

Internal Revenue Service
TEGE Appeals Programs
300 N. Los Angeles Street
Los Angeles, CA 90012

Department of the Treasury
CERTIFIED

Number: 201020034
Release Date: 5/21/2010

Date: February 25, 2010

A

B

Taxpayer Identification Number:

Person to Contact:

Employee ID Number:

Tel:

Fax:

Refer Reply to:

AP:LA:EMW

In Re:

Exempt status

Tax Years: 2005 and subsequent
years

UIL Index:

501.00-00

501.35-00

Last Day to File a Petition with the
United States Tax Court:

MAY 26 2010

Dear :

This is a final adverse determination as to your exempt status under section 501(a) as an organization described under section 501(c)(3) of the Internal Revenue Code effective January 1, 2005. Our adverse determination was made for the following reason(s):

You are not operated exclusively for charitable, educational, or other exempt purposes as required by section 501(c)(3) of the Internal Revenue Code. You did not engage primarily in activities which accomplish one or more of the exempt purposes specified in section 501(c)(3). Treas. Reg. § 1.501(c)(3)-1(c)(1).

Contributions to your organization are not deductible under Code § 170. You are required to file federal Form 1120 for the year(s) shown above.

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 before the 91st (ninety-first) day after 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.

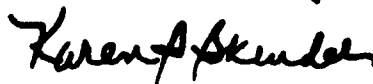
You also have the right to contact the Office of the Taxpayer Advocate. However, you should first contact the person whose name and telephone number are shown above since this person can access your tax information and can help you get answers. You can call 1-877-777-4778, and ask for Taxpayer Advocate assistance.

Taxpayer Advocate assistance cannot be used as a substitute for established IRS procedures, formal appeals procedures, etc. The Taxpayer Advocate is not able to reverse legal or technically correct tax determinations, or extend the time fixed by law that you have to file a petition in the United States Tax Court. The Taxpayer Advocate, can however, see that a tax matter, that may not have been resolved through normal channels, gets prompt and proper handling.

We will notify the appropriate State officials of this final adverse determination of your exempt status, as required by Code section 6104(c).

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

Sincerely,



Karen A. Skinder
Appeals Team Manager

cc:



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
Internal Revenue Service

ORG
ADDRESS

Taxpayer Identification Number:

Form:

Tax Year(s) Ended:

Person to Contact/ID Number:

Contact Numbers:

Telephone:

Fax:

Certified Mail - Return Receipt Requested

Dear :

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

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

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

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

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

Letter 3618 (04-2002)
Catalog Number 34809F

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

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

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

Thank you for your cooperation.

Sincerely,

Sunita B. Lough
Director, EO Examinations

Enclosures:
Publication 892
Publication 3498
Report of Examination

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LEGEND

ORG = Organization name XX = Date Trustee = trustee Donor = donor
CO-1, CO-2, CO-3 = 1ST, 2ND & 3RD COMPANIES BM-1, BM-2, BM-3, BM-4 & BM-5 =
1ST, 2ND, 3RD, 4TH & 5TH BOARD MEMBERS

PRIMARY ISSUE:

Whether the ORG qualifies for exemption under Section 501(c)(3) of the Internal Revenue Code.

FACTS:

The ORG was created with a Declaration of Trust by and between Donor ("Donor") and Donor ("Trustee") on December 13, 19XX. 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 Trust Instrument provides that the Donor renounces any power to determine or control, by alteration, amendment, revocation, termination or otherwise, the income or principal of the Trust estate. In addition, the Trust Instrument also provides that the Donor renounces any interest, either vested or contingent, including any reversionary interest or possibility of reverter, in the income or principal of the Trust estate.

The Declaration of Trust further provides that each year the Trustee shall distribute % of the net income of the Trust to the CO-1, the named Primary Charity. In addition to this distribution, each year the Trustee shall distribute a total of % of the net income to one or more identified charitable organizations or to the Primary Charity as directed by at least three members of the Board of Directors (the "Board").

The Declaration of Trust provides that the Board shall have the authority, power and discretion of the Trust and that the members of the Board shall be determined as follows:

- One Board member shall be appointed by the Primary Charity.
- Two Board members shall be from the class consisting of Donor and Trustee and their descendants (the Trustee Family).
- The other members of the Board shall be BM-1 and BM-2.

The Trust Document provides that upon the 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).

In an undated copy to the Internal Revenue Service, the Declaration of Trust was amended to change the Board to include:

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- Three board members shall be appointed by the Primary Charity who shall be BM-3, BM-4, and BM-5.
- Two Board members shall be from the class consisting of Donor and Trustee and each of their descendants (the Trustee Family).

By letter dated May 10, 20XX, the ORG was recognized by the Service as exempt from Federal income tax under section 509(a) because it is described in section 501(c)(3) and classified as an organization that is not a private foundation because it is described in section 509(a)(3).

After an initial contribution of \$ to the Primary Charity in 20XX, the ORG did not make any further distributions to the CO-1 and did not have board representation appointed from the Primary Charity. The only other distribution made by the ORG was to CO-2 on January 3, 20XX in the amount of \$. This organization was not originally designated as a recipient in ORG's Trust document. The ORG has conducted no financial or exempt activities since this distribution.

According to oral testimony from Donor, the original intention of the foundation was not to support the designated Primary Charity. The foundation was intended as a to benefit CO-3 for ; however, this was never created.

The ORG has not filed Form 990 since its inception in 19XX. The organization maintains one financial account. This account is a mutual fund with In January 20XX, Donor funded the Trust with \$ in , a publicly traded stock. After this stock declined in value, the foundation sold it to invest the proceeds in a lower risk mutual fund. The value of this mutual fund as of December 31, 20XX is \$. Third party financial statements for this account shows no additional funding or withdrawals conducted from January 20XX to December 20XX.

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.

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

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

Regulation section 1.501(c)(3)-1(d)(2) defines charity as relief of the poor and distressed or of the underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening of the burdens of Government; and promotion of social welfare by organizations designed to accomplish any of the above purposes, or (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency.

IRC §170(c) Code defines the term "charitable contribution" as a contribution or gift to or for the use of--

- (1) A State, a possession of the United States, or any political subdivision of any of the foregoing, or the United States or the District of Columbia, but only if the contribution or gift is made for exclusively public purposes.
- (2) A corporation, trust, or community chest, fund, or foundation--
 - (A) created or organized in the United States or in any possession thereof, or under the law of the United States, any State, the District of Columbia, or any possession of the United States;
 - (B) organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals;
 - (C) no part of the net earnings of which inures to the benefit of any private shareholder or individual; and
 - (D) which is not disqualified for tax exemption under section 501(c)(3) by reason of 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 (or in opposition to) any candidate for public office.

A contribution or gift by a corporation to a trust, chest, fund, or foundation shall be deductible by reason of this paragraph only if it is to be used within the United States or any of its possessions exclusively for purposes specified in subparagraph (B). Rules similar to the rules of section 501(j) shall apply for purposes of this

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paragraph.

(3) A post or organization of war veterans, or an auxiliary unit or society of, or trust or foundation for, any such post or organization--

(A) organized in the United States or any of its possessions, and

(B) no part of the net earnings of which inures to the benefit of any private shareholder or individual.

(4) In the case of a contribution or gift by an individual, a domestic fraternal society, order, or association, operating under the lodge system, but only if such contribution or gift is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals.

(5) A cemetery company owned and operated exclusively for the benefit of its members, or any corporation chartered solely for burial purposes as a cemetery corporation and not permitted by its charter to engage in any business not necessarily incident to that purpose, if such company or corporation is not operated for profit and no part of the net earnings of such company or corporation inures to the benefit of any private shareholder or individual.

TAXPAYER'S POSITION:

The taxpayer does not agree to the revocation of his IRC § 501(c)(3) status. The original intention was to provide scholarship funds to CO-3 through a private foundation. Although he was unable to provide this scholarship due to financial hardship, he would like to maintain ORG as a dormant private foundation for future use when he will be able to maintain it financially.

GOVERNMENT'S POSITION:

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

The Facts show that ORG is not operated exclusively for a tax exempt charitable purpose as defined under Regulation section 1.501(c)(3)-1(d)(2). The foundation does not conduct exempt-related activities for the benefit of either an organization organized under 170(c) or for the benefit of their own Primary Charity.

ORG fails to conduct exempt-related activities or to provide contributions in the support of exempt-related activities as required under Regulation section 1.501(c)(3)-1(c)(1) which requires 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).

Accordingly, ORG's status as an organization described under section 501(c)(3) should be revoked, effective January 1, 20XX, because it did not operate exclusively for

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exempt purposes, and will be responsible for filing and reporting all income on Form 1041 for tax years ending December 31, 20XX, 20XX, 20XX and 20XX.

ALTERNATIVE ISSUE # 1:

Should ORG be reclassified as a private foundation?

FACTS:

The original Declaration of Trust, which created on December 13, 19XX, and an undated amendment filed with the Internal Revenue Service, provides that each year the Trustee shall distribute % of the adjusted net income of ORG (the "Organization") to the CO-1 (Primary Charity). The document also provides that the Board of Directors (the "Board") shall consist of three members appointed by the Primary Charity: BM-3, BM-4, and BM-5, and two members shall be from the class consisting of the Trustee Family.

After an initial contribution to the Primary Charity in 20XX of \$ the ORG did not make any further distributions to the CO-1 and did not have board representation appointed from the Primary Charity. The Organization did not produce Board meetings minutes and did not retain any record of Board decisions or oversight. There is no evidence that representatives of CO-1 ever attended or participated in any meetings of the Board of the Organization. There is no evidence that any financial reportings were made to the Primary Charity. Donor stated there were no Board meetings from 20XX to 20XX.

According to oral testimony from Donor, the original intention of the foundation was not to support the designated Primary Charity. The foundation was intended as a scholarship fund to benefit CO-3 for ; however, this was not created.

The only other distribution made by ORG was to CO-2 on January 3, 20XX in the amount of \$. This organization was not originally designated as a recipient in the ORG's Trust document. ORG has not conducted financial or exempt activities since this distribution.

LAW:

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

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(1) *In general.* —An organization is organized exclusively for one or more 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.

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

(1) *Permissible beneficiaries.* —A supporting organization will be regarded as “operated exclusively” to support one or more specified publicly supported organizations (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

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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.

Income Tax Regulations section 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

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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.

Income Tax Regulations section 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.

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

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

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(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.

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

(1) General rule

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

(2) Responsiveness test

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

(ii)

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

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

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

(d) By reason of (a), (b), or (c) of this subdivision, the officers, directors or trustees of the publicly supported organizations have a significant voice in the investment policies

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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

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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.

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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.

Income Tax Regulations section 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

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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.

TAXPAYER'S POSITION:

Donor originally intended to provide scholarship funds to CO-3 through a private foundation. Although he was unable to provide this scholarship due to financial hardship, he would like to maintain ORG as a dormant private foundation for future use when he will be able to maintain it financially.

GOVERNMENT'S POSITION:

As set forth above, it is the government's primary position that the tax exempt status of ORG (the "Organization") should be revoked. Alternatively, the Organization 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).

Public charities (organizations described in section 501(c)(3) that meet the requirement of sections 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 on the theory that the public charities that they support, rather than the public, will provide the scrutiny 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 and that the public charity (or publicly supported organization) is motivated to be attentive to the operations

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of the supporting organization and that it is not controlled, directly or indirectly, by disqualified persons.

Operational Test

The Organization does not meet the operational test set forth in Treasury Regulation § 1.509(a)-4(e)(1). 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). As was discussed under the Primary Issue above, the Organization has made only two distributions since its inception, one to the Primary Charity and another to a 501(c)(3) organization not designated in Schedule A with their Declaration of Trust. Since the final distribution in January 20XX, the organization has not contributed to any publically supported organization. Therefore, it has not established that it operated exclusively for the benefit of their designated publicly supported organizations.

The operational test requires the Organization to exclusively engage in activities that benefit specified publicly supported organizations. The Organization has not conducted financial or exempt activities since January 20XX. Furthermore, the final distribution was to _____, an organization not specified in the original declaration of trust. The lack of exempt-related activities and a distribution to an organization not determined by the organizing documents violates the operational test. This distribution was in violation of Treas. Reg. § 1.509(a)-4(e)(1).

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).

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In the present case, the facts indicate that there was no substantial control or direction over the policies or activities of the Organization by CO-1. The Organization did not produce Board meetings minutes and did not retain any record of Board decisions or oversight. Donor stated there were no Board meetings from 20XX to 20XX. The evidence developed thus far shows that the appointed representatives of the Primary Charity never attended any board meetings or trustee meetings. There is no common supervision or control by the same persons over the Organization and the specified publicly supported charities.

The third and final relationship possible for section 509(a)(3) organizations is the "operated in connection with" relationship which requires that the supporting organization be responsive to the needs or demands of the publicly supported organization and constitute an integral part of, or maintain a significant involvement in the affairs of, the publicly supported organization. This relationship is satisfied where the supporting organization meets both the "responsiveness" and "integral part" tests. The integral part test has not been met in this case.

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

Treas. Reg. § 1.509(a)-4(i)(3)(ii) provides that the activities engaged in for or on behalf of the publicly supported organizations must be activities to perform the functions of, or to carry out the purposes of, such organizations and, but for the involvement of the supporting organization, would normally be engaged in by the publicly supported organizations themselves. Thus, this part of the integral part test applies in those situations in which the supporting organization actually engages in activities which benefit the publicly supported organizations as opposed to simply making grants to the publicly supported organizations. Compare to Treas. Reg. § 1.509(a)-4(i)(3)(iii) (which sets forth the rules of the integral part test applicable to supporting organizations that make payments to or for the use of publicly supported organizations), see also Roe Foundation, T.C. Memo. 1989-566; Cuddeback Memorial Fund v. Commissioner, T.C. Memo. 20XX-300. The Organization does not meet this test because it does not perform any activities for or on behalf of the publicly supported organizations.

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Treas. Reg. § 1.509(a)-4(i)(3)(iii)(a) provides that the amount of support received by a publicly supported organization must represent a sufficient part of the organization's total support so as to insure such attentiveness. Generally, grants or distributions of amounts that are less than 10 percent of the publicly supported organization's total support are insufficient to insure the publicly supported organization's attentiveness. Treas. Reg. § 1.509(a)-4(i)(3)(iii)(b) provides that a supporting organization can meet the attentiveness requirement, even where the amount of support received by the publicly supported organization does not represent a sufficient part of the publicly supported organization's total support, if it can be demonstrated that support is earmarked for a substantial program of the publicly supported organization that would be interrupted without the supporting organization's support. And finally, Treas. Reg. § 1.509(a)-4(i)(3)(d) provides that "[a]ll pertinent factors. . . will be considered in determining whether the amount of support received by a publicly supported organization is sufficient to insure the attentiveness of such organization to the operations of the supporting organization." It goes on to note the importance of the percentage of the income received from the supporting organization is in determining if the publicly supported organization will have the requisite degree of attentiveness and concludes that evidence of actual attentiveness is almost as important.

The Organization did not produce evidence that shows that the CO-1 would be attentive to its operations. The individuals who represented the Primary Charity on the Organization's board never attended or participated in any board meeting. There is no evidence that the individuals were involved in the decisions regarding investments and/or operations of the Organization as no Board meetings were produced. Trustee reported there were no Board meetings between 20XX and 20XX. Thus, it is apparent that the Primary Charity was not attentive to the operations of the Organization.

Accordingly, the Organization 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) effective January 1, 20XX.

ALTERNATIVE ISSUE # 2:

Based on ORG's reclassified as a private foundation, is it liable for the tax on the failure to distribute income under IRC § 4942?

FACTS:

The Organization maintains a mutual fund as their sole asset. The mutual fund has not been increased by additional contributions or diminished by contributions during the examination period between January 1, 20XX and December 31, 20XX. The average fund balance was calculated for this time period as follows:

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	<u>20XX</u>	<u>20XX</u>	<u>20XX</u>	<u>20XX</u>
Beginning Fund Balance	\$			
January				
February				
March				
April				
May				
June				
July				
August				
September				
October				
November				
December				
Total				
Divided by 13 periods				
Average Fund Balance	\$			

After an initial contribution to the Primary Charity in 20XX of \$, the ORG did not make any further distributions to the CO-1 and did not have board representation appointed from the Primary Charity. The only other distribution made by ORG was to CO-2 on January 3, 20XX in the amount of \$\$\$. This organization was not originally designated as a recipient in the ORG's Trust document. ORG has conducted no further financial or exempt activities since this distribution

LAW:

IRC § 4942(a) imposes a tax on the undistributed income of a private foundation for any taxable year, which has not been distributed before the first day of the second taxable year following such taxable year, a tax equal to 15 percent of the amount of such income remaining undistributed at the beginning of such second taxable year.

Public Law 109-280, Title XII, § 1244(c), Aug. 17, 2006, 120 Stat. 1108, provided that the imposition of tax shall be equal to 30 percent of such income remaining undistributed at the beginning of such second taxable year. The amendments made by this section shall apply to distributions and expenditures after the date of the enactment of this Act [Aug. 17, 2006].

IRC § 4942(b) imposes an additional tax in any case in which an initial tax is imposed under IRC § 4942(a) on the undistributed income of a private foundation for any taxable year, if any portion of such income remains undistributed at the close of the taxable period, there is hereby imposed a tax equal to 100 percent of the amount remaining undistributed at such time.

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IRC § 4942(c) defines the term "undistributed income" as with respect to any private foundation for any taxable year as of any time, the amount by which the distributable amount for such taxable year exceeds the qualifying distributions made before such time of such distributable amount.

IRC § 4942(d) defines distributable amount as with respect to any private foundation for any taxable year, an amount equal to the sum of the minimum investment return plus amounts described in IRC § 4942(f)(2)(c), income modifications, reduced by the sum of the taxes imposed on such private foundation for the taxable year under IRC § 4940.

IRC § 4942(e) defines minimum investment return for any private foundation for any taxable year as 5 percent of the excess of the aggregate fair market value of all assets of the foundation other than those which are used directly in carrying out the foundation's exempt purpose, over the acquisition indebtedness with respect to such assets.

Regulation section 53.4942(a)-2(c)(3) defines assets used (or held for use) in carrying out the exempt purpose as an asset that is actually used by the foundation in the carrying out of the charitable, educational, or other similar purpose which gives rise to the exempt status of the foundation, or if the foundation owns the asset and establishes to the satisfaction of the Commissioner that its immediate use for such exempt purpose is not practical (based on the facts and circumstances of the particular case) and that definite plans exist to commence such use within a reasonable period of time. Consequently, assets which are held for the production of income or for investment (for example, stocks, bonds, interest-bearing notes, endowment funds, or, generally, leased real estate) are not being used (or held for use) directly in carrying out the foundation's exempt purpose, even though the income from such assets is used to carry out such exempt purpose.

Regulation section 53.4942(a)3(b)4 defines the minimum distribution required during start-up period for private foundations created before January 1, 1972, the start-up period is the four taxable years immediately preceding the taxable year beginning in calendar year 1976. For private foundations created after December 31, 1971 (or for organizations that first become private foundations after that date), the start-up period is the four taxable years following the taxable year in which the private foundation was created (or otherwise became a private foundation). For purposes of this subparagraph (4), a private foundation will be considered "created" in the taxable year in which the private foundation's distributable amount (as determined under section 4942(d)) first exceeds \$500.

(ii) Start-up period minimum amount. The amount that a private foundation must actually distribute in cash or its equivalent during the private foundation's start-up period is not less than the sum of:

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(a) Twenty percent of the private foundation's distributable amount (as determined under section 4942(d)) for the first taxable year of the start-up period,

(b) Forty percent of the private foundation's distributable amount for the second taxable year of the start-up period,

(c) Sixty percent of the private foundation's distributable amount for the third taxable year of the start-up period, and

(d) Eighty percent of the private foundation's distributable amount for the fourth taxable year of the start-up period.

(iii) Timing of distributions. The requirement that a private foundation distribute the start-up period minimum amount during the start-up period is a requirement that such amount be distributed before the end of the start-up period, and is not a requirement that any portion of such amount be distributed in any one taxable year of the start-up period.

TAXPAYER'S POSITION:

Donor originally intended to provide _____ to CO-3 through a private foundation. Although he was unable to provide this scholarship due to financial hardship, he would like to maintain ORG as a dormant private foundation for future use when he will be able to maintain it financially, subject to excise tax.

GOVERNMENT'S POSITION:

As set forth above, it is the government's primary position that the tax exempt status of ORG (the "Organization") should be revoked. Alternatively, the Organization should be reclassified as a private foundation. If reclassification is upheld, the organization is liable for tax on the undistributed income under IRC § 4942(a) and (b).

As ORG has not distributed charitable contributions to either their Primary Charity or other designated charities, IRC § 4942(a) and (b) will be assessed for tax years ending December 31, 20XX, 20XX, 20XX and 20XX as indicated below:

IRC § 4942(a) Taxes on failure to distribute income

	<u>20XX</u>	<u>20XX</u>	<u>20XX</u>	<u>20XX</u>
Average fair market value of assets	\$			

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Less 1 1/2 % cash deemed held for charitable activities	_____			
Value of noncharitable-use assets	\$			
Minimum investment return rate	5%	5%	5%	5%
Minimum investment return Less IRC § 4940(a) tax	0	0	0	0
Distributable amount				
IRC § 4942(d) Rate for start up period	20%	40%	60%	80%
Start up period Minimum distributable amount - Treas. Reg. 53.4942(a)3(b)4				
Qualifying distributions IRC § 4942(g).	0	0	0	0
Less operating expenses	0	0	0	0
Start up period Minimum distributable amount - Treas. Reg. 53.4942(a)3(b)			\$	
LESS				
Adjusted qualifying distributions			0	0
0	0			
Undistributed Income	\$			
Initial tax rate	15%	30%	30%	30%
Total IRC § 4942(a) tax	\$			

Additional tax under IRC § 4942(b)

In any case in which an initial tax is imposed under IRC § 4942(a) on the undistributed income of a private foundation for any taxable year, if any portion of such income

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remains undistributed at the close of the taxable period, there is hereby imposed a tax equal to 100 percent of the amount remaining undistributed at such time.

Year	<u>20XX</u>	<u>20XX</u>	<u>20XX</u>	<u>20XX</u>
Undistributed Income	\$			
IRC § 4942(b) tax rate	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>

Total tax under IRC § 4942(b)

For the reasons set forth above, it is determined that ORG is not an organization described in section 501(c)(3). Alternatively, the Organization should be reclassified as an organization that is a private foundation defined in section 509(a) and it should be held liable for the excise taxes under section 4942(a) and (b).