hereby agree and consent that the annual meeting of the shareholders and the annual meeting of directors of the Corporation be held on the date designated hereunder, and do hereby waive all notice whatsoever of such meeting and of any adjournment thereof. [Emphasis added.]**

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We do further agree and consent that any and all lawful business may be transacted at such meetings or at any adjournment or adjournments thereof as may be deemed advisable by any shareholder or director present thereat. Any business transacted at such meetings or a any adjournment or adjournments thereof shall be a valid and legal and of the same force and effect as if such meeting or adjourned meetings we held after the notice.

The directors and shareholders of this company pursuant to statutory requirements of that law held its annual meeting of the shareholders and immediately thereafter, held its annual meeting of board of directors as of the day set forth below.

The undersigned constituting all the shareholders, directors, and the secretary of this company hereby acknowledge that by placing their signatures below they consent to the waiver notice of these meetings and consent to said meetings being held by said shareholders, board of directors and secretary.

Upon motion duly noted and seconded and unanimously carried out, the following was considered and voted upon by the undersigned. ... [The minutes listed some of the matters that took place during the year.]

ORG has not paid dividends. ...

There being no further business to come before the meeting of the undersigned, upon motion duly make and seconded and unanimously carried, the meeting was adjourned.

Date: ...

\_\_\_\_\_  
Director  
Secretary

A review of ORG's Bylaws indicate that Section 6.03 states "Directors shall be elected at each annual meeting of the board of directors to hold office until the next annual meeting by plurality vote of the directors in office immediately preceding the election; ..."

Section 6.06 of the Bylaws states "Annual meetings of the board of directors shall be held for the purpose of organization, election of directors and officers and the transaction of other business. Annual meetings shall be held on the first day of February of each year at 10:00 a.m."

Section 6.09 of the Bylaws states "A majority of the authorized number of directors shall constitute a quorum for the transaction of business ... A meeting at which a quorum is initially present may continue to transact business, notwithstanding the withdrawal of directors, if any action taken is approved by at lease a majority of the required quorum for that meeting."

We compared the minutes to the bylaws to see whether ORG complied with its own rules, and observed the following inconsistencies:

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- With the references to shareholders and dividends, the minutes appeared to follow the format of a for-profit corporation.
- None of the minutes mentioned which officers and board members were present, and whether a quorum was met.
- The minutes began with the statement “We, the undersigned, being all of the shareholders, directors, and the secretary of the Corporation, hereby agree and consent...” It appeared to imply that Director was the sole shareholder/director/secretary of ORG.
- These annual meetings were held in December, even though the Bylaws required them to be held on or the next working day after the first day of February.
- There were no elections of directors.
- The property transfers from ORG to President and to Residential Investment were director related transactions. However, there were no discussions or approval by the board.
- The use of office space and sharing office staffs by related entities were not addressed.
- In May 20XX, EMP-4’s family was added into the health insurance policy, and was paid for by ORG. In other words, the board member, CFO, EMP-1’s wife, was receiving benefits from ORG without the board’s approval and without consideration of conflict of interest. This transaction was not discussed or approved by the board.

### LAW

The Code §501(a) states “An organization described in subsection (c) ... shall be exempt from taxation under this subtitle.”

The exempt organization listed under the Code §501(c)(3) is described as “Corporations... organized and operated exclusively for religious, charitable ... **no part of the net earnings of which inures to the benefit of any private shareholder or individual...**” [Emphasis added.]

The Income Tax Regulations (“the Regulation”) §1.501(a)-1(c) states “The words “private shareholder or individual” in section 501 refer to persons having a personal and private interest in the activities of the organization.”

The Regulation §1.501(c)(3)-1(c)(1) states “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.”

The Regulation §1.501(c)(3)-1(c)(2) states “**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.**” [Emphasis added.]

The Regulation §1.501(c)(3)-1(d)(1)(ii) states “An organization is not organized or operated exclusively for one or more of the purposes specified in subdivision (i) of this subparagraph unless it serves a public rather than a private interest. 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 designated individuals,

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the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.”

The Regulation §1.501(c)(3)-1(d)(1)(ii), although states in terms of the "net earnings" of an organization, the inurement doctrine applies to any of an organization's charitable assets. See *People of God Community*, 75 T.C. 127, 133 (1980). Payment of excessive compensation is a form of inurement. For example, in *Mabee Petroleum Corp. v. U.S.*, 203 F. 2d 872, 875 (5<sup>th</sup> Cir. 1953), the Fifth Circuit held that the organization's payment of a full-time salary for part-time work was inurement.

The Regulation §1.501(c)(3)-1(d)(2) states “The term “charitable” ... includes: Relief of the poor and distressed or of the underprivileged; ... or (iv) to combat community deterioration and juvenile delinquency.”

In *Better Business Bureau of Washington, D.C. v. U.S.*, 326 U.S. 279, 283 (1945), the Supreme Court held that the “presence of a single... (nonexempt) purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly... (exempt) purposes.”

Revenue Ruling 70-585, 1970-2 C.B. 115, provides that nonprofit housing organizations created to aid low and moderate income families by lessening neighborhood tensions, eliminating prejudice and discrimination, and combating community deterioration may qualify for exemption under §501(c)(3) of the Code.

Receipt by an exempt organization of less than fair market value in a sale or exchange of property with an insider is also a form of inurement. In *Sonora Community Hospital v. Commissioner*, 46 T.C. 519 (1966), two doctors transferred their private practice of medicine, including the building in which the practice was housed, to a non-profit hospital they controlled. A portion of the building was occupied by a for-profit laboratory under a prior agreement with the two doctors. The doctors caused the hospital to acquiesce in the arrangement with the laboratory. The hospital received no consideration for the assignment of its space to the laboratory either as part of the sale or through a share of the laboratory's gross revenues. Payments in consideration of the assignment that should have been paid to the hospital were paid directly to the two doctors. The doctors performed no services for the laboratory. The Tax Court held that the arrangement resulted in an inurement of the hospital's charitable assets to the two doctors.

In *Anclote Psychiatric Ctr. v. Commissioner*, T.C. Memo 1998-273 (1998), an organization's board of directors caused the organization to sell its largest asset – a hospital – to a for-profit entity formed by the directors. The board of directors obtained an independent appraisal of the hospital and hired independent counsel to represent the organization. The closing, however, occurred almost two years after the appraisal. The parties failed to make adjustments to the values established in the appraisal. The Tax Court determined that the purchase price received by the organization on the sale of the hospital was not within a reasonable range of what could be considered fair market value. Accordingly, the Tax Court held that the sale transaction resulted in inurement within the meaning of §501(c)(3).

The provision of inurement can be direct or indirect. In *Anclote Psychiatric Ctr.*, *supra*, the sale transaction giving rise to the inurement was between an exempt organization and a for-profit corporation formed by the organization's directors. Although the for-profit corporation was the direct beneficiary of the below-market sale transaction, the Tax Court held that the transaction resulted in “an advantage” to the

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shareholders of the for-profit corporation and that this “advantage” constituted inurement of the organization’s charitable assets to the shareholders.

In *Church by Mail, Inc. v. Commissioner*, 765 F.2d 1387 (9<sup>th</sup> Cir. 1985), the Ninth Circuit treated as inurement compensation paid by a controlled entity to the organization’s insiders. In *Church by Mail*, two individuals, Reverend Ewing and Reverend McElrath, ran a church that mailed printed sermons to several million homes. They also owned a for-profit advertising agency which provided the Church’s printing and mailing services. The Ninth Circuit found that the combined compensation paid to Reverend Ewing and Reverend McElrath by the Church and the advertising agency was excessive. The Ninth Circuit rejected the Church’s argument that the portion of the compensation paid by the advertising agency should not be included in the determination of reasonableness and treated this portion as indirect inurement of the Church’s earnings to the Church’s insiders. *Id.* The Ninth Circuit based its conclusion on the following legal principle: “[W]hen a second organization is created which serves to funnel income to the individual who controls the purportedly exempt organization and the income exceeds a reasonable salary, the income inures to the benefit of a private person within the meaning of I.R.C. section 501(c)(3).” *Id.*

Indirect inurement can occur even if the organization’s insiders are not formally in control of the intermediary used to funnel the funds from the organization to the insiders. In *Church of Scientology of California v. Commissioner*, 823 F.2d 1310, 1315 (9<sup>th</sup> Cir. 1987), the organization transferred in excess of \$ 3.5 million to a for-profit corporation incorporated by the organization’s founder and his wife. The directors of the corporation were high-ranking members of the Church of Scientology. At the time of the transfer, the founder and his wife were not directors, officers or employees of the corporation. The founder was no longer serving as the head of the church but continued to exert significant control over the church by making policy statements, directives and orders. 823 F.2d at 1314. In particular, his approval was required for all financial planning. *Id.* The directors of the corporation approved the founder’s decision to transfer \$ 2 million from the corporation’s account to the ship *Apollo* aboard which the founder and his family lived. The Ninth Circuit held that the organization’s funds funneled through the corporation constituted inurement to the founder and his family. 823 F.2d at 1318.

The prohibition on inurement in the Code §501(c)(3) is absolute. The Service has the authority to revoke an organization’s exempt status for inurement regardless of the amount of inurement. See *Spokane Motorcycle Club v. U.S.*, 222 F.Supp. 151 (E.D. Wash. 1963); *The Founding Church of Scientology*, 412 F.2d 1197, 1202; *Airlie Foundation*, 283 F. Supp. 2d 58. Moreover, for purposes of establishing that inurement occurred, it is not necessary to calculate the precise amount of inurement as long as it is shown that the value of the transfer giving rise to inurement is not within a reasonable range of what could be considered fair market value. See *Anclote Psychiatric Ctr. v. Commissioner*, T.C. Memo 1998-273.

## Record Keeping Requirement

The Code § 6001 states, “Every person liable for any tax imposed by this title, or for the collection thereof, shall keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary may from time to time prescribe. Whenever in the judgment of the Secretary it is necessary, he may require any person, by notice served upon such person or by regulations, to make such

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returns, render such statements, or keep such records, as the Secretary deems sufficient to show whether or not such person is liable for tax under this title.”

The Code §6033(a)(1) states, “In general. ... every organization exempt from taxation under section 501(a) shall file an annual return, stating specifically the items of gross income, receipts, and disbursements, and such other information for the purpose of carrying out the internal revenue laws as the Secretary may by forms or regulations prescribe, and shall keep such records, render under oath such statements, make such other returns, and comply with such rules and regulations as the Secretary may from time to time prescribe...”

The Regulation §1.6001-1(a) states, “*In general.* ... any person required to file a return of information with respect to income, shall keep such permanent books of account or records, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by such person in any return of such tax or information.”

The Regulation §1.6001-1(c) states, “*Exempt organizations.* —In addition to such permanent books and records as are required by paragraph (a) of this section with respect to the tax imposed by section 511 on unrelated business income of certain exempt organizations, every organization exempt from tax under section 501(a) shall keep such permanent books of account or records, including inventories, as are sufficient to show specifically the items of gross income, receipts and disbursements. Such organizations shall also keep such books and records as are required to substantiate the information required by section 6033.”

The Regulations §1.6001-1(e) states, “*Retention of records.* —The books or records required by this section shall be kept at all times available for inspection by authorized internal revenue officers or employees, and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law.”

The Revenue Ruling 59-95, 1959-1 CB 627, (Jan. 01, 1959) states, “An organization previously held exempt from Federal income tax was requested to produce a financial statement as of the end of the year and a statement of its operations during such year. However, its records were so incomplete that it was unable to furnish such statements. ... *Held,* failure or inability to file the required information return or otherwise to comply with the provision of section 6033 of the Code and the regulations which implement it, may result in the termination of the exempt status of an organization previously held exempt, on the grounds that the organization has not established that it is observing the conditions required for the continuation of an exempt status.”

### **Effective date of revocation**

The Regulation §1.501(a)-1(a)(2) states “Subject only to the Commissioner's inherent power to revoke rulings because of a change in the law or regulations or for other good cause... an organization that has been determined by the Commissioner or the district director to be exempt under section 501(a) or the corresponding provision of prior law may rely upon such determination so long as there are no substantial changes in the organization's character, purposes, or methods of operation.”

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The Regulation §601.201(n)(3)(ii) states a “ruling or determination letter 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.”

The Regulation §601.201(n)(6)(i) states “[a]n exemption ruling or determination letter may be revoked or modified by a ruling or determination letter addressed to the organization... The revocation or modification may be retroactive if the organization omitted or misstated a material fact, operated in a manner materially different from that originally represented...”

### **GOVERNMENT POSITION**

#### **Issue 1 – Operational Test**

In order for an organization to retain its exempt status it must demonstrate to the Service that it meets both the organizational and the operational tests. The facts stated above indicate that ORG failed the operational test.

Charitable purposes include relief of the poor and distressed, the Regulation §1.501(c)(3)-1(d)(2). ORG’s rental activity and selling of real properties in the manner described above doesn’t address the needs of low-income people. In fact, the rental activity and the selling of real properties were operated in a manner no different than other business entities that are engaging in such activities in a commercial manner.

The rental rate was the same regardless of whether a tenant receives rental assistance from government agencies. In fact, ORG required the tenant to pay the difference if the rental assistance amount was less than the rental rate. The government agency did not require the landlord to be an exempt organization.

In 20XX ORG also sold 2 properties. Fixing and selling properties at market rate doesn’t constitute assisting low-income families. Therefore, the activities as described above did not meet the operational test as described under §1.501(c)(3)-1(c) of the Regulation.

ORG has bylaws but chooses not to comply with them. It held the annual board member meetings in December instead of February. It made no elections during the annual meetings. It did not discuss and/or approve many of the significant matters that took place during the years. These actions represent ORG disregarding its own rules and regulations, which in turn indicates that ORG did not meet the operational test as described under §1.501(c)(3)-1(c) of the Regulation.

#### **Issue 2 – Net Earnings Inuring to the Benefit of Officers and Directors**

President was an officer of ORG. EMP-4 was the spouse of EMP-5, the operating director of ORG. More than insubstantial amount of each of the entities utilizing ORG’s street and PO Box addresses are/were owned by President and EMP-1. Therefore, President, EMP-1 and all entities they own/owned are private shareholders or individuals within the meaning of the Regulation §1.501(a)-1(c).

#### **Issue 2, Category 1 – Office space and staffs utilized by related entities**

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ORG allowed President, EMP-1 and entities they own/owned to utilize its staffs, supplies, and office space, without any reimbursements. Such usage was not approved by the ORG board members. Therefore, such usage inured to the benefit of President, EMP-1 and entities they own/owned, and represented an act prohibited by the Code §501(c)(3).

**Issue 2, Category 2 – Health Insurance for the Gooch Family**

During the years 20XX and 20XX, ORG paid for the health insurance of EMP-1’s family, which was not approved by the board of directors. Therefore these payments constituted net earnings inuring to the benefits of EMP-1, and represented an act prohibited by the Code §501(c)(3).

**Issue 2, Category 3 – Properties transferred out of ORG**

Any transactions between an exempt organization and another party should be at market rate or below market rate to the benefit of the exempt organization. If a transaction is below market rate but the party being short-changed is the exempt organization, then the transaction constitutes misuse of exempt organization’s funds.

Since 20XX, ORG transferred several properties to President. The monetary considerations were limited to the amount of outstanding loans. These transfers were not approved by the board members of ORG. Therefore these transfers constituted net earnings inuring to the benefits of President, and represented an act prohibited by the Code §501(c)(3).

**Issue 2, Overall**

The records indicate there were substantial net earnings inuring to the benefits of private shareholders and individuals going as far back as 20XX year. There was no oversight by a disinterested board. The individuals in charge of ORG utilized ORG as if it was another for profit business under their control. No segregation of duties, funds, or authorities observed. Accordingly, the exemption status of ORG should be revoked due to its net earnings inured to the benefit of these private shareholders and individuals within the meaning of the Regulation §1.501(c)(3)-1(c)(2).

**Issue 3 – Record Keeping Requirement**

Through out the examination, ORG was unwilling or unable to produce the records necessary to support and substantiate the financial information reported on the annual returns it filed. The records it managed to provide did not match one another in several instances. Accordingly, failed to comply with requirements under the Code §§ 6001 and 6033 and the Regulations thereunder.

**TAXPAYER POSITION**

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ORG agreed and terminated its operation in August 20XX. ORG transferred the three properties at Address, Address, and Address and the cash balance of \$ to an unrelated organization exempt under IRC § 501(c)(3).

**CONCLUSION**

Based on the information secured during the examination, we conclude that ORG is not operated for exempt purposes under §501(c)(3) of the Code. An organization can not be recognized as exempt under §501(c)(3) unless it shows that it is operated exclusively for charitable, education, or other exempt purposes and its net earnings does not inure to the benefit of any private shareholder or individual. Among other things, ORG's activities must demonstrate conclusively that it meets the operational test of §1.501(c)(3)-1(c) of the Regulation. The activities show that the primary purpose is renting properties out to general public that does not exclusively serve a purpose described in §501(c)(3) of the Code. It also engaged in many transactions enabling its net revenues to benefit President and EMP-1, the private shareholders or individuals of ORG. Therefore, the exempt status granted to ORG should be revoked effective from January 01, 20XX in accordance with the Regulation §601.201(n)(6)(i).