

Internal Revenue Service
Appeals Office
1375 E. Ninth Street
One Cleveland Center #815
Cleveland, OH 44114-1739

Number: **201052022**
Release Date: 12/30/2010

Date: October 5, 2010

A
B

Certified Mail

Dear :

This is a final adverse determination regarding your exempt status under section 501(c)(3) of the Internal Revenue Code (IRC). It is determined that you do not qualify as exempt from Federal income tax under IRC Section 501(c)(3) effective December 22, 2000. Your application for exemption (Form 1023) and associated materials misstated material facts, and you operated in a manner materially different than originally represented.

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

You are not operated exclusively for exempt purposes described in I.R.C. § 501(c)(3) for the following reasons:

- (1) Your net earnings inured to the benefit of your founder Trustees within the meaning of Treas. Reg. § 1.501(c)(3)-1(c)(2).
- (2) You operated for the private benefit of individuals including your creators, Trustees, and entities your Trustees own or control, as more than an insubstantial part of your activities, within the meaning of Treas. Reg. § 1.501(c)(3)-1(c)(1) and (d)(1)(ii).

In the event there is a final order from a court of competent jurisdiction finding that you were in fact described in section 501(c)(3), then we are alternatively

Department of the Treasury

Person to Contact:

Employee ID Number:

Tel:

Fax:

Refer Reply to:

In Re:

Form Required to be Filed:

EIN:

Tax Period(s) Ended:

UIL:

501.03-05

determining you are a private foundation described in section 509(a) rather than a supporting organization described in section 509(a)(3) for the following reasons:

- (1) You failed the operational test described in Treas. Reg. § 1.509(a)-4(e) by making 20 percent of your grants to organizations other than the supported organizations specified in your Declaration of Trust.
- (2) You failed the control test described in I.R.C. § 509(a)(3)(C) and Treas. Reg. § 1.509(a)-4(j)(1) because A ("A") primary assets, held by D, were under the sole management of A's founders and Trustees, requiring no input from the other Trustees. Thus, these disqualified persons could and did require A to perform acts that significantly affected its operations without the votes of the remaining Trustees and, as such, these disqualified persons had control over A.
- (3) Because E and F, in fact, controlled A, A was not "operated, supervised, or controlled by" or "supervised or controlled in connection with" its supported organizations and was also not "operated in connection with" its supported organizations; as such, A failed the relationship test described in Treas. Reg. § 1.509(a)-4(f).
- (4) A failed the organizational test described in Treas. Reg. § 1.509(a)-4(c) because its Declaration of Trust empowers A to support or benefit organizations other than the specified publicly supported organizations by (a) a dissolution clause that permits A to distribute its assets to organizations other than the specified publicly supported organizations upon A's termination and (b) a provision that allows A's Board of Trustees to add or remove organizations from its list of specified publicly supported organizations at will.

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

You are required to file Forms 1120, U.S. Corporation Income Tax Return, for tax periods beginning on and after December , 20 with the Service Center,

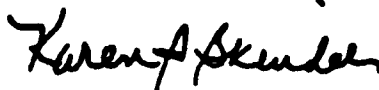
If you decide to contest this determination under the declaratory judgment provisions of Code section 7428, a petition to the United States Tax Court, the United States Court of Claims, or the district court of the United States for the District of Columbia must be filed within 90 days from the date this determination was mailed to you. Contact the clerk of the appropriate court for rules for filing petitions for declaratory judgment. To secure a petition form from the United States Tax Court, write to the United States Tax Court, 400 Second Street, N.W., Washington, D.C. 20217.

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 determination may affect your state responsibilities and requirements.

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 is not able to reverse legally correct tax determinations, nor extend the time fixed by law that you have to file a petition in the U.S. 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. If you want Taxpayer Advocate assistance, please contact the Taxpayer Advocate for the IRS office that issued this letter. See the enclosed [redacted] for Taxpayer Advocate telephone numbers and addresses.

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

Sincerely,



KAREN A. SKINDER
APPEALS TEAM MANAGER

Enclosure:

1

LEGEND:

A =
B =
C =
D =
E =
F =



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY

Internal Revenue Service
TE/GE EO Examination
1100 Commerce Street
Dallas, TX 75242

May 17, 2007

Taxpayer Identification Number:

Form:

Tax Year(s) Ended:

December 31,

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,

Marsha A. Ramirez
Director, EO Examinations

Enclosures:
Publication 892
Publication 3498
Report of Examination

Form 886-A	EXPLANATION OF ITEMS	Schedule or Exhibit No.
Name of Taxpayer XX EIN XX		Years Ended

PRIMARY ISSUE: Whether the XX tax exempt status under Internal Revenue Code § 501(c)(3) should be retroactively revoked because it has not established that it operated exclusively for exempt purposes.

FACTS

November, 20 : The XX, with offices in XX, XX and XX, XX, engaged in tax planning for XX and XX of XX. XX issued an invoice for \$ to XX and XX for "Total Fees as per Engagement Agreement" for this tax planning. The tax planning included the establishment of the following entities, with all of the LLCs having the same two managers, XX and his wife, XX:

- XX
- XX
- XX
- XX
- XX
- XX

December, 20 : Two separate life insurance applications, completed and signed by XX and XX, husband and wife, were submitted by XX, of XX, to obtain life insurance. The December, 20 cover letter states, "XX and XX, as managers of the XX, LLC would like to apply for a \$ Stag Variable Life Policy on XX's life and a \$ Stag Variable Life policy on XX's life in order to provide cash accumulation and for estate planning purposes...The XX, LLC was established as part of their overall estate planning design and will be owner and beneficiary of the policies".

Organizing Documents

The XX Declaration of Trust (Declaration) was entered into on December, 20. The Foundation is governed by the State. According to the Declaration, the Foundation's purpose is the establishment of an organization which is described in Section 501(c)(3) and Section 509(a)(3) of the Internal Revenue Code of 1986.

Article II, Section 1, of the Declaration provides that the Foundation will be "organized, and at all times thereafter operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of, one or more specified organizations described in Section 509(a)(1) or (2) of the Internal Revenue Code and may not engage in activities which are not in furtherance of the purposes of Section 509(a)(3)(A). The specific purpose of this Foundation is

Form 886-A	EXPLANATION OF ITEMS	Schedule or Exhibit No.
Name of Taxpayer XX EIN XX		Years Ended

to manage, invest, and distribute Foundation assets primarily for the benefit of the following primary supported charitable organization (The "Primary Supported Organization"):

The XX

The XX is irrevocably designated as the Primary Supported Organization and is entitled to receive such distributions as are necessary for the Foundation to qualify as a Supporting Organization to the Primary Supported Organization and may enforce its rights to such distributions to the extent necessary to effectuate the purposes of this Section. The Foundation will furnish reports at least annually to the Primary Supported Organization which will include its assets, income and expenses. The Foundation will be operated in such a way so as to be responsive to the needs of the Primary Supported Organization and may make distributions to the Primary Supported Organization through an advised fund of the Primary Supported Organization or in such other manner as is directed by the Primary Supported Organization".

The Foundation may also support thirty-eight other named 501(c)(3) charitable organizations including The XX and The XX. The primary purpose clause states "Upon majority vote of the Board of Trustees, qualified 501(c)(3) charitable organizations including the Primary Supported Organization and the other Supported Organizations which are granted the authority to select members of the Board of Trustees pursuant to Article III, Section 1 may be added to or removed from this list of organizations. The Foundation may not act to support or benefit charitable organizations other than those named pursuant to this Section", (Article II, Section 1).

Article II, Section 2 provides "No part of the Trust (including the net earnings of the trust fund) shall inure to the benefit of any private shareholder or individual and ... Notwithstanding any other provision of this Trust, this organization shall not carry on any activities not permitted to be carried on by an organization exempt from Federal income tax under section 501(c)(3) ... or the corresponding provision of any future United States Internal Revenue Law".

In Article V, Section 3, the Declaration provides "This Trust is irrevocable except as follows:

- a. Until such time as the Trustees receive a written determination from the Internal Revenue Service ... the Settlers (or their legal representatives) shall have the limited right to amend this Trust in order to obtain the said written determination; and
- b. Upon the majority consent of the Trustees and written notice to the Internal Revenue Service and the Attorney General, the Trustees may amend the Trust Agreement in any manner which does not jeopardize the qualification...under Section 501(a) of the Code and as an organization described in Section 501(c)(3) of the Code".

Form 886-A	EXPLANATION OF ITEMS	Schedule or Exhibit No.
Name of Taxpayer XX EIN XX		Years Ended

The Trustees' general powers and duties include, "Pursuant to this Trust Agreement and law, the Trustees shall not exercise their powers except in full compliance with federal laws governing tax exempt organizations under Section 501(c)(3) of the Code so that this Trust at all times qualifies as a tax exempt organization to which donations shall be tax deductible pursuant to Sections 170(a)(1), 2055 and 2522 of the Code".

The Declaration further provides "Assets, as used herein, shall refer to all types of property interests which may be owned from time to time by the Trustees on behalf of the Trust".

Article II, Section 3 of the Declaration describes the use of trust funds and states "The trustees in their discretion shall distribute all, or part, of the net annual income of the Trust to fulfill the purposes of this Trust. The Trustees may also invade the principal of the Trust to fulfill the purposes of the Trust".

The dissolution clause of the Declaration provides "The Trust shall continue forever unless the Trustees terminate it and distribute all of the principal and income, which action may be taken by the Trustees in their discretion at any time. On such termination, assets shall be distributed for one or more exempt purposes within the meaning of Section 501(c)(3) of the Internal Revenue Code, or the corresponding section of any future federal tax code, or shall be distributed to the federal government, or to a state or local government, for a public purpose.

Upon winding up and dissolution of this Trust, after paying or adequately providing for the debts and obligations of the Trust, the remaining 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) of the Code. In the event that the Trust does not obtain tax-exempt status under Sections 501(c)(3) and 509(a)(3) of the Code, the assets of the Trust shall go to the Donor, or by power of appointment as a contingent remainder."

Regarding the board, the Declaration provides "The Board of Trustees shall initially be composed of five (5) members, a majority of which may never be disqualified persons as that term is defined by Internal Revenue Code Section 4946(a)(1). The Board shall always consist of at least three (3) Trustees. The Primary Supported Organization and The XX Foundation, Inc. (hereinafter "Voting Supported Organizations") shall, at all times, each have the right to select at least one (1) Trustee, or in the alternative an equal number of Trustees so that, at all times, the Voting Support Organizations, or their replacements, shall have the right to select a majority of the voting members of the Board of Trustees (the "Supported Trustees"). In addition, at such time, if any, as The XX is created, and provided that it is organized and qualifies as an organization described in Section 509(a)(1) or 509(a)(2) of the Code, then The

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Name of Taxpayer XX EIN XX		Years Ended

XX shall also become a Voting Supported Organization...The Family Trustees shall collectively have two votes for any matter before the Board of Trustees”.

The Declaration was signed by XX and XX as Settlers and as Founders/Donors. Other signatories included XX, XX, and XX as the Trustees.

The Foundation maintains that the original trust was “inadvertently not retained” and that it was replaced by a revised trust as signed by successor trustees and the only change was the appointment of the non-family trustees. (Letter Dated December , 20 , IDR , Item)

Trustees/Board Members

Trustees per the Declaration: Three of the five original trustees listed on the Declaration, XX, XX and XX resigned in January and February of 20 and were replaced, which left XX and XX along with the following new trustees:

- XX.
- XX.
- XX.

Application for Recognition of Exemption (Form 1023)

Exemption Application Board of Directors: Per the Application, the Foundation’s Board of Directors were as follows:

- XX
- XX
- XX
- XX
- XX

The XX filed Form 1023, Application for Recognition of Exemption, with the Internal Revenue Service on or around November , 20 . The Application was signed by XX.

In Part II of the application regarding disqualified persons, it stated “XX and XX are substantial contributors to the Foundation...The foundation provides that, at all times, the Foundation will be controlled by non-disqualified persons”. It was further represented that the Foundation’s facilities or operations will not be managed by another organization or individual under a contractual agreement and that there are no contracts or agreements.

Form 1023, Part II, Activities and Operational Information, provided “The Foundation will at all times operate to support the purposes and activities of certain named 509(A)(1) and 509(A)(2)

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charitable organizations. The primary supported organization of the Foundation is The XX. The Foundation will, at a minimum, distribute fifty-one (51 %) of its net income to the primary supported organization and will furnish the primary supported organization with regular financial reports. In addition to supporting the primary supported organization, the Foundation will also support certain other specifically listed charitable organizations as outlined in the trust agreement. At the direction of the primary supported organization and the other supported organizations, the Foundation will financially support a variety of activities."

Later and in response to an Information Document Request (IDR) that requested additional information on the 51 % net income distributions, a representative stated "The attorney who prepared the Form 1023 made a mistake on said form, Part II, question 1 because a Type I Support Organization is not required to make a minimum of 51 % of its net income to the primary supported organization. The Trust Agreement does not state that the Foundation will, at a minimum, distribute fifty-one percent (51 %) of its net income to the primary supported organization. Also note that the primary supported organization is provided with the financial reports that are included in the tax returns."

In response to an IDR requesting a description of the entities represented by the board members, specifically, "a description of the entities eleemosynary purpose and modus operandi", the representative responded: "The supported organizations, The XX, XX, and XX, were selected because they work with other similar supporting organizations. Each organization seeks to advance charitable giving in the private sector, especially among higher net worth donors. For example, the XX and XX specifically seek to educate individuals and families to the financial, social and personal benefits of charitable giving. The XX is committed to helping individuals, corporations and communities express themselves in the charitable, educational, scientific and religious sector and initiating charitable activities that in the spirit of charitable entrepreneurship may eventually become self-supporting independent foundations some day."

Based upon its representations, the XX was recognized as exempt from tax under section 501(a) as an organization described in section 501(c)(3) on January 1, 2000. It was classified as a supporting organization described in section 509(a)(3). Later, in a letter dated February 1, 2001, the Foundation advised the Service that the XX's name had been changed to The XX, effective December 31, 2000.

Although various LLCs were created and funded before the application for exemption was filed, there was no disclosure on the application regarding the related LLCs and the various assets held by them. Further, no LLC operating agreements accompanied the application.

State of California Exemption Application

Form 886-A	EXPLANATION OF ITEMS	Schedule or Exhibit No.
Name of Taxpayer XX EIN XX		Years Ended

The Foundation filed an Exemption Application, Form 3500, with the stating "The specific purpose for which the support organization was formed is to manage, invest, and distribute Foundation assets primarily for the benefit of The XX". The state granted exemption in a letter dated April , 20 . In 20 , the Foundation registered with the California Registry of Charitable Trusts.

Initial Contribution

The acknowledgement letter to XX and XX letterhead stated "Thank you for your generous contribution to the XX of \$ on December , 20 . Please retain this letter for your tax records. You did not receive any goods or services in consideration of your contributions. The XX".

Bank account transactions for the initial contribution of \$ by XX and XX show the transfer occurred in December 20 . The bank records show the following:

- **Bank Checking Accounts:** Initial business checking accounts for the Foundation and various LLCs with XX Bank also known as (aka) XX Bank were opened on December , 20 . Signature cards show XX and XX had sole signature authority.
- **XX Bank Account:** On December , 20 , a \$ check, the initial deposit, was deposited into the Foundation's XX Bank Account # XX from the personal account of XX and XX. On the same date, \$ was withdrawn from the Foundation's account leaving a \$ balance. No other activity occurred in the Foundation's bank account for years 20 and 20 . Beginning in year 20 , monthly checks in the amount of \$ signed by XX were paid to XX purportedly for investing and consulting services.
- **XX, LLC Bank Accounts:** On the same date as the \$ deposit into the Foundation's account, December , 20 , \$ was withdrawn and transferred into bank account #XX0. This account was in the name of XX, LLC. XX, LLC was owned 100% by XX and XX. This was the initial deposit into the account. This account was one of two accounts in the name of XX. The other account is #XX. The \$ deposit ticket identified account #XX as being in the name of XX, LLC. On the same date, \$ was transferred out of account # leaving a remaining balance of \$ at year end. Although XX and XX maintain account #XX was XX, LLC's bank account, XX Bank's monthly summary account statements show account #XX was owned by XX, LLC until at least October 20 . At the end of 20 , account #XX had a balance of \$ and account #XX had a balance of \$ and both were identified as owned by XX, LLC on the bank statements. In October 20 , the bank summary statements listed account # XX under XX LLC's name but still summarized it under XX LLC. Beginning in August 20 ,

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Name of Taxpayer XX EIN XX		Years Ended

account #XX was separately identified as owned by XX, LLC on the monthly bank statements.

- XX, LLC: On the same date of the initial deposit, December , 20 , \$ of the \$ that had been transferred to XX, LLC's bank account was transferred to XX Bank account #XX which was owned by XX, LLC. This was the initial deposit into this account. On December , 20 , a \$ check was written to XX from this account. The check's remarks section stated, "from XX LLC Policy #XX, Insured. The check cleared on January , 20 , leaving a \$ balance in the account.
- \$100 Contributions: Exhibits A to the LLC Operating Agreements provided for a \$ initial contribution. In Exhibit A to the XX, LLC Operating Agreement, it stated there was a \$ initial contribution by its member, The XX Foundation.

To summarize, in addition to the Foundation, two LLCs were created by XX and XX. XX and XX were the sole managers of the LLCs. The Foundation represented the entities were related as follows :

- 1) XX
- 2) XX
- 3) XX

In response to an IDR, the Foundation provided "Attached are the bank statements for XX, LLC and XX, LLC showing where the \$ went from the XX account on December , 20 . \$ was transferred to the XX, LLC bank account number XX. \$ was transferred to the XX, LLC bank account number XXX. Please note that XX owns % of XX, LLC. Also note that XX, LLC owns % of XX, LLC. Please see the attached Operating Agreements for both XX, LLC and XX, LLC."

Other entities created and controlled by XX and XX as managers, in year 20 or subsequent to year 20 , include but are not limited to the following:

- XX
- XX
- XX
- XX
- XX
- XX

Most of the bank accounts for the various LLCs were located at the same financial institutions. In 20 , the XX accounts were closed and similar accounts were opened with XX. Various financial transactions flowed back and forth between the various entities created, managed and/or owned by XX and XX including XX, LLC and XX, LLC, the two entities represented as being owned by the Foundation:

Form 886-A	EXPLANATION OF ITEMS	Schedule or Exhibit No.
Name of Taxpayer XX EIN XX		Years Ended

	<u>NAME</u>	<u>EIN</u>	<u>XBANK #</u>	<u>X #</u>
X		X	X	X
X		X	X	X
X		X	X	X
X		X	X	N/A
Y		X	X	X
XX		X	X	N/A
X		X	X	X
X		X	X	X
X				
X		X	Unknown	Unknown
X		X	Unknown	Unknown
X		X	Unknown	Unknown

*XX and XX (CRT) entered into a partnership agreement in February 2003 whereby the partnership profits and losses were allocated 99% to the CRT and 1% to the Foundation.

The source of funds for all the initial deposits to open the XX accounts in 2004 was from the personal bank account of XX and XX.

Board Minutes – The XX

The XX board minutes were dated as follows and stated "all of the Trustees of the Foundation were either physically present at the meeting or participated by teleconference":

- November , 20
- November , 20
- November , 20

November , 20 – XX Minutes: The November , 20 minutes read "this was the first Annual Meeting that there were no previous minutes":

- "XX was appointed Chairman of the Meeting and XX was appointed the Secretary of the Meeting".
- "the Supported Trustees shall collectively have three votes for any matter before the Board of Trustees, which shall be divided equally among the Supported Trustees that are in attendance at the meeting and that the Family Trustees shall collectively have two votes for any matter, which shall be divided equally among the Family Trustees that are at the meeting".
- Investments were reviewed to ensure that the investments are reasonable and prudent investments, and do not, either directly or indirectly, privately benefit any individual, and "that such investments are not more than an insubstantial part of the charitable activities of the Foundation" and that the Family Trustees, "provided no input regarding the

Form 886-A	EXPLANATION OF ITEMS	Schedule or Exhibit No.
Name of Taxpayer XX EIN XX		Years Ended

reasonableness or appropriateness of such investments and abstained from any and all votes related to such investments".

- Assets, contracts, loans, leases and/or other arrangements entered into by the Foundation were reviewed to ensure favorable terms and did not benefit, directly or indirectly, any private individuals.
- "The Board determined that any provisions regarding a minimum distribution of % of net income to the Primary Supported Organization *be removed*. This will allow the foundation to provide support in the manner it sees necessary to assist any of the listed Supported Organizations".
- The Foundation would support only those Supported Organizations of the Foundation and in addition a grant in the amount of \$ would be provided to each of the supported organizations: XX, XX, Inc. and XX.

February , 20 - XX Resolution: In a Unanimous Consent Resolution dated February , 20 , the Trustees "authorized to pay for the costs associated with establishing a Charitable Remainder Trust whereby the Foundation is named sole beneficiary with a minimum % irrevocable designation of such. The Foundation is anticipating the costs to be approximately \$ and the benefit to be derived from the Charitable Remainder Trust is anticipated to be \$... The Trustees of the Foundation hereby empowered XX and XX to sign all documents and take all other actions ... to effect the establishment of the Charitable Remainder Trust."

November , 20 - XX Minutes In the November 20 minutes the Chairman explained "the Foundation % wholly owns XX, LLC. This entity is currently being managed by XX and XX. In addition, XX currently acts as a Chairman providing consulting services for the Foundation" ... and the Investments, LLC. The Family Trustees abstained from voting and the board determined "that \$ /year still constitutes a reasonable salary."¹

- XX's qualifications are as follows:
 - MBA from XX
 - Member of XX
 - 20 Participant in The XX
 - Member of Silicon XX
 - Partner in XX

¹ XX received \$ per month. XX drew checks in the amount of \$ per month from the Foundation's bank account payable to XX as the Foundation Director. In addition, checks in the amount of \$ per month were drawn on XX LLC's bank account to XX and were noted as being a money management fee.

Form 886-A	EXPLANATION OF ITEMS	Schedule or Exhibit No.
Name of Taxpayer XX EIN XX		Years Ended

The board again resolved that \$ be provided to each of the supported organizations: XX, XX Foundation, Inc. and XX Foundation. An additional amount totaling \$ would be provided to various other entities exempt under IRC 501(c)(3).

November, 20 - XX Minutes: The November, 20 board minutes stated XX is elected to serve as President and XX as Vice President, Secretary and Treasurer.

- Reasonable consulting fees in the amount of \$ /month were paid to XX for remuneration for his services reviewing the Foundation's various investments, managing XX, LLC, and reviewing donations and the necessities of the Foundation. XX of XX explained "this has previously been discussed with the attorney, and the answer is, yes, so he will ask the attorney to write a Memorandum addressed to the Board of Trustees confirming that a Trustee can be paid reasonable compensation for services rendered".
- Chairman XX "explained that the Foundation currently owns a \$ XX Life Insurance policy on XX Life with a current Account Value of \$."
- "XX and XX are the current Managers for this entity and with the Board of Trustee's approval, they can go ahead and make the investment decisions and report back to the Board".

The current assets as summarized in Exhibit A to the board minutes were as follows:

<u>Current Assets</u>	
X	Owens \$ Life Insurance Policy on X's Life-Account Value at 09/30/04
X	Software company funded by X. \$ Investment
X	Venture capital leverage returns. \$ Investment
X	Fidelity mutual fund account as of 10/ /20
X	% ownership in X funds.
X	Promissory Note for \$ %
X	As of 10/ /20

The "Foundation's purpose...is to continue to grow in size so that it may continue providing support to its Supported Organizations...the Chairman stated that the Foundation's four key areas to support as follows: Job Training, Youth Development, Environmental and Human Rights."

The board again resolved that \$ be provided to each of the supported organizations: XX, XX, Inc. and XX. Grants made at the time of the board meeting totaled \$. An additional

Form 886-A	EXPLANATION OF ITEMS	Schedule or Exhibit No.
Name of Taxpayer XX EIN XX		Years Ended

amount totaling \$ would be provided to various other entities exempt under IRC 501(c)(3).

Board Minutes – XX, LLC & XX, LLC

Board minutes of XX, LLC were provided and reflect XX owned % of it and that it had investments in XX, LLC. The XX, LLC board minutes were dated:

- December , 20
- December , 20
- December , 20
- December , 20

All minutes were signed by XX and XX and stated the only individuals present were the two managers, namely:

- XX and
- XX

All minutes basically stated the following: "The annual meeting of the Member of XX, LLC (the "Company") was held on (day of week followed by the actual date i.e. Friday, December , 20). XX, as Trustee of The XX, which is the Member of the Company, acted as Chairman of the meeting and called the meeting to order. Roll call of the Member was read and the Member present at the meeting, which constituted a quorum, was as follows:

MEMBER

The XX
XX, Trustee
XX, Trustee

December , 20 board minutes stated the annual XX, LLC company meeting was held on December , 20 and the "Chairman read and confirmed the previous minutes of the last member meeting". The Service requested the year 20 board minutes because none had been provided. The Foundation responded that the minutes referenced the XX, LLC Operating Agreement. This implies the operating agreement substituted for the 20 board minutes.

No board minutes were provided for XX, LLC.

State of Filing for Limited Liability Company (LLC) – XX, LLC

Form 886-A	EXPLANATION OF ITEMS	Schedule or Exhibit No.
Name of Taxpayer XX EIN XX		Years Ended

Operating Agreement: The XX, LLC Operating Agreement dated December , 20 , states The XX has a % interest. XX is Trustee and manager and XX is the other manager. Exhibit A of the Operating Agreement reflects The XX as "Members" and the initial "Contributions" of \$

Articles of Organization: XX filed Limited Liability Company Articles of Organization for XX, LLC dated December , 20 , stating there was more than one manager. XX, LLC used a California agent for service of process:

XX
 XX
 XX

The LLC filed a bi-annual Form LLC-12 with the Secretary of State dated February , 20 . The two managers listed were XX and XX. On September , 20 , the LLC filed its second bi-annual Form LLC-12R (Renewal) which was signed by XX. The \$ annual limited liability tax was paid from the LLC bank account to the Franchise Tax Board.

Form 8832, Entity Classification Election: The Foundation stated, "Form 8832 was not required as the LLC was treated as a disregarded entity" and XX, LLC does not file a tax return because the Foundation is the sole member.

State of Alaska Filing for Limited Liability Company (LLC) – XX

EIN: The Employer Identification Number (EIN) form for XX, LLC was filed on XX.

Operating Agreement: The XX, LLC Operating Agreement was dated 12/ /20 and was signed by XX and XX, Managers. The body of the operating agreement states the following:

- "Distribution of its assets shall be conducted exclusively by the Managers who are hereby authorized to do any and all acts and things reasonably necessary to accomplish the foregoing.
- All distributions in liquidations shall be made pro rata to the Members in kind.
- The Managers shall have the right to obtain, on behalf of and at the expense of the Company, a life insurance policy or policies on the life or lives of one or more Members or any other persons which the Managers deem necessary or desirable respecting the operations of the company. The Company shall be the owner of each such policy. For each policy, if any: The named beneficiary under the policy may not be changed without the mutual consent of the Managers".
- Exhibit A states the Initial Contribution is \$ and XX, LLC is the % Member.
- Exhibit B, Designation of Beneficiary, is blank (IDR 09, Item 2).

Form 886-A	EXPLANATION OF ITEMS	Schedule or Exhibit No.
Name of Taxpayer XX EIN XX		Years Ended

- In response to IDR 031, Item 3, requesting partnership agreements and other documents that show XX, LLC relationships with all partners, owners, and investors for years 20 , 20 , 20 , 20 and 20 , the response was "Attached is a copy of the XX, LLC Operating Agreement showing the Member as XX, LLC. The Operating Agreement is dated 12/ /20 and there have been no changes to it since that time".

Articles of Organization: The Certificate of Organization, Limited Liability Company, was filed with the State of Alaska on XX. The accompanying form listed the LLC's managers as XX and XX and was signed and dated XX and date stamped by the State of Alaska as received on XX.

State of LLC Biennial Reports: Copies of the State of LLC Biennial Reports filed with the State of Alaska were obtained from the Foundation and from the State of Alaska. The reports identify the LLC members or managers and persons owning 5% or more interest in the LLC.

State of reports, signed by XX and filed with the State of , reported that through year 20 , XX, a personal trust, and not XX, LLC was owner of XX, LLC. Beginning in 20 , the State of reports reflected that XX, LLC was owned by XX, LLC.

Form 8832, Entity Classification Election: In response to a request for entity classification, the Foundation's representative stated "Form 8832 was not required as the LLC was treated as a disregarded entity." (IDR 31, Item 2)

Form 990, Return of Organization Exempt From Income Tax

Each year XX signed the annual Form 990 returns filed with the Service. The 20 and 20 Form 990 annual returns stated the books were in care of XX) in XX, . The returns were prepared by XX, LLP in , . Schedule A attached to Forms 990 for 20 and 20 , stated the Foundation's "primary exempt purpose is to manage, invest, and distribute Foundation assets primarily for the benefit of The XX, which is the primary supported charitable organization. The Foundation may also support the 501(c)(3) organizations listed on Form 990, Schedule A, Page 2, Part IV, Line 13." Forms 990 for the years ending December , 20 through 20 reported the following revenue and expenses and assets with no liabilities except for \$ in year 20 :

FORM 990 REVENUE _____

- Contributions
- Interest on Savings
- Dividends & Interest
- Other Revenue

Plus:

Form 886-A	EXPLANATION OF ITEMS	Schedule or Exhibit No.
Name of Taxpayer XX EIN XX		Years Ended

Gross Amount- Sale (Sec)	0				
Less Cost/Expense	0				
Gain (Loss) (Securities)	0				
Net Income					

FORM 990 EXPENSES

Program Services	0				
Management & General	0				
Other Expenses	0	0	0	0	0
Total Expenses	0				

Excess (Deficit) for Year	6,000,000	-7,023	-442,025	-128,207	10,236
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Net Assets BOY	0				
Increase in Net Assets					
Other Changes in Net Assets	0	0			
Net Assets/Fund Bal EOY					

ASSETS

Cash					0
Savings					
Investments					
Other Assets					
Assets EOY					

LIABILITIES

Other Liabilities	0	0	0	0	
Liabilities EOY	0	0	0	0	

NET ASSETS

Although the Foundation claimed XX, LLC was treated as a disregarded entity, the liability of \$ on the balance sheet for 20 was reported as due to XX, LLC on Statement 9 attached to the return.

On attachments to the annual information returns, the Foundation reported the following assets/investments:

FORM 990 INVESTMENTS

Form 886-A	EXPLANATION OF ITEMS	Schedule or Exhibit No.
Name of Taxpayer XX EIN XX		Years Ended

X	0	0			
X	0	0			0
X	0	0			
X	0	0	0	0	0
X	0	0			
X	0	0			
XX	0	0			
X	0	0			
X	0	0	0	0	
	<i>Subtotal</i>	0			
	Due fm X, LLC	0	0	0	0
	Cash & Temporary Investments		0		
	<i>Total</i>				

XX Life Insurance: Beginning in 20 , an investment of \$ in XX Life Insurance was reported on the Forms 990. The amount represented the December 20 and 20 premiums totaling \$ for the purchase of the \$ life insurance policy on XX by XX, LLC.

XX Loan: Beginning in 20 , the Foundation reported a \$ loan to XX as an investment and not as a receivable on the balance sheet. No loan information was disclosed on Schedule A including any collateral received by the SO for the loan.

XX Investment - \$: In the initial interview, XX stated that a \$ investment was made in a private company called XX a startup tech company. The money was invested as seed capital. Mr. XX stated that XX, a venture capital company, also invested in XX.

Legacy Ventures - \$: The Foundation provided the 2003 Schedule K-1 to Form 1065 for Partner #8, XX, LLC XX, LLC. The year-end capital account of \$ for XX, LLC represented a % interest in XX II, LLC. During the initial interview, XX stated the partnership is a "fund of funds for venture capital investments." The minimum investment is \$1 Million and, as of 20 , the Foundation has committed \$ of the \$. XX stated he met with other partners on a regular basis. So far, the fund has had a break-even status.

Other Assets/Investments: All of the assets and/or investments were held in the names of various LLCs and only a minimal amount of cash was directly held in the name of XX or The XX. Statement 8 attached to the Form 990 for 2004 stated that \$ was due from XXI, LLC.

XX Investments Account Application: The XX Investments account application identified XX, LLC as account holder but did not identify the LLC as being wholly owned by the Foundation. The individual signors, XX and XX, were not identified as trustees of the Foundation.

Form 886-A	EXPLANATION OF ITEMS	Schedule or Exhibit No.
Name of Taxpayer XX EIN XX		Years Ended

Form 990 Distributions for Charitable Purposes

For years 2000 through 2004, grants of \$, \$, \$ and \$ respectively to various IRC 501(c)(3) organizations, including an annual amount of \$ to \$ to the XX, were reported on the Forms 990. All of the grants for 2003 and some of the grants for 20 were paid by check from the XX, LLC bank account. There was a \$ discrepancy between the amount of the grants per the bank records (\$) and the amount reported on the Form 990 for 2003 (\$). There was a \$ discrepancy between the amount of the grants per the bank records (\$) and the amount reported on the Form 990 for 2004 (\$). The following is the information reported on the Forms 990 with the discrepancies for 20 and 20 noted in **Bold** print:

	<u>IRC 501(c)(3)</u>	<u>20</u>	<u>20</u>	<u>20</u>	<u>20</u>
X		0		0	
X		0	0	0	
X		0	0	0	
X			0	0	0
X			0	0	0
X			0	0	
X		0		0	0
X		0		0	0
X		0		0	0
X		0		0	
X		0		0	
X		0		0	
X		0		0	
X		0		0	
X		0		0	
X		0		0	
X		0		0	
X		0	0	0	0
X		0	0	0	

Form 886-A	EXPLANATION OF ITEMS	Schedule or Exhibit No.
Name of Taxpayer XX		Years Ended
EIN XX		

X	0	0		
X	0	0		0
X	0	0		
X	0	0		
X	0	0		
X	0	0		
X	0	0		
X	0	0		
X	0	0		
X	0	0	0	
X	0	0	0	
X				0
X				0
TOTALS				

Contributions Per Form 990 Return

Form 990 Expenditures

For years 20 through 20 , the XX reported expenses as follows:

<u>EXPENSES</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
Other losses – Investments	0	0	0	0	
Taxes	0			0	
Foreign Taxes Paid	0				
Licenses & Fees	0				
Interest					
Investment Fees	0			0	
Inv Fees – Passthru Entity	0	0	0		0
Consulting Fees	0	0			
Total Expenses	0				

\$ was paid annually to XX for years 20 through 20 as investing and consulting fees. Despite a request that they be produced, no documents were provided that identified recipients of the remaining 20 investment fees of \$ from pass-through entities and 2004 investment fees of \$. For years 20 and 20 , XXX compensation (consulting

Form 886-A	EXPLANATION OF ITEMS	Schedule or Exhibit No.
Name of Taxpayer XX EIN XX		Years Ended

fees) represented % and % respectively of total expenses paid by the Foundation including amounts for charitable purposes:

<u>FORM 990 EXPENSES</u>	
Program Services	0
Management & General	0
Other Expenses	0
Total Expenses	0

**Form 990 Disclosures Regarding Related Party Transactions
(Exempt and/or Taxable Subsidiaries, Disregarded Entities, and Partnerships)**

On Forms 990 for years 20 and 20, Part VI, Other Information, the Foundation answered "no" to question 80a: Is the organization related to (other than by association with a statewide or nationwide organization) through common membership, governing bodies, trustees, officers, etc., to any other exempt or nonexempt organization. However, in Part IX of the return, "Information Regarding Taxable Subsidiaries and Disregarded Entities", the Foundation noted, "See Stmt __", a statement that reported the Foundation's % ownership in XX, LLC.

On Forms 990 for 20, 20, and 20, Part VI, Other Information, the Foundation answered "yes" to question 80a: Is the organization related to (other than by association with a statewide or nationwide organization) through common membership, governing bodies, trustees, officers, etc., to any other exempt or nonexempt organization and checked the exempt box noting, "See Statement ...", which disclosed a relationship with the following public charities:

- XX
- XX
- XX

Year 20 Form 990: In Part III, Question 2b of Schedule A attached to the Form 990 for 2001, the Foundation answered yes to the "Lending of money or other extension of credit" and noted, "See Stmt 8". Statement 8 provided:

- "XX, LLC, which is wholly owned by the XX, loaned \$ to XX, LLC. XX, LLC is managed by XX and XX who are trustees of the XX. However, XX and XX are not members of XX, LLC.
- XX, LLC also loaned \$ to XX, LLC. XX and XX each own % of XX, LLC.
- XX, LLC also loaned \$ to XX, LLC. XX and XX each own % of XX, LLC."

Year 20 Form 990: In Statement 7 to Form 990, Part IV, Line 56, Other Investments, the Foundation reported \$ as an investment in XX, LLC.

Form 886-A	EXPLANATION OF ITEMS	Schedule or Exhibit No.
Name of Taxpayer XX EIN XX		Years Ended

Year 20 Form 990: On Line 88 of Part VI, Form 990 Other Information for 20 , the Foundation reported it owned a % or greater interest in a taxable corporation or partnership, or an entity disregarded as separate from the organization under Regulations sections 301.7701-2 and 301.7701-3. On Statement 9, the Foundation reported a % ownership in XX, LLC with end-of year (EOY) assets of \$. The Foundation reported total assets of \$ and income of \$. Thus, \$ was its investment in XX, LLC and its only other asset was \$ that was reported as non-interest bearing cash on the Form 990.

Year 20 Form 990: In Part IX of the return, "Information Regarding Taxable Subsidiaries and Disregarded Entities", Statement 12 reported the Foundation's % ownership in XX, LLC. The LLC was reported to have \$ in income and \$ in assets.

On Line 88 of Part VI, Form 990 Other Information for , the Foundation reported it owned a % or greater interest in a taxable corporation or partnership, or an entity disregarded as separate from the organization under Regulations sections 301.7701-2 and 301.7701-3. On Statement 9, the Foundation reported a % ownership in XX, LLC, with EOY assets of \$. The Foundation reported total net assets of \$ and income of \$. Thus, with the exception of \$, all of the Foundation's assets were held in the name, XX, LLC.

Statement 8 provided \$ was due to the Foundation from XX, LLC. Statement 9 reported the Foundation owed \$ to XX, LLC.

Supporting Organization Activities and Transactions

Transactions and activities conducted by the Foundation through its trustees, XX and XX were as follows:

1) \$ Loan to XX % - \$ Transfers to XX & XX

Form 990: Forms 990 for years 20 through 20 reported, "Loan to XX % - \$" as "Other Investments" in a Balance Sheet attachment. It was not reported as a receivable and there was no collateral for the loan.

Promissory Note - XX Loan: The Promissory Note, dated June , 20 , stated:

Borrower: XX, A corporation
 Lender: XX, LLC, a limited liability company
 Amount: \$
 Maturity: June , 20

Form 886-A	EXPLANATION OF ITEMS	Schedule or Exhibit No.
Name of Taxpayer XX EIN XX		Years Ended

The promissory note stated the borrower will make annual interest payments of % per annum and pay all principal and interest in full on June , 20 . The note was signed by XX, V.P. of XX.

XX Corporation Guarantee

Attached to the Promissory Note was a Guaranty by XX Corporation (Guarantor). The Guaranty states that as an inducement to Lender to lend \$ to XX Corporation (Borrower) pursuant to the terms of that certain Promissory Note dated June , 20 (Promissory Note), the Guarantor agreed:

1. "Borrower shall promptly and full perform, pay and discharge all of its liabilities, obligations, and indebtedness arising from or relating to the Promissory Note...if Borrower fails to pay...Guarantor agrees to pay the Indebtedness on demand"
2. "Guaranty is an absolute and unconditional Guaranty of payment and not of collectability".
3. ..."Lender shall not be required to (i) to proceed against Borrower by suit or otherwise..."
7. ..."Guaranty shall remain in full force and effect until all Indebtedness has been fully paid".
14. ..."Each Guarantor shall be jointly and severally liable, with each other and with Borrower, for all obligations and liabilities arising under this Guaranty".
15. "Guaranty, together with the Promissory Note, constitutes the entire agreement between Lender and Guarantor concerning the subject matter hereof, and may not be altered or amended except by written agreement signed by Lender and Guarantor. All prior and contemporaneous agreements, arrangements, and understandings between the parties hereto as to the subject matter hereof are rescinded.

The Guaranty was signed by XX, Vice President of XX and was dated June , 20 . Each unsigned page of the Guaranty was initialed by "X".

XX Annual Interest on \$ Loan: A copy of XX Financial Corporation's check for the annual interest payment of \$ dated July , 20 was provided. The check was payable to XX, LLC and was reported on the Foundation's 20 annual information return, Form 990, as interest income. The check was deposited into XX, LLC account with XX. Subsequently, for 2004, interest income of \$ was reported on the Form 990 as well.

November , 20 - XX Minutes: The November , 20 minutes stated "XX and XX are the current Managers for this entity and with the Board of Trustee's approval, they can go ahead and make the investment decisions and report back to the Board...the Foundation owns a Promissory Note for \$ with a fixed interest rate of % which will be due by

Form 886-A	EXPLANATION OF ITEMS	Schedule or Exhibit No.
Name of Taxpayer XX EIN XX		Years Ended

June 20 and which the Foundation will look at reinvesting at that time". Current assets attached to the minutes included the amount of \$ with XX (XX).

XX Collateral and Investment Rating: Although repeatedly requested both verbally and in writing, no information and/or documentation regarding any collateral to secure the \$ promissory note was provided other than the statement, "the Promissory Note and the Guaranty, which acts as the collateral." As to questions about XXs investment rating, the response was "XX is not a public company therefore there is no rating. The majority of all correspondence was verbal...a check issued to them for \$." (IDR 023, Item 4)

XX's Unaudited Financial Statements: Note 5, Amounts Due to Related Parties, in XX's unaudited consolidated financial statements for Year 20 stated, "The amounts due to related parties are broken down in the following manner: \$ to XX Development..." and denotes that XX is a related entity.

XX Subsidiaries and/or Related Entities: XX has numerous subsidiaries and related entities including XX Ltd., XX LLC, XX, LLC, XX, LLC (XX), etc. XX and the related entities are engaged in tax shelters involving oil and gas exploration and mare leasing activities. XX and XX personally engaged in transactions with XX and/or XX related entities. For instance, on December , 20 , XX, LLC, XX, issued Check # , drawn on XX, payable to XX for \$. The XX check was endorsed by XX and was deposited into the personal XX checking account # XX of XX and XX.

United States District Court, Eastern District of -

XX Court Documents: On XX, several plaintiffs filed documents with the U.S. District Court clerk of the Eastern District of against XX, LLC, XX, LLC, XX, etc. stating, "Operating in a number of states, including , defendants aggressively marketed and sold thoroughbred mare Lease Programs (*the) to wealthy individuals interested in the thoroughbred horse industry. The United States government is currently pursuing a criminal investigation into the activities of the defendants relating to the , and in February, 20 acting on federal search warrants, seized the books and records of XX, LLC. As a result, the participation of Plaintiffs and all others who participated in the have been called into question...Defendant XX, LLC ("XX") is a limited liability company organized and existing under the laws of Utah and authorized to conduct business in ...XX and/or XX, LLC operate two horse farms ... in XX, LLC ("XX") is a limited liability company organized and existing under the laws of ...XX ("XX") is a corporation organized and existing under the laws of with a registered agent located in ...XX is a closely-held corporation that owns, indirectly though subsidiaries, XX...In addition to XX, XX owns approximately % of XX, a publicly

Form 886-A	EXPLANATION OF ITEMS	Schedule or Exhibit No.
Name of Taxpayer XX EIN XX		Years Ended

traded corporation...have agents, or transact their affairs...and conducted their fraudulent scheme, through use of the United States Mail or interstate wire communications in an illegal manner". The suit further cites the peddling of "XX Mare Lease Programs as an extremely profitable opportunity, with a historical net cash return on investment of %...XX Brochures also touted its ownership of high quality thoroughbred mares and its ability to provide the 'Ultimate Tax Solution, which converts ordinary income to long-term capital gains'...the Mare Lease Programs included a feature whereby the participants could defer the profit on the sale of their foals and, by exchanging their interests in the foals or leases for ownership units in one or more limited liability companies or partnerships, obtain capital gains treatment for the income from their participation in the mare Lease Program...XX...made available both stock and working interests in gas properties which it owned in order to facilitate this aspect of the program and offer further incentives to participants..."

The suit further discussed the investment as follows: as an "Illustration... for an up-front investment of approximately \$ in XX, 'a division of the XX Group,' ...participation would generate tax savings of approximately \$ and net after tax mare lease revenue of approximately \$...The Illustration also offered the option of using a percentage of the interests for repayment of the NELC loan and, by virtue of a put option associated with the XXX stock, provided for a projected net after tax return of %." 2

\$1M XX Deposits

XX Related Deposits of \$: There were two separate \$ transactions, one that occurred in October 20 and one in January 20 that originated from XX and/or XX related entities that were deposited into the XX, LLC bank account. On the very same dates as the monies were deposited from XX, the amounts were transferred by XX to personal bank accounts of XX and XX:

- On October , 20 , a \$ deposit was made by XX to XXX, LLC, XX Acct. #XX. On the same date, the \$ amount was withdrawn from the XX, LLC bank account by XX. The explanation provided was that it was a deposit error: "The \$ was paid to XX and XX as per the terms of a Stock Purchase Agreement dated March , 20 , between them personally and XX, LLC. A \$ payment was due September , 20 , but not paid until October , 20 . Incorrect wiring instructions (account number) were accidentally provided to XX and thus the \$ due to XX was mistakenly placed into the XX".

Form 886-A	EXPLANATION OF ITEMS	Schedule or Exhibit No.
Name of Taxpayer XX EIN XX		Years Ended

- On January , 20 , another \$ wire transfer deposit was made by a XX related entity (XX) to the XX, LLC XX Acct. #XX.³ On the same date, January , 20 , the \$ was withdrawn from Account # XX by XX and deposited into the personal XX bank account #XX of XX and XX.

IDR 032, Item 2

IDR 032, Item 2, addressed the issue of the \$ deposits that were stated as being incorrectly deposited into the XX, LLC bank account.

In response to IDR 032, the following documents were provided:

- On the same bank statement from the personal account of XX and XX⁴ as the \$ check dated December , 20 , to the Foundation,⁵ there was another \$ check dated December , 20 , and payable to XX, Inc. for an investment in XX gas. For years 20 and 20 , XX and XX individually received \$ and \$ for investment returns of \$ % and % respectively.⁶

<i>DATE</i>	<i>BANK</i>	<i>ACCOUNT</i>	<i>AMOUNT</i>	<i>NAME</i>
XX		x		Unknown
x		x		x
x		x		x
x		x		x
x		x		x
x		x		x
x		x		x
x		x		x
x		x		x
xx				
xx				

³ Summoned January 20 bank statement received from third party record keeper, X(West),

⁴ X

⁵ As previously noted, \$ of this amount was immediately withdrawn from the Foundation's bank account and was deposited into the account of XX, IncXX and XX own % XX, Inc.

⁶ This was not the experience of a related investor. For years 20 and 20 , the two years XX, LLC filed Form 1065 returns, it reported losses related to its investments in XX and mare leasing. XX, LLC is wholly owned by XX and XX who are its sole members. Subsequently the investment and financial transactions of XX, LLC were reported on XX and XX personal returns.

Form 886-A	EXPLANATION OF ITEMS	Schedule or Exhibit No.
Name of Taxpayer XX EIN XX		Years Ended

XX and XX invested \$ _____ initially. This investment changed form as follows:

<u>DATE</u>	<u>FROM</u>	<u>TO</u>	<u>AMOUNT</u>	<u>PURPOSE</u>
X		X	\$	
X		X	\$	
X		X	\$	

Bank records reflected the following deposits into the accounts as noted below:

<u>Date</u>	<u>Actual Date</u>	<u>Desc.</u>	<u>Amount</u>	<u>Bank Acct.</u>	<u>Bank</u>	<u>Acct. #</u>	<u>Source Wire Xfer</u>
		Principal		X	X	X	?
		Principal		X	X	X	?
		Principal		X	X	X	X
		Principal		X	X	X	X
		Principal		X	X	X	X
		Principal		X	X	X	X
		Interest		X	X	X	X
	<u>Total</u>						

The two \$ _____ deposit amounts were deposited into the XX, LLC bank account in October 20 _____ and in January 20 _____ and then withdrawn and deposited into XX and XX personal bank account. XX and XX contend the amounts belong to them personally.

During April 20 _____, information provided to another IRS agent regarding the personal investments of XX and XX with XX related entities included the following statements:

"1. The XX were leasing broodmares, which they bred to produce foals. Under terms of the leasing and breeding agreement, the foals produced from the breeding activity are owned by the XX and the leased broodmares are returned to the lessor...The XX sold their interest in their unborn 20 _____ foal in August 20 _____. It was sold (exchanged) for a working interest in the XX Program."

"3. ...Please note that on December _____, 20 _____ the XX's owed \$ _____ on the XX _____, which included \$ _____ of accrued interest. The original amount borrowed on this loan was \$ _____. Also note that on December _____, 20 _____ the XX's owed \$ _____ on the XX _____, which included \$ _____ of accrued interest. The original amount borrowed on this loan was \$ _____. The total amounts owing on the _____ (\$ _____) and the _____ (\$ _____) equal the amount borrowed (\$ _____) on the XX, LLC income tax return."⁷

⁷ XX, LLC. Also, see

Form 886-A	EXPLANATION OF ITEMS	Schedule or Exhibit No.
Name of Taxpayer XX EIN XX		Years Ended

"...The balance sheets for the XX, LLC tax returns are incorrect because the Assignment of the Lease and Breeding Agreement (Lease) did not include any liability...XX XX, husband and wife, wholly own XX, LLC as community property...may treat the entity as a disregarded entity for federal tax purposes. "

"6. ...The XX contracted with XX to feed and care for the leased broodmares. In 20 , XX did not have a farm of its own. It contracted with other farms in the Lexington Kentucky area to board the horses."

IDR 037, Item 2

In response to IDR 037, Item 2, the following additional support documents were provided:

- Excluding the two \$ transactions, the bank account transactions, before and the bank account transactions after, were directly deposited into the personal bank account of XX. The final \$ payment included interest of \$ for a total deposit of \$. Only the two \$ amounts were deposited into the XX, LLC bank account – and one of these differed in origin (XX versus XX).
- On 10/15/2004, \$ wire transfer to XX, LLC reflected the originator was "XX".
- 01/06/2005, \$ wire transfer to XX, LLC reflected the originator was "XX".

The following documents were provided:

United States District Court, Northern District of -

- In a letter dated July , 20 , XX and XX, Managers of XX, LLC, requested XX Financial Corporation to contact the two managers, "in regards to how you plan to satisfy payment in full of the \$ principal and accumulated interest at % since June , 20 ".
- In a letter dated August , 20 , the law firm of XX was retained for an initial amount of \$ with respect to the claims of XX, LLC against XX Financial Corporation ("XX"). The retainer letter provided to the Service was missing Pages 3 and 4. The missing pages to the retainer letter were subsequently provided (IDR 037) and included the statement, "By signing this letter you acknowledge that our firm also represents and will in the future represent other clients with claims against XX and/or it affiliates and principals . . . and forever waive any conflict of interest arising in the firm's joint representation of you and others with claims against XX, its affiliated companies and/or its principals".

Form 886-A	EXPLANATION OF ITEMS	Schedule or Exhibit No.
Name of Taxpayer XX EIN XX		Years Ended

- In XX, XX, LLC filed civil proceedings against XX with the United States District Court, Northern District of _____ for breach of contract in failing to pay a promissory note when due. The body of the document stated the amounts included the principal sum of \$ _____ .00 plus accrued interest in the sum of \$ _____ or such other and greater sums as may be proven at trial.
- On XX, XX answered the complaint: "Defendant alleges they are not liable to FLI because any alleged Note has been paid in full, and FLI is due no more monies."⁸
- On XX, a case management conference was held in the US District Court, _____ District at _____ with Judge XX. Counsel for the Plaintiff stated to the Judge that it was a straightforward case for the \$ _____ in loan principal plus interest. Counsel for XX stated that his client telephoned right before the conference and stated the case involved a series of transactions including leasing, investments, and mining. And the amount due to the Plaintiff was at least \$ _____ less than the claimed amount. The Judge responded by mandating an accounting by January _____, 20 _____. The claim is to be presented before a magistrate judge in February or March 20 _____ with potential deferral back to the U.S. District Court on April _____, 20 _____.
- XX court documents dated January _____, 20 _____ included:
 - At the present time, XX does not dispute that the principal is due on the subject note. This is based on our review of the documents we currently possess, and may change as new documents and evidence are discovered. Further, this does not take into account any setoffs.
 - XXs current investigation evidences that a significant setoff overpayment in excess of \$ _____ has been paid, which should be deducted from the amount owed. We are currently assessing whether other overpayments were made.
 - The Internal Revenue Service is currently in possession of computerized records, documents, and other relevant XX documentation relative to the overpayment. This has made it difficult to obtain all possible supporting documents. Moreover, your failure to adequately respond to discovery has made resolution of this matter more difficult. XX will address discovery issues in a forthcoming meet and confer letter.
 - Documents produced in our initial disclosure are also relevant to this accounting. We will not produce them again.
- On March _____, 20 _____, Declaration of XX was filed with the U.S. District Court as one of the five Trustees of the XX stating that no payment, other than the three interest payments had been received by _____. XX declarations included these statements:

⁸ refers to XX, LLC.

Form 886-A	EXPLANATION OF ITEMS	Schedule or Exhibit No.
Name of Taxpayer XX EIN XX		Years Ended

Statement 16: "Defendant then includes in Exhibit B a copy of the Note, as well as a guarantee of payment provided by XX Corporation, an entity that is not a party to this action".

Statement 18: "Defendant produced documents relating to transactions involving The XX and other entities. None of the parties involved in those transactions were either FLI or the Defendant".

Statement 19: "In addition to being a Trustee of XX, I am also a Trustee of the XX. In that capacity I can and do testify that The XX is a Trust organized and existing under law, with me and XX as its two Trustees."

Statement 20: "The assets of The XX are managed entirely separately from, and have no relationship to, the assets of either XX or ."

Statement 21: "The Note which is the subject of this action has no relationship to the XX".

- U.S. District Court summary judgment is scheduled for May , 20 .

To summarize:

- In 20 , XX and XX invested \$ with a XX related entity and during the same period, and from the same bank account, the XX bank account was funded with another \$. (But see footnote 6 above)
- In 20 , XX and XX, as trustees, facilitated an unsecured loan between the Foundation, via XX, LLC, and XX with approximately % or \$ of the Foundation's assets. No collateral was received by the Foundation in exchange for the \$ except for the XX Corporation Guaranty.
- XX and XX personally and through another LLC had investments with XX and/or XX related entities involving mare and coalbed methane gas leasing as reported on their personal returns and on returns of XX, LLC, an LLC wholly owned by them. It was represented to another IRS agent that these investments were acquired with loans: A XX of \$ (original amount) and a XX of \$ (original amount). As of December , 20 , XX and XX owed \$ on the XX and owed \$ on the XX for a total amount of \$ (including interest).
- In October 20 and again in January 20 deposits of \$ were wired into the XX, LLC account by XX and XX respectively. On the same dates, XX and XX withdrew each of the two \$ amounts and transferred them to their personal bank accounts at the same financial institution.
- XX and XX maintain the \$ transfers are returns of their principal.
- In August 20 , XX and XX retained counsel and filed a claim on behalf of XX, LLC against XX Corporation, Case # XX for the \$ loaned to XX but unpaid at maturity plus outstanding interest.

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- In December 20 , XX declared before a U.S. District Court judge that the \$ amount due XX, LLC was at least \$ less than claimed and that the case involved a series of transactions including horse leasing, investments, and mining.
- Dated January , 20 , XX court documents stated that a significant setoff overpayment in excess of \$ has been paid and there may be additional overpayments. However, obtaining additional documents may be difficult because an IRS division is currently in possession of XX documentation.
- Dated March , 20 , XX filed a declaration that included statements that the Guarantor, XX Corporation, is not a party to the action, the XX and other entities are not party to the transactions involving or the defendant, and the assets of the XX are managed entirely separately from, and have no relationship to the assets of either XX or

2) XX, LLC Transactions

In addition to the initial deposit of \$ in year 20 , to the XX, LLC XX, the LLC had the following transactions:

- On December , 20 , there was a transfer of \$ from the XX, LLC's XX Account to XX, LLC XX. The amount was then telephone transferred to XX, LLC's bank account and was withdrawn for a "cashier's check" payable to in the amount of \$. The Foundation's representative stated a cashier's check rather than a regular check had been issued because XX and XX were on travel status.
- In January 20 , a \$ check was issued for payment of the XX, LLC filing fee.
- On January , 20 , \$ was transferred from the personal account of XX and XX to the XX, LLC XX Bank Account. On February , 20 , a check was issued from the XX, LLC account payable to the XX for an "annual fee". Invoice , dated 01/ /20 stated the \$ payment was for the annual fee for the XX Irrevocable Trust, c/o XX, PO Box , XX. The XX Irrevocable Trust is not a Foundation entity. It is an entity created, owned and controlled by XX and XX with their son, XX, as beneficiary.
- In 20 , the XX National Bank account for XX, LLC was closed. On June , 20 , XX Account # XX was opened with a \$ deposit and another deposit of \$ on June , 20 . The source of the funds for the \$ deposit was from XX and XX personal account.

XX Deposit Account Application: The business entity selected on the 2004 XX Deposit Account Application for XX LLC was that of an unincorporated association and business trust. Options available but *not selected* on the account application were "Not For Profit" and "Public

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Entity". Private investments/charitable foundation were listed as the Industry/Business Activity. In response to a question about "to what industry does the business sell, the application stated "N/A. Private Investments Only". The signed XX Deposit Account Application stated that two managers, XX and XX, each owned % of the entity.

State of XX LLC Biennial Reports: Copies of the XX LLC Biennial Reports filed with the State of XX were obtained from the Foundation and from the State of XX. Specifically, in Box of the ⁹ for the periods ending December , 20 , 20 and 20 , the State of XX required "names and addresses of:

- 1) the LLC's members or managers; and
- 2) persons owning % or more interest in the LLC".

State of XX reports, signed by XX and filed with the State of XX, reported that through year 20 , XX Irrevocable Trust (not XX, LLC) was owner of XX, LLC. State records provided:

	NAME	ADDRESS	CITY STATE ZIP	MBR.	MGR.	% INT.	% INT.	% INT.
X		X	X		X	%	%	%
X		X	X		X	%	%	%
X		XX	X	X		%	%	
X		X	X	X				%

- Therefore, XX, not once but twice, provided information to the State of XX that the XX Irrevocable Trust was the % member and owner of XX, LLC through year 20 .
- Information provided to the State of XX contradicted information provided to the Service that XX, LLC was at all times the % member and owner.
- As such, the owner would also hold the \$ life insurance policy on XX.

In 20 , ownership of XX, LLC was changed from the XX Irrevocable Trust to the XX, LLC on the state report filed with the State of XX.

XX Irrevocable Trust – Relationship to XX, LLC

Trust Document: The XX Irrevocable Trust dated December , 20 , was signed by XX and XX as "settlers" and named as beneficiaries, the couple's son, XX, born on November , 19 , and any children subsequently born to or legally adopted by Settlers. The irrevocable trust document further states "In particular, the Investment Trustee may invest assets in XX, LLC, an XX limited liability company for the purposes expressed herein, may make capital contributions to XX, LLC and become a member of XX, LLC. . . It is Settlers' expressed desire

⁹ State of & LLC

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that this Trust will work in conjunction with XX, LLC to invest, distribute and manage its assets". The purpose of the Trust is to trade, buy, lease, improve, develop and sell real estate, personal property, minerals, oil and gas and allied enterprises...either directly or through various entities owned by the Trust¹⁰. At the age of 25 or older, each child of the settlers shall be entitled to one vote.

During the initial interview, the Foundation's representative stated The XX Irrevocable Trust did not materialize. However, in response to IDR 008, Item 4, Forms 1041 were provided for the XX Irrevocable Trust. For years 20 and 20 , the returns had a XX address and for years 20 through 20 the returns were filed in care of the XX Trust Company, XX. For years 20 through 20 , the returns reported a fiduciary fee of \$.

Trustee Fees:

- Dated January , 20 , Invoice for \$ was issued for the annual fiduciary fee for the XX Irrevocable Trust, c/o The XX (XX), PO Box , XX, XX.
- On January , 20 , \$ was transferred out of the personal account of XX and XX into the XX, LLC XX Bank Account. The source of funds was a \$ loan advance for XX and XX's personal account # with XX Bank.
- On February , 20 , a check was issued from the XX, LLC bank account payable to the for the "annual fee" for the annual fiduciary fee for the XX Irrevocable Trust.

To summarize:

- XX and XX created the XX Irrevocable Trust. The Trust's beneficiary, xx is the creators' son. The annual fiduciary fee is \$.
- The Declaration of Trust dated December , 20 , specifically provides that the Trust will work with XX LLC and be a member to XX LLC.
- XX and XX created the XX, LLC, which was represented to the Service as being wholly owned by XX, LLC. XX, LLC was further represented to the Service as being wholly owned by the XX Foundation. In 20 , XX, LLC purchased a \$ life insurance policy on the life of XX for \$. The source of the funds was the initial deposit of \$ into the Foundation's bank account. Of this \$, \$ was transferred to XX LLC's bank account and then \$ was transferred to XX LLC's bank account.
- In 20 , \$ was transferred out of XX and XX's personal bank account and was deposited into the XX LLC bank account. A \$ check was issued from the XX, LLC bank account to pay the XX Irrevocable Trust annual fiduciary fee.

¹⁰ See XX and XX subsidiaries and related entities.

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- For years 20 through 20 , XX filed State of XX documents that reported the XX, LLC was owned by the XX Irrevocable Trust, a trust created by XX and XX to benefit their son.

3) Applications, Policies, and Transactions

November , 20 - XX Foundation Minutes: The November , 20 minutes stated "The Chairman explained that the Foundation currently owns a \$ on XX's Life with a current Account Value of \$. In Exhibit A to the minutes it stated that XX, LLC is the % owner of the policy.

Although the Foundation provided some of the life insurance documents, such as a copy of the policy and application, beneficiary information and cash surrender value, a third party record keeper summons was issued to . Documents received included a copy of a December , 20 , XX (XX) cover letter that stated, "XX and XX, as managers of the XX, LLC would like to apply for a \$ on XX's life and a \$ on XX's life in order to provide cash accumulation and for estate planning purposes...XX and XX are married...The XX, LLC was established as part of their overall estate planning design and will be owner and beneficiary of the policies."

Applicant, XX: The cover letter included an application for \$ of life insurance with dated December , 20 , for applicant, XX. The beneficiary information was a "limited liability corporation for trust fund". XX signed as proposed insured and XX signed as applicant/owner. The initial premium was set at \$. The narrative attached to the application stated "The applicant is married to XX. (See Companion Report.) They have one child, XX. Child is in good health" and the applicant has no life insurance in force. The beneficiary/purpose of the insurance is cited as follows: "The Beneficiary of this life insurance application is a Limited Liability Corporation that is being developed as a Trust Fund to fund a retirement plan as well as to provide for future estate planning requirements".

IDR 031, Item 7: IDR 031, Item 7, was issued to request an explanation as to why the was selected for an investment and how it furthers the charitable activities and purpose of the Foundation. The response was "At the time XX and XX established the Foundation, the goal was to be able to donate upwards of \$ a year for a period of ten years. This goal was based on their desire to create a sizable Foundation to ensure there was a sufficient endowment to provide assistance to the named supported organizations on a perpetual basis. The premium paid on the insurance was based on the desire to immediately fund the endowment in case of XX's premature passing. In addition, the Foundation could use the policy as a resource for obtaining monies in the future due to the policy owner having access to the cash value. The original goal had been to insure both XX

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and XX. Unfortunately, XX was uninsurable at the time and thus the insurance was placed on XX's Life."

Applicant, XX: Also dated December , 20 and enclosed with the above noted XX cover letter, was a second completed application for a \$ life insurance policy with for XX as insured, with owner and beneficiary as the XX, LLC, EIN XX. The application stated the LLC was managed by the insured and provided for a 100% death benefit. A medical questionnaire on XX was completed, signed and dated as of December 12, 2000, and was witnessed by an examining physician. The application was stamped as received by the insurance company on December , 20 .

Life Insurance Policy, XX: On December , 20 , a variable life insurance policy, , for insured, XX , was issued by to the XX LLC, XX

The first annual premium was \$ and the additional first year scheduled premium was \$ for a total of \$ for the contract. Investments were in several mutual funds with an aggressive stance. The policy states that annual premiums are required. The exclusions from coverage cited No reference was made for exclusions. The policy delivery receipt was dated January , 20 and was signed by XX, as policy owner. December , 20 was listed as the scheduled maturity date for an initial face amount of \$

Policy Amendment, XX: The January , 20 Amendment to the Application states the face amount of the policy is \$ for the insured, XX and the owner is XX, LLC.

Life Insurance Premium Payments: The cancelled check(s) used to pay the insurance premiums were as follows from the XX, LLC account:

<u>Date</u>	<u>Payee</u>	<u>Amount</u>	<u>Bank</u>	<u>Account</u>
12/28/20		\$ X		X
12/18/20		\$ X		Cashier Check

On December , 20 , there was a transfer of \$ from XX, LLC Account into XX, LLC XX Bank Account #XX. The amount was then transferred into the XX, LLC bank account and withdrawn for a cashier's check payable to Company in the amount of \$

Form 990 Investment: An investment in at a cost basis of \$ was reported on the annual information returns, Forms 990, for all years as follows:

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FORM 990 INVESTMENTS

x	0	0			
x	0	0			
x	0	0			0
xx	0		0	0	0
x	0	0			
XX, LLC	0	0			
	0	0			
x	0	0			
x	0	0			
	0	0	0	0	
<i>Subtotal</i>	0				
x	0	0	0	0	
Cash & Temporary Investments		0			
<i>Total</i>		0			

Policy Ownership Change: On July , 20 , a letter to the insurance company, signed by XX and XX, Managers of XX, LLC, stated, "In December of 20 we were in the midst of completing our which involved the setting up of several LLCs. Due to the confusion at that time, the owner of policy number was inadvertently put in as XX, LLC when it should have been XX, LLC. It has always been our intent to have XX, LLC be the owner and beneficiary of this policy. It should be noted that we are the Manager of both LLCs. So that we do not have a transfer for value or contemplation of death problem in correcting the original error of the owner and beneficiary, we would appreciate your acceptance of our submission of the corrected application with the corrected owner and beneficiary."¹¹ On August , 20 , policy owner and beneficiary was changed by to XX, LLC. However, the Exhibit A to the November 20 XX's board minutes, prepared by XX, represented that XX, LLC was the 100% owner of the \$ life insurance policy on XX.

Cash Surrender Value: Third party record keeper information provided that the cash surrender value of the policy as of November , 20 was \$

On December , 20 , a form for a change in allocation of premium payments was prepared and signed by XX and XX. The insured's name was listed as XX, Policy Owner name was XX, LLC and the Co-Policy Owner's name was XX, Manager.

¹¹ See conflicting board minutes dated November , 20 and Attachment A that stated, "100% XX, LLC Owns \$ Life Insurance policy on XX's Life - Account Value at 09/ /20 " at \$

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As of November , 20 , the Policy Value was \$ with a Policy Surrender Value of \$

On December , 20 , and prepared a "life insurance policy illustration" using , as prepared for XX. The insured was XX. Owner type was reported as "insured". The 1035 exchange amount was \$ for a face amount of \$

During the period December , 20 and March , 20 , additional premiums of \$ were reflected in the variable life insurance account. Ending account value at March , 20 was \$ with a loan amount of \$

On June , 20 , The provided an ownership history notification that stated "At the time of application approval, the policy owner was XX, LLC. On July , 20 , we received a letter advising The that the policyowner should have been XX, LLC. The processed the change of ownership from XX, LLC to XX, LLC. As of the date of this letter, the policyowner is XX, LLC. There is no indication in our records that the policyowner was ever changed to XX."

In summary:

- In December 20 , \$ of the initial \$ "contribution" to the Foundation was paid as a premium to purchase a \$ life insurance policy on XX from the XX, LLC bank account. The insurance policy was never directly held in the name of the XX Foundation and/or The XX.
- In 20 , XX and XX utilized their authority as LLC managers to change the beneficiary from the XX, LLC to the XX, LLC stating "It should be noted that we are the Manager of both LLCs. So that we do not have a transfer for value or contemplation of death problem in correcting the original error of the owner and beneficiary". In 20 , a 1035 exchange for life insurance policy proceeds was prepared by the insurance company for XX, as owner and insured.
- For years 20 through 20 , XX filed reports with the State of XX reporting the XX Irrevocable Trust as owner of the XX, LLC, and therefore, the owner of the \$ life insurance contract.
- The November , 20 board minutes for the Foundation, Exhibit A showing current assets, stated that the Chairman, XX, reported "100% XX, LLC ...Owns \$ Life Insurance policy on XX's Life - Account Value at 09/ / ' of \$. This contradicts the paperwork that shows the ownership was changed to XX, LLC in 2002.
- Beginning in 2002 on Forms 990, an investment of \$ in Insurance was reported at cost. The "investment" in Insurance was not reported on the Forms 990 for 20 and 20 . Cash surrender value of the life

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insurance policy as of November 19, 2004 was \$ _____, _____ % of the \$ _____ amount expended.

4) Charitable Remainder Trust and XX Partners

XX Charitable Remainder Trust

During the initial interview, the Foundation's representative stated the charitable remainder trust had never been created and the Foundation had a \$ _____ credit for the amount that had been paid and that the fee that was to be charged was a lost leader and paid to a third party. The following documents are to the contrary:

January _____, 20____ - XX (XX)

On XX letterhead also identifying XX, _____ License #xx, a billing statement was issued to the XX Foundation for, "Preparation and establishment of Charitable Remainder Trust for which the XX Foundation shall be the Irrevocable Charitable Remainderman for a minimum of _____ % of the total remainder interest". The total due was \$ _____. The notation at the bottom of the billing statement said " _____ % Deposit due upon receipt. Balance due upon completion of creation of CRT. Please Make Checks Payable to: 'The XX, Inc.'"

February _____, 20____ - XX Foundation Resolution:

In a Unanimous Consent Resolution dated February _____, 20____, the Trustees "authorized to pay for the costs associated with establishing a Charitable Remainder Trust whereby the Foundation is named sole beneficiary with a minimum _____ % irrevocable designation of such. The Foundation is anticipating the costs to be approximately \$ _____ and the benefit to be derived from the Charitable Remainder Trust is anticipated to be \$ _____. ...The Trustees of the Foundation hereby empowered XX and XX to sign all documents and take all other actions ... to effect the establishment of the Charitable Remainder Trust". The resolution was signed by the trustees appointed by the supported organizations, The XX, The XX, and The XX Foundation, Inc. along with Trustees, XX and XX.

February _____, 20____ - CRT Trust Document:

The Declaration of Trust for the XX Charitable Remainder Trust¹² (CRT) was dated February _____, 20____. Exhibit A, Schedule of Assets, did not describe any assets. In Article III, Termination, it stated the XX Foundation was the charitable remainderman and "In no event shall the interest of the XX Foundation as a Charitable Remainder be reduced to less than

¹² See XX Investment Partners partnership

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(%) of the total remainder interest". The CRT was signed by XX and XX as donors and trustees.

There is a disparity as to the named beneficiary, XX Foundation, because the board changed the name of the XX Foundation to The XX on December , 20 . The Service was notified in a letter dated February , 20 . The board resolution, trust document, and partnership below were created subsequent to the name change.

IDR Responses

IDR 004, Item 2: "A total of \$ paid to The XX, Inc. for the preparation of a Charitable Remainder Trust and consulting services regarding such (paid \$ on 1-24-2003 and \$ on 12-4-03)."

IDR 027, Item 1: "No assets were deposited into the CRT in 2003 or any future year".

XX Investment Partners

Also dated February , 20 , was the XX Investment Partners partnership agreement as signed by XX and XX as Trustees for the Foundation and again as Trustees for the CRT. It states "This Partnership Agreement is entered into by and between (i) the XX Foundation (the "Foundation") and (ii) the XX Charitable Remainder Trust (the "Trust")...the business of the Partnership shall be conducted under the name of "XX Investment Partners."

The partnership agreement further states, "The Trust shall contribute to the Partnership those assets listed on Exhibit A...The Foundation shall contribute to the Partnership in an amount equal to th of the agreed value of the capital contribution made by the Trust...all profits and losses of the Partnership shall be allocated % to the Trust and % to the Foundation". In Section 4 regarding distributions, it states "Any such distributions shall first be made % to the Trust and % to the Foundation ...The Partnership shall be dissolved upon (i) the vote of those Partners who represent more than % of the Partnership capital, or (ii) the expiration of years from the date of this Agreement." Exhibit A for assets contributed by the CRT was left blank and no exhibit was provided for assets contributed by the Foundation. There is a Form 1065 filing requirement for the entity; however, no returns were filed for the partnership for years 20 and 20 .

In summary:

- \$ of the Foundation's assets were paid in two separate installment payments in January and December 20 to XX for the creation of a CRT the Foundation stated never materialized.

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- Further, an additional entity, XX Investment Partners, was created in conjunction with the formation of the CRT. A partnership agreement was signed by XX and XX who represented both entities.

5) Compensation

An annual amount of \$ _____ was paid to XX for years 20 _____ through 20 _____ for investment and consulting services. XX is also a full-time employee and executive director of another unrelated IRC § 501(c)(3) entity. Sources for the payments were from transfers among the various Foundation accounts:

- Monthly checks of \$ _____ were issued from the XX Foundation bank account to XX and were signed by XX.
- Additional monthly checks of \$ _____ were issued from the XX, LLC bank account and were also signed by XX.

The board first noted the compensation in the November 20 _____ board minutes of the XX Foundation. It was also addressed in the November 20 _____ minutes.

Form 990 Expenditures - XX Consulting and Investing Fees

For years 20 _____ through 20 _____, the XX Foundation reported investment fees and consulting fees as expenses on the Form 990 Annual Information returns as follows:

EXPENSES					
Other losses – Investments	0	0	0	0	
Taxes	0			0	
Foreign Taxes Paid	0				
Licenses & Fees	0				
Interest					
Investment Fees	0			0	
Inv Fees – Passthru Entity	0	0	0		0
Consulting Fees	0	0			
Total Expenses	0				

Although disclosed on the annual Form 990 returns for years 20 _____ through 20 _____ and noted in the November 20 _____ board minutes, compensation was otherwise undocumented:

- There were no formal contracts with XX for compensation.
- There were no invoices submitted by XX for services rendered.
- No compensation comparison studies had been done by the board.

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- No specific duties and/or responsibilities for compensation were identified by the board.
- No W-2 forms were issued for any years by the Foundation and/or by XX, LLC for the \$ paid annually to XX if he was paid as an employee.
- No 1099 forms were issued for any years by the Foundation and/or by XX, LLC for the \$ paid annually to XX if he was paid as an independent contractor.
- Additional investment fees of \$ and \$ for years 20 and 20 respectively were paid to others for investment services.

In summary:

- For years 20 and 20, XX's compensation represented % and % respectively of the total expenses paid by the Foundation (including amounts paid for charitable purposes).

XX, LLC

Operating Agreements: The Operating Agreement for XX, LLC was filed with the California Secretary of State on December , 20 . The Operating Agreement stated there were two members: XX & XX. Each member has a % interest in the LLC.

XX, LLC Summary Bank Accounts: The XX, LLC bank accounts with XX Bank (aka xx Bank) for years 20 through partial year 20 (through August 20) were summarized as follows:

- Business Checking Account # XX
- Business Checking Account # XX (as of October 20 it was listed as XX LLC but still summarized in the Holdings statement until August 20)

Account #XX was the bank account where \$ of the initial contribution deposited into the XX Foundation in year 20 was transferred on the same day. Summoned bank records make it appear that the account form from XX Bank for Account #XX appears to have been altered, after the fact. The signature card for the #XX account appears to have been altered because the font for the account number was not consistent with the font for all of the other account signature cards. During the initial interview, one of the two Foundation representatives stated that XX, LLC was funded with \$ of the \$ initial contribution to the Foundation.

Account Registration Verification: Numerous requests were made for the XX Bank account registration form that reflected the EIN for business checking account #XX. The Foundation representative repeatedly stated the account belonged to XX, LLC and continued to identify Account #XX by hand writing in "XX, LLC" on the XX, LLC summary bank statements next to

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the account number. Subsequently, in October of 20 , XX Bank statements reflected Account #XX was identified as owned by XX, LLC but not at the time of the \$ initial transfer in year 20 .

XX, LLC XX Bank account was closed in June 20 . The signature cards reflected XX LLC was owned by XX and XX.

XX Account: A XX account for XX, LLC was opened in 20 and reflects that XX and XX each own % of the LLC account.

Summary of XX Bank Accounts

A third party record keeper summons was issued to XX. Documents received included the following XX accounts that were opened in June 20 with initial deposits of \$ from XX and XX's personal checking account. XX account applications reflected the entities were % owned by XX and % by XX:

XX ACCT #	NAME	% OWNED PER BANK	REMARKS	DESIGNEE	ACCT TYPE	% OWNED PER AUDIT
x			XX & XX	Managers	LLC	% by SO % by SO Beginning in 20
x			XX & XX	Managers	LLC Out-State	> % by SO ¹³
x			XX & XX	Managers	LLC	XX & XX
x			XX & XX	Managers	LLC	XX & XX
x			XX & XX	Managers	Not-for-Profit	% by SO

XX, LLC and XX, LLC are LLCs owned by XX and XX. Specifically, the account application for XX, LLC, dated May , 20 , stated, "LLC is for private investment purposes only. xx, it will hold the assets pertaining to the family's horse farm...Account is part of five other XX entities".

On September , 20 , the above six XX accounts were bundled, for waiver of monthly maintenance fees for life, under the name of XX, LLC. In contrast, the previous financial institution, XX Bank, only included XX, LLC, as the bundled account for a period of time under XX, LLC.

¹³ The evidence is inconsistent on this point. There is no written agreement that gives XX LLC an equity interest in XX LLC. The K-1s for 20 reflect that XX has a % interest in XX LLC. The minutes for XX XX LLC do not reflect this and reflect the members as XX and XX. The XX account also shows XX and XX as % each owners of XX XX LLC. See also later discussion regarding the promissory notes. This is indicative of the commingling of funds and lack of proper documentation that has occurred throughout this case. XX and XX change ownership of the entities at will.

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XX, LLC

XX LLC is a pool of approximately six to eight venture capital (VC) funds. XX claimed the Foundation became a one-third partner in 2002 for the amounts the Foundation had loaned to XX, LLC in 20 . In the initial interview, XX explained that % of the LLC is owned privately by XX and his wife, XX and the remaining % is owned by the Foundation through XX, LLC, with profits and losses allocated based on the initial contributions and/or the cost basis.

Operating Agreement: XX and XX executed the XX, LLC Operating Agreement on December , 20 . The Operating Agreement was filed with the California Secretary of State on December , 20 , and stated there were two members: XX & XX and each member had a % interest in the LLC. Initially Exhibits A & B were not provided but were subsequently submitted in response to IDR 021, Item 2.

- *Exhibit A* reflects initial contributions of the two % members of \$ each or \$.
- *Exhibit B* dated December , 20 provides for the designation of beneficiaries. The beneficiaries were:
 - The XX Trust for XX, Member, and
 - The XX Trust for XX, Member

Contrary to the Operating Agreement's stated initial contributions, there were no initial deposits of \$ /each into the XX, LLC XX Bank Account # in 2000. The bank statement showed a transfer on February , 20 , of \$ from Account #, which is a personal account of XX and XX, as the opening balance and initial deposit for XX, LLC. EIN Form SS-4 reflected a partnership entity.

Board Minutes: In IDR #17, the Trustee was requested to provide the board minutes for XX, LLC for years 20 through 20 . For year 20 , the Foundation's representative stated there had been no activity and therefore there were no board minutes. For years 20 through 20 , the board minutes were exact replicas of each other except for the dates the annual meeting was held:

- Thursday, December , 20 ,
- Monday, December , 20 ,
- Tuesday, December , 20 , and
- Friday, December , 20 .

The board minutes had no discussion of loans in 20 or the addition of XX, LLC as a partner in 20 . Specifically, the board minutes for December , 20 reported the members as XX

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and XX. For the board meeting on December , 20 , XX and XX were reported as the managers and there was no mention of XX, LLC.

Foundation as Partner:

Numerous IDR's (008, 013, and 017) were issued to request documentation that identified XX, LLC as a partner in XX LLC. The response was that Forms 1065 and K-1 reflects the ownership and no other documents were required to be filed with the state. In a letter dated December , 20 and again on December , 20 , the Foundation's representatives stated "We have provided you with the distributions and capital interest changes for XX, LLC from 20 -20 since 20 was the year the ownership changed".

Forms 1065:

- XX, LLC filed Forms 1065 and reported % partnership percentages for XX and XX for years 20 through 20 .
- In December 20 , per the Forms 1065, XX, LLC added XX, LLC as a one-third partner.
- No formal documents were provided for the partnership change.

Year 20 Form 1065 - Form 1065 for 2001 as filed by XX, LLC reported a note payable in the amount of \$ from XX, LLC.

Year 20 Form 1065 - In 2002, the Foundation purportedly became a one-third partner in XX, LLC. The capital contribution reported on XX, LLC's Form 1065 consisted of a \$ receivable and additional assets from XX, LLC for total capital contributed of \$. For 20 , XX, LLC Schedule K-1 reported XX, LLC has a % in profit sharing, loss sharing and ownership of capital.

Percentages for years 20 through 20 for XX, XX, and XX, LLC were as follows:

	20	20	20	20	20
<u>Partnership Percentage -EOY</u>	<u>%</u>	<u>%</u>	<u>%</u>	<u>%</u>	<u>%</u>
XX	%	%	%	%	%
XX	%	%	%	%	%
XX Invest. LLC (% owned by Foundation)	0%	0%	%	%	%
<u>Percentage Total</u>	<u>%</u>	<u>%</u>	<u>%</u>	<u>%</u>	<u>%</u>

Form 990 Returns

Year 20 Form 990: No receivables were reported on the Form 990 balance sheet for 20 . The Foundation's balance sheet reflected its only assets were investments. Receivables of \$ in loans were reported in a Schedule A attached to Form 990 as follows:

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- XX, LLC - \$
- XX, LLC - \$
- XX, LLC - \$

XX Bank Accounts: XX, LLC's XX Bank Account # was opened on December , 20 and closed in May 20 as reflected on the account holder card for its EIN. XX and XX as managers had signature authority.

The \$ undocumented loan actually consisted of transfers and commingled assets:

- From XX, LLC Bank Account # XX to XX, LLC's XX Bank Account #XX, and
- From XX, LLC XX Bank #XX to XX, LLC XX Bank # XX and then to XX, LLC Bank Account #XX.

Year 20 deposits to fund XX, LLC consisted of numerous telephone bank transfers from XX, LLC XX Bank Account #XX. Total transfers of \$ represented the only year 20 deposits into the XX, LLC account with the exception of the initial bank deposit of \$ by XX and XX on February , 20 . The telephone transfers were primarily used to cover XX LLC's capital calls on investments executed by XX.

Year 20 bank transactions for XX LLC included a fax dated June , 20 signed by XX and XX to XX, Inc. (XX) to request a \$ transfer from XX, LLC XX Investment account. The amount was ultimately transferred to XX, LLC. The specifics of the \$ transaction are as follows:

<u>Date</u>	<u>From</u>	<u>To</u>	<u>Amount</u>	<u>From Acct.</u>	<u>To Ac</u>
x	x	x	x	x	x
x	x	x	x	x	x
x	x	x	x	x	x

In IDR 018, Item 7, there was a request to provide the account statements for the \$ withdrawal and deposit/transfer of assets from the Investments account in June 20 along with the related correspondence and transfer instructions. In response, the Foundation stated "We have provided the documentation for the \$ from to XX, LLC. The money was then transferred into XX by telephone instructions. There is not documentation for the telephone call".

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In Year there was additional commingling of assets between the Foundation and XX and XX and entities they owned with the XX, LLC bank account used for the various transfers:

<u>Date</u>	<u>From</u>	<u>To</u>	<u>Amount</u>	<u>From Acct.</u>	<u>To Acct.</u>
X	X	X	X	X	X
X	X	X	X	X	X
X	X	X	X	X	X
X	X	X	X	X	X
XX F. & XX	X	X	X	X	X
XX F. & XX	X	X	X	X	X

In Year 20 , the XX, LLC XX Bank Account #XX was closed on June , 20 . The \$ remaining account balance was transferred to the personal account of XX and XX, Account # XX with XX Bank (IDR 28, Item 2)

XX Account: Although XX, LLC purportedly held an approximate one-third ownership interest in XX, LLC as of December 20 , the account application for the XX Business checking account opened on May , 20 reflected a limited liability company for private investment purposes with two managers, XX and XX. XX and XX were also listed as : % owners each with sole signatory authority.

Promissory Notes

In IDR 017, Item 9, the Foundation was requested to provide the note payable and documentation (cancelled checks/account transfers) for the \$ amount received by XX LLC from XX, LLC in 20 . In addition the Foundation was requested to provide documentation for repayment of the note payable (principal and any interest) to XX LLC in 20 . In response to the IDR, the Foundation stated "Notes were not provided since the advances were converted to capital" in 20 and "repayments are documented on the spreadsheet provided".

The Foundation provided the following summary of the purported promissory notes:

Promissory Notes	Dated	Amount	Interest Rate	Due Date
1	04/	\$	%	04/
2	04/	\$	%	04/
3	07/	\$	%	07/
4	10/	\$	%	10/

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\$ _____

Promissory Note 1: Dated April , 20 , a promissory note was executed between Borrower, XX, LLC and Lender, XX, LLC for \$ _____ at a fixed rate of % per annum. Such principal and interest shall be due and payable on the first day of each year thereafter to and including April , 20 , whereupon the entire unpaid principal plus accrued and unpaid interest would be due and payable. In response to IDR 29, Item 6, the Foundation stated, "the promissory note in the amount of \$ _____ is a revolving line of credit. This promissory note has a 'Membership conversion'. The notes in #3 above were converted to membership interests under this promissory note. The only amounts borrowed in 20 _____ on this line of credit were from the notes in #3 above totaling \$ _____." #3 included the amounts of \$ _____, \$ _____ and \$ _____ for a total of \$ _____.

Promissory Note 2: Dated April 1, 2001, a second promissory note was executed between Borrower, XX, LLC and Lender, XX, LLC for \$ _____ at a fixed rate of % per annum. Borrower shall pay all principal and interest in full on April , 20 _____. In response to IDR 22, Item 12, the Foundation stated the note repayment of \$ _____ was converted to equity as held by Investments, LLC in, LLC.

Promissory Note 3: Dated July , 20 _____, a third promissory note was executed between Borrower, XX, LLC and Lender, XX, LLC for \$ _____ at a fixed rate of % per annum. Borrower shall pay all principal and interest in full on July , 20 _____. In response to IDR 22, Item 12, the Foundation stated the note repayment amount of \$ _____ was converted to equity as held by Investments, LLC in Ventures, LLC. In IDR 28, Item 5, the Foundation was requested to provide the documents for the "change in partnership and other documents that provide for the XX Investment LLC owner relationship with all partners, owners and investors of the XX Ventures LLC for each of the years 20 _____, 20 _____, 20 _____, 20 _____ and 20 _____ that have not been previously provided". The Foundation's response was that the information is being requested from the attorney.

Promissory Note 4: Dated October , 20 _____, a fourth promissory note was executed between Borrower, XX, LLC and Lender, XX, LLC for \$ _____ at a fixed rate of % per annum. Borrower shall pay all principal and interest in full on October . 20 _____. In response to IDR 22, Item 12, the Foundation stated the note repayment amount of \$ _____ was converted to equity as held by Investments, LLC in, LLC on January _____, 20 _____.

In summary:

- In 20 _____, XX and XX, partners in XX, LLC borrowed money from XX, LLC and commingled the funds. The amounts from the loans were the only assets in the partnership bank account except for the initial deposit of \$ _____ by XX and XX. In

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- addition, XX and XX as owners and managers of XX LLC executed promissory notes in 20 totaling \$. The Form 990 reported a loan of \$ to XX, LLC while the XX, LLC 20 Form 1065 reported a note payable of \$ to XX, LLC.
- In December 20 , XX and XX purportedly added XX, LLC as a one-third partner in XX, LLC and the loaned monies along with additional funds became the capital account of XX, LLC for its partnership share. The source of funds were requested but no documents were provided. For 20 , Form 990 reported an investment in XX, LLC of \$ while XX, LLC 20 Form 1065 reported a capital account of \$ for XX, LLC.
 - In 20 and 20 , XX, LLC's partnership share was reduced to % and % respectively. No documents were provided to substantiate the partnership percentage reduction.
 - No documents, other than the issued Forms 1065 and Forms K-1, provide any substantiation of ownership by XX, LLC in the partnership of XX, LLC. There is no partnership agreement wherein XX, LLC was added as a partner.

LAW

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

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

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

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

The presence of a single substantial nonexempt purpose can destroy the exemption regardless of the number or importance of exempt purposes. Better Business Bureau v. United States, 326 U.S. 279, 283, 90 L. Ed. 67, 66 S. Ct. 112 (1945); American Campaign Academy v. Commissioner, 92 T.C. 1053, 1065 (1989); see also Old Dominion Box Co., Inc. v. United States, 477 F.2d. 340 (4th Cir. 1973) ("operating for the benefit of private parties who are not members of a charitable class constitutes a substantial nonexempt purpose"). When an organization operates for the benefit of private interests, such as designated individuals, the creator or his family, or persons directly or indirectly controlled by such private interests, the organization by definition does not operate exclusively for exempt purposes. American Campaign Academy v. Commissioner, *supra* at 1065-66.

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

GOVERNMENT POSITION ISSUE #1

The facts show that the Foundation is not operated for a tax exempt purpose because the assets of the organization served XX, XX, and entities they owned and controlled private interests.

The Foundation was created in conjunction with other entities by and for the benefit of XX and XX in an attempt to create a structure of multiple entities designed to shift income and reduce or eliminate taxes. The facts show that XX and XX created the Foundation to generate improper charitable contribution deductions and other tax benefits without relinquishing dominion and control over the purported gifts. Moreover, bank statements, insurance applications and other documents show the assets that purportedly belonged to the Foundation were used to personally benefit XX, XX and entities they owned and controlled.

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The application for exemption was filed almost a year after the Foundation was created and funded. In the application for exemption, XX declared under penalties of perjury, that his statements were, to the best of his knowledge, true, correct, and complete including the Part II statement regarding disqualified persons where the founder stated, "XX and XX are substantial contributors to the Foundation... The foundation provides that, at all times, the Foundation will be controlled by non-disqualified persons". Contrary to the statement, the founders have absolute control over the Foundation's assets, which were manipulated and commingled with the personal assets of the founders, and with the assets of entities the founders owned and controlled. The Foundation's assets inured to the private benefit of the two donors and founders, XX and XX, and entities they owned and controlled.

On the same date that it was funded with \$, XX and XX transferred all but \$ of the Foundation's assets to XX LLC's bank account. They owned and controlled XX LLC. Approximately one year later this bank account was re-titled to XX LLC. Also, on the same date, XX and XX transferred one sixth of the assets (\$) to the account of XX LLC to purchase a life insurance policy on XX for which XX LLC was the beneficiary. XX LLC had one member. While XX claims the sole member was XX, LLC, the filings with the State of XX reported the sole member was XX Irrevocable Trust. XX and XX owned the trust and its beneficiary was their son. The Declaration of Trust for XX Irrevocable Trust states the trust was to work with XX LLC and be a member to XX LLC. XX LLC paid annual fiduciary fees for the XX Irrevocable Trust. The life insurance policy was not reported as an asset of the Foundation in 20 or 20 . In 20 , XX had the life insurance company change the owner's name to XX LLC. The life insurance policy was still reported as an asset of XX LLC to the board in 2004. In 20 and later years, the Foundation reported the life insurance policy as its asset on its Forms 990.

In 20 , the Foundation purportedly loaned money to XX LLC at a time when the partners were XX (%) and XX (%). No loan documents were produced to substantiate these loans. The Form 990 for the Foundation and the Form 1065 for the LLC for 20 reported different amounts as notes receivable/payable. In 20 , these notes were allegedly exchanged for a equity interest in XX Ventures LLC. Again, the Form 990 and the Form 1065 report different values for this equity interest. XX and XX appear to have exchanged almost nothing in exchange for their interest in XX LLC. In both 20 and 20 , the Foundation's equity interest in XX LLC was reduced but there was no documentation to show why the interest was reduced. There was no partnership agreement adding the Foundation (directly or via XX) as a partner.

In 20 , one-half of the Foundation's assets were transferred to a XX related entity for a \$ unsecured promissory note. The only security was a Guaranty by the parent

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company, XX. Subsequently, XX and its subsidiary, XX transferred \$ each in two separate transfers in October 20 and January 20 to the Foundation's bank account. XX transferred each of these deposits on the same day to the personal bank account of XX and XX. XX and XX's personal investments with XX and XX related entities yielded them extraordinary investment returns and % return of their principal. Conversely, the Foundation's \$ loan to XX yielded an investment loss of \$ plus accrued interest. Further, XX failed to compel the guarantor to honor its commitment to pay FLI the \$ as agreed upon in writing. Defendant XX stated that at least \$ had been paid to the Foundation in offsets and that amount should be deducted from the \$ With \$ paid for a life insurance policy, \$ in a breached loan, and another approximate \$ "invested" in a partnership, few assets remained for the Foundation to conduct charitable activities, especially after payment of XX's annual compensation.

In , \$ of the Foundation's monies were paid to create a charitable remainder trust that the Foundation claims never materialized and yet another partnership was created in conjunction with that charitable remainder trust.

Beginning in 20 , the Foundation paid \$ per year to XX as investing and consulting fees. The board approved the compensation in 20 . Investing fees were also paid in other years: \$ in 20 , \$ (in addition to the \$) in 20 , \$ (in addition to \$) in 20 , and \$ (in addition to the \$) in 20 . No documents were produced to show the recipients of the additional investment fees. No Forms W-2 or 1099 were provided to XX by the Foundation to report this compensation. There were no invoices for services rendered or compensation comparison studies. The compensation accounted for a significant amount of the expenses paid by the Foundation each year. Between the "investments" of the Foundation's funds and the compensation paid to XX, the Foundation was left with few assets to conduct charitable activities.

XX and XX are insiders who control the Foundation and who diverted the Foundation's assets for their personal and private benefit. The commingling of funds, transfers of ownership, inconsistent reporting, and purported lending of money without documentation between entities show that XX and XX retained dominion and control over the Foundation's assets and considered the assets to be their own.

The Foundation filed annual information returns for each year which did not fully disclose the transactions and relationships between the various entities. It provided no specific details about its purported investments in the various LLCs and the purported loans with XX and with the LLCs and it provided limited information that would show these monies were used by its founders for their private use. The returns stated that it had not engaged in any excess benefit transactions. The Foundation's returns did not accurately reflect its assets and the statements

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provided by the Organization Manager, XX, regarding whether the Foundation engaged in an excess benefit transaction were false.

The government contends that the exemption should be revoked retroactively because The XX omitted and concealed material information on its application for exemption under IRC 501(c)(3). The relationships between the Foundation and the various entities owned and/or controlled by the donors through the management and the operation of taxable business ventures was concealed and not disclosed on the Foundation's application for exemption. The Service was not alerted that the Foundation was entangled in business deals with its insiders, that XX and XX could change the name of the owner of various assets and the relationship between these entities at will, and it did not consider the private benefit to these insiders in its determination that The XX was established primarily for public purposes under 501(c)(3). Omission of these material facts was intentional.

In Share Network Foundation v. Commissioner, the Judge noted that there is a negative inference when an exempt organization provides vague information, particularly when the organization is controlled by members of one family. Similarly, The XX is controlled by members of the same family and did not provide a candid disclosure of very important facts. It failed to provide concrete documentation in response to material questions related to its activities. Thus, the inference is that its activities provided significant economic and private benefits to its insiders, and that the facts, if disclosed, would show that the Foundation failed to meet the requirements for exemption.

An organization is described in section 501(c)(3) only if no part of its net earnings inures to the benefit of any private shareholder. The inurement prohibition is designed to ensure that charitable assets are dedicated exclusively to furthering public purposes. An organization is not operated exclusively for exempt purposes if its net earnings inure to the benefit of private shareholders or individuals. Treas. Reg. § 1.501(c)(3)-1(c)(1).

A gift to a charitable organization must be a voluntary transfer of money or property without the receipt of adequate consideration, made with charitable intent. Hernandez v. Commissioner, 490 U.S. 680, 690 (1980). To claim a deduction under section 170, a donor must surrender dominion and control over the gift. United States v. Estate Preservation Services, 202 F.3d. 1093, 1101 (9th Cir. 2000). XX and XX transferred assets to the Foundation and claimed a deduction under section 170. A charity's assets are required to be irrevocably dedicated to charitable purposes. Treas. Reg. § 1.501(c)(3)-1(b)(4). The inurement prohibition serves to prevent the individuals who operate the charity from siphoning off any of a charity's income or assets for personal use. By returning assets to XX and XX and entities they own and control, the Foundation breached the dedication requirement and its net earnings have inured to the benefit of XX and XX.

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Although the inurement prohibition is stated in terms of net earnings, it applies to any of a charity's assets that serve the interests of its private shareholders. Harding Hospital, Inc. v. United States, 505 F.2d 1068, 1072 (6th Cir. 1974). The investments in a life insurance policy whose owner/relationship to the Foundation changed as the founders determined, an unsecured promissory note, and XX partnerships/LLCs (especially where the investments were not properly documented, fluctuated, were inconsistently reported and where the Foundation's assets were used to pay expenses of non-exempt entities owned and controlled by the founders), in addition to transfers of money into personal bank accounts and bank accounts of LLCs owned and controlled by the founders serves the private interests of the donors and personally benefited XX and XX. When a charity's investments are decided in part by the needs of private interests, the charity is not operated exclusively for exempt purposes. Western Catholic Church v. Commissioner, 73 T.C. 196, 214 (1979), aff'd, 631 F.2d 736 (7th Cir. 1980).

In this case, XX and XX used the Foundation to facilitate a circular tax avoidance scheme. Church of World Peace v. Commissioner, T.C. Memo. 1994-87. The Foundation's assets served private interests and the Foundation was operated as part of a tax avoidance scheme. Tax avoidance schemes do not further an exempt purpose. Freedom Church of Revelation, 588 F. Supp. 693, 696 (D.D.C. 1984).

The Foundation, which is controlled by its founders, is operated to enable its founders to engage in financial activities which are beneficial to them and to entities they own and control but detrimental to the Foundation. Accordingly, it is operated for a substantial non-exempt purpose. See Rev. Rul. 67-5, 1967-1 C.B. 123.

The Foundation's net earnings have inured to the benefit of insiders. Treas. Reg. § 1.501(a)-1(c).

Therefore, based on the information set forth above, the XX Foundation also known as The XX's tax exempt status under section 501(c)(3) of the Code should be revoked because the Foundation did not establish that it is operated exclusively for tax-exempt purposes. Its net earnings inured to the benefit of private individuals. It serves the private interests of XX and XX and entities they own and control.

CONCLUSION ISSUE #1

The XX's tax exempt status under section 501(c)(3) of the Code should be revoked because it has not established that it is operated exclusively for tax-exempt purposes or that its net earnings did not inure

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to the private benefit of the XX and XX and entities they own and control. The XX failed to satisfy the "operational test" under Regulations Section 1.501(c)(3)-1(d)(ii). It failed to establish that it is not operated for the benefit of its founders, donors and Trustees and entities they own and control.

Revocation of The XX tax exempt status is effective beginning December , 20 .

Form 1041 U.S. Income Tax Return for Estates and Trusts should be filed for tax years ending December 31, [20 , 20 and 20 . Subsequent returns are due no later than the 15th day of the 4th month following the close of the trust's accounting period.

Returns should be sent to the following mailing address:

For tax year ending December , 20 , the Form 1041 is due April , 20 , and should be sent to the following address:

ISSUE #2 – ALTERNATIVE POSITION

If The XX's exempt status is not revoked, whether it should be classified as a private foundation because it is not a supporting organization.

BRIEF EXPLANATION OF FACTS – ALTERNATIVE ISSUE

See prior Facts as well as the statement of facts below.

The Foundation applied for and was recognized as exempt as an organization described in sections 501(c)(3) and was classified as a supporting organization defined in section 509(a)(3). The Foundation filed Forms 990, Return of Organization Exempt from Income Tax, for all years.

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The dissolution clause of the Declaration of Trust provides that if the Trustees terminate the trust, the remaining assets shall be distributed for one or more exempt purposes within the meaning of section 501(c)(3) of the Internal Revenue Code or to the federal government, or to a state or local government, for a public purpose. If the Trust does not obtain tax-exempt status under Sections 501(c)(3) and 509(a)(3) of the Code, the assets of the Trust shall go to XX and XX or by power of appointment as a contingent remainder.

The Declaration of Trust provides that the Board shall consist of up to 5 members and no less than 3 members. One Board member each shall be appointed by the XX, The XX Foundation, Inc. and The XX, when it qualifies as an organization described in Section 509(a)(1) or 509(a)(2). Two board members shall be from the class consisting of XX and XX and their descendants, which shall collectively have two votes.

The XX Foundation donor advised fund was established with the supported organization, the XX, on October , 20 . The Foundation's records show the following activity in the donor advised fund:

<u>SOURCE/TRANS.</u>	<u>DATE</u>	<u>AMOUNT</u>	<u>PURPOSE/SOURCE/DSTN</u>
Cash Contribution	10/	\$	X
Cash Contribution	01/		X
Cash Contribution	10/	\$	X
Cash Contribution	02/	\$	X
Grantee Payment	02/	-\$	X
Cash Contribution	03/	\$	X
Grantee Payment	03/	-\$	X
Cash Contribution	12/	\$	X
Grantee Payment	02/	-\$	X
Cash Contribution	02/	\$	X
TOTAL		<u>\$</u>	

In addition to the amounts deducted from the donor advised account for grants, the XX deducted a % marketing service fee.

LAW ISSUE #2 – ALTERNATIVE ISSUE

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

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

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

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,

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

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

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

Income Tax Regulations section 1.509(a)-4(g) provides guidance on the meaning of "operated, supervised, or controlled by" as follows:

(1)

(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:

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

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

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;

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

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

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

(iii)

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

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

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

(3) Integral part test; general rule

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

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

(iii)

(a) The supporting organization makes payments of substantially all of its income to or for the use of one or more publicly supported organizations, and the amount of support received by one or more of such publicly supported organizations is

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

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

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

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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.

Revenue Ruling 76-32, 1976-1 C.B. 160, held, even though the reports are voluntarily submitted, so long as the agreement is observed it will be considered evidence of actual attentiveness within the meaning of section 1.509(a)-4-(i)(3)(iii)(d) of the Regulations for purposes of determining whether the attentiveness requirement of the integral part test of section 1.509(a)-4(i)(3)(iii) is satisfied. However, while the agreement will be considered evidence of actual attentiveness under section 1.509(a)-4(i)(3)(iii)(d), it will not, in itself, satisfy the attentiveness requirement of the integral part test of section 1.509(a)-4(i)(3)(iii). Rather, in order to satisfy that requirement, all of the factors mentioned in the regulations must be taken into consideration.

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

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

GOVERNMENT POSITION ISSUE #2 – ALTERNATIVE ISSUE

It is the government's position that the XX's tax exempt status should be revoked (see Issue #1). However, if The XX's tax exempt status is not revoked, it 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 was intentionally inclusive so that all organizations exempted from tax by section 501(c)(3) are private foundations except for those specified in section 509(a)(1) through(4), Roe Foundation

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Charitable Trust v. Commissioner, T.C. Memo. 1989-566, 58 T.C.M. (CCH) 402, 404 (1989); Quarrie Charitable Fund v. Commissioner, 603 F.2d 1274, 1277 (7th Cir. 1979). The Foundation currently is excepted from private foundation status because it is currently classified as an organization described in section 509(a)(3) which defines supporting organizations.

Publicly supported organizations as defined in sections 509(a)(1) and (2) are excepted from private foundation status on the theory that their exposure to public scrutiny and their dependence on public support keep them from the abuses to which private foundations are subject. Supporting organizations are similarly excepted from private foundation status. Supporting organizations are excepted if they are subject to the scrutiny of public charities that provide sufficient oversight to keep supporting organizations from the types of abuses to which private foundations are prone. Quarrie Charitable Fund, 603 F.2d at 1277-78.

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

- 1) Organizational and Operational Tests under IRC § 509(a)(3)(A).
- 2) Relationship Test under IRC § 509(a)(3)(B).
- 3) Lack of Disqualified Person Control Test under IRC § 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 of the supporting organization and that it is not controlled, directly or indirectly, by disqualified persons.

Organizational and Operational Test (IRC 509(a)(3)(A))

Per Treas. Reg. § 1.509(a)-4(c)(1)(iii) and (iv), an organization's governing instrument must state the specified publicly supported organization(s) on whose behalf the organization is to be operated and cannot expressly empower the organization to support or benefit any organizations other than the specified publicly supported organizations(s). The XX's Declaration of Trust allows distributions to organizations other than the specified publicly supported organization upon dissolution. The possible beneficiaries are not limited to The XX and the organizations specified on Schedule A. Therefore, the organizational test is not met. See Quarrie Charitable Fund v. Commissioner, 603 F.2d 1274 (7th Cir. 1979) (the court held the organizational test was not satisfied where the trustee had the power to determine the charitable use was unnecessary or impracticable and to distribute the income to any charitable corporation he selected).

In addition, the operational test set forth in Treas. Reg. § 1.509(a)-4(e)(1) is not satisfied. A supporting organization will be regarded as "operated exclusively" to support a specified

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publicly supported organization(s) only if it engages in activities which support or benefit the specified publicly supported organizations(s). The XX has served private interests and has made payments for the benefit of the XX and his wife, XX and entities they own and manage. Therefore, it has not established that it operates exclusively for the benefit of the publicly supported organizations. Most of the distributions and activities have personally benefited the founders and their entities and not specified publicly supported organizations.

Relationship Test (IRC 509(a)(3)(B))

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.

While the facts show the public charities never exerted substantial control or direction over the policies or activities of The XX, the Declaration of Trust provides that three of the five trustees will be appointed by the publicly supported charities, and they were. Thus, the technical requirements to satisfy the first type of relationship were satisfied.

Control Test (IRC 509(a)(3)(C))

Internal Revenue Code § 509(a)(3)(C) and Treas. Reg. § 1.509(a)-4(j)(1) provide that a supporting organization may not be controlled, directly or indirectly, by disqualified persons. XX and XX are substantial contributors to The XX and are, therefore, disqualified persons to The XX. While there are supposed to be five trustees, three of them appointed by public charities, the facts show that XX and XX controlled the operations of the Foundation. They entered into transactions that benefited themselves and entities they owned and managed. These transactions impaired the ability of the Foundation to perform charitable activities. The public charities did not exercise oversight so as to prevent these transactions. Only XX and XX had signatory authority over the Foundation's accounts. In addition, the regulations state, among the factors to be considered in determining if disqualified persons indirectly control an

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organization is the nature of the organization's holdings. In this case, the Foundation is the sole member of XX LLC, and most of its activities were conducted through this entity. XX and XX were the only managers of XX LLC and as such controlled its activities. Therefore, XX and XX had indirect control over the activities of the Foundation because of their control over its primary asset.

CONCLUSION ISSUE #2 – ALTERNATIVE POSITION

Therefore, if its exempt status is not revoked, The XX should be reclassified as an organization that is a private foundation defined in section 509(a). It cannot be classified as a supporting organization because it has not established that it has met the requirements set forth in Treas. Reg. § 1.509(a)-4(c) through (j).

This determination is effective beginning December , 20 . Retroactive reclassification is appropriate because the Foundation did not divulge in its application that it would operate for the benefit of its founders and entities they own and manage and that it would be controlled by its founders.

The effect of this determination is that the Foundation is required to file Form 990-PF Return of Private Foundation. Form 990-PF should be filed for tax years ending December 31, 20 , 20 and 20 . Subsequent returns are due no later than the 15th day of the 5th month following the close of the Organization's accounting period. For tax year 20 , Form 990-PF is due May 15, 2007.

Send your returns to the following mailing address:

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