Internal Revenue Service
Appeals

Department of the Treasury

Address any reply to:
****

Employer Identification Number:
****

Person to Contact:
****

Contact Telephone Number:
****

Fax Number:
****

Release Number: 201113041
Release Date: 4/1/2011
Date: January 7, 2011

Uniform Issue List:

0501.03-30

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Certified Mail

Dear

This is our final adverse determination with respect to your exempt status under section 501(a) of the Internal Revenue Code ("Code"). Recognition of your exemption under Code section 501(c)(3) is revoked beginning January 1, 20XX.

Our adverse determination was made because **** is not operated exclusively for exempt purposes. Under Treasury Reg. § 1.501(c)(3)-1(c)(1), 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 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.

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

You are required to file Federal income tax returns on form **** for any years, which are still open under the statute of limitations. Based on the information you furnished, it appears that returns should be filed beginning with the year ending December 31, 20XX. You should file any returns due for these years or later years with the Department of the Treasury, Internal Revenue Service Center, **** (as applicable for ****).

You have waived your right to contest this determination under the declaratory judgment provisions of Section 7428 of the Code by your execution of Form 906, Closing Agreement Concerning Specific Matters, an executed copy of which is being sent to you under separate cover.

If you have questions about this letter, you may write to or call the contact person whose name, telephone number, and IRS address are shown on the first page of this letter. If you write, please include your telephone number, the best time for us to call you if we need more information, and a copy of this letter to help us identify your account. Keep the original letter for your records. If you prefer to call and the telephone number is outside your local calling area, there will be a long distance charge to you.

The contact person identified on the front of this letter can access your tax information and help you get answers. You also have the right to contact the office of the Taxpayer Advocate. You can call 1-877-777-4778 and ask for Taxpayer Advocate assistance, or you can contact the nearest Taxpayer Advocate office by calling **** or by writing to Local 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.

Sincerely yours,

/s/
Appeals Team Manager

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
Internal Revenue Service
68 Sewall St., # 201
Augusta, ME 04330

Taxpayer Identification Number:

ORG
ADDRESS

Form:

Tax Year(s) Ended:

Person to Contact/ID Number:

Contact Numbers:
Telephone:
Fax:

Certified Mail - Return Receipt Requested

Dear

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

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

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

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

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

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

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

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

Thank you for your cooperation.

Sincerely,

Marsha A. Ramirez
Director, EO Examinations

Enclosures:
Publication 892
Publication 3498
Report of Examination

LEGEND
ORG = Organization name XX = Date State = state GB = gb President = president Vice President = vice president Secretary = secretary Attorney = attorney

UNAGREED CASE REPORT - REVOCATION OF 501(c)(3) EXEMPT STATUS

ORG - EIN: EIN

ISSUE

1. Whether the tax-exempt status of the ORG should be revoked based on inurement issues revealed during the course of our examination.

BACKGROUND

The ORG is recognized as a 501(c)(3) tax-exempt organization, and is a non-profit corporation under the laws of the State of State. According to its Articles of Incorporation, the primary purpose of the organization is to pursue "the study of how the interaction of land use, disturbance and climate impact the structure and biodiversity of southwest ORG, and the publication of papers relating to such study". The ORG is a one-person corporation operated by its President, President. The governing board of the organization consists of three immediate family members; President, President of the organization, President's Father, Vice President, Vice President of the organization, and President's Wife, Secretary, Secretary/Treasurer of the organization. The President does not have an employment contract with the organization, and the organization does not have a conflict of interest policy. After first obtaining exemption in 19XX, the organization relocated from State to State in 20XX. When the examination began, the organization's incorporation in State was undergoing dissolution. President reestablished the corporation in State three weeks after the field examination occurred.

FACTS

The ORG's records demonstrated that the organization's President, President, consistently utilized the organization's income for private purposes. Our examination revealed the following inurement issues and private benefit transactions that resulted from the organization being under the control of one-person with a family-based governing board:

- The general ledgers demonstrated President's routine use of organizational income for private purposes through consistent entries into account # 20XX entitled "Loans to Officers".
- The governing board of the organization, composed solely of GB members, prepared and signed "after-the-fact" Board approvals for "loans" that were actually the sum of a series of withdrawals and personal expense payments previously made by President from the organization's checking account as documented by multiple entries into the "Loans to Officers" account.

- The governing board composed solely of GB members prepared and signed approvals to cover "loans", salary increases, and payment of the GB's medical expenses by the organization.
- President sold his personal Land Rover vehicle and Rhodes Block Islander sport fishing boat to the organization without transferring title to the assets.
- President upgraded the Rhodes Block Islander sport fishing boat using organizational funds, and was unable to substantiate the existence/ownership of the asset.
- The organization funded President's auto expenses, to include repairs and mileage, without his transferring title of the vehicle to the organization, and without proper administration of an accountable plan.
- The organization funded President's travel expenses under a non-accountable plan.
- The organization paid President's personal legal expenses.
- The records demonstrated President's routine use of the "loans to officers' account, his consistent commingling of personal and business activities using the organization's bank accounts and credit cards, and inadequate records to support his activities.

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.

Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization will not be regarded as operated exclusively for exempt purposes if more than an insubstantial part of its activities is not in furtherance of exempt purposes.

Section 1.501(c)(3)-1(d)(ii) of the regulations provides that 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, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

Section 1.501(c)(3)-1(d)(2) of the regulations provides that the term "charitable" is used in section 501(c)(3) of the Code in its generally accepted legal sense, and includes the promotion of education.

The presence of a single substantial nonexempt purpose can destroy the exemption regardless of the number or importance of exempt purposes. Better Bus. Bureau v. United States, 326 U.S. 279. 283, 90 L. Ed. 67, 66 S. Ct. 112 (1945); Am. Campaign Acad. v. Commissioner, 92 T.C. 1053, 1065 (1989); see also Old Dominion Box Co., Inc. v. United States, 477 F2d. 340 (4th Cir. 1973), cert. denied, 413 US 910 (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. Am. Campaign Acad. v. Commissioner, supra at 1065-1066, and John Marshall Law School v. United States, 228 Ct. Cl. 902 (1981).

FINAL-REG, TAX-REGS, **§1.501(c)(3)-1. Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals**

(f) *Interaction with section 4958*

(1) *Application process.* —An organization that applies for recognition of exemption under section 501(a) as an organization described in section 501(c)(3) must establish its eligibility under this section. The Commissioner may deny an application for exemption for failure to establish any of section 501(c)(3)'s requirements for exemption. Section 4958 does not apply to transactions with an organization that has failed to establish that it satisfies all of the requirements for exemption under section 501(c)(3). See §53.4958-2.

(2) *Substantive requirements for exemption still apply to applicable tax-exempt organizations described in section 501(c)(3)*

(i) *In general.* —Regardless of whether a particular transaction is subject to excise taxes under section 4958, the substantive requirements for tax exemption under section 501(c)(3) still apply to an applicable tax-exempt organization (as defined in section 4958(e) and §53.4958-2) described in section 501(c)(3) whose disqualified persons or organization managers are subject to excise taxes under section 4958. Accordingly, an organization will no longer meet the requirements for tax-exempt status under section 501(c)(3) if the organization fails to satisfy the requirements of paragraph (b), (c) or (d) of this section. See §53.4958-8(a).

(ii) *Determination of whether revocation of tax-exempt status is appropriate when section 4958 excise taxes also apply.* —In determining whether to continue to recognize the tax-exempt status of an applicable tax-exempt organization (as defined in section 4958(e) and §53.4958-2) described in section 501(c)(3) that engages in one or more excess benefit transactions (as defined in section 4958(c) and §53.4958-4) that violate the prohibition on inurement under section 501(c)(3), the Commissioner will consider all relevant facts and circumstances, including, but not limited to, the following —

(A) The size and scope of the organization's regular and ongoing activities that further exempt purposes before and after the excess benefit transaction or transactions occurred:

(B) The size and scope of the excess benefit transaction or transactions (collectively, if more than one) in relation to the size and scope of the organization's regular and ongoing activities that further exempt purposes;

(C) Whether the organization has been involved in multiple excess benefit transactions with one or more persons;

(D) Whether the organization has implemented safeguards that are reasonably calculated to prevent excess benefit transactions; and

(E) Whether the excess benefit transaction has been corrected (within the meaning of section 4958(f)(6) and §53.4958-7), or the organization has made good faith efforts to seek correction from the disqualified person(s) who benefited from the excess benefit transaction.

(iii) All factors will be considered in combination with each other. Depending on the particular situation, the Commissioner may assign greater or lesser weight to some factors than to others. The factors listed in paragraphs (f)(2)(ii)(D) and (E) of this section will weigh more heavily in favor of continuing to recognize exemption where the organization discovers the excess benefit transaction or transactions and takes action before the Commissioner discovers the excess benefit transaction or transactions. Further, with respect to the factor listed in paragraph (f)(2)(ii)(E) of this section, correction after the excess benefit transaction or transactions are discovered by the Commissioner, by itself, is never a sufficient basis for continuing to recognize exemption.

(iv) *Examples.* —The following examples illustrate the principles of paragraph (f)(2)(ii) of this section. For purposes of each example, assume that O is an applicable tax-exempt organization (as defined in section 4958(e) and §53.4958-2) described in section 501(c)(3). The examples read as follows:

Example 1. (i) O was created as a museum for the purpose of exhibiting art to the general public. In Years 1 and 2, O engages in fundraising and in selecting, leasing, and preparing an appropriate facility for a museum. In Year 3, a new board of trustees is elected. All of the new trustees are local art dealers. Beginning in Year 3 and continuing to the present, O uses a substantial portion of its revenues to purchase art solely from its trustees at prices that exceed fair market value. O exhibits and offers for sale all of the art it purchases. O's Form 1023, "Application for Recognition of Exemption," did not disclose the possibility that O would purchase art from its trustees.

(ii) O's purchases of art from its trustees at more than fair market value constitute excess benefit transactions between an applicable tax-exempt organization and disqualified persons under section 4958. Therefore, these transactions are subject to the applicable excise taxes provided in that section. In addition, O's purchases of art from its trustees at more than fair market value violate the proscription against inurement under section 501(c)(3) and paragraph (c)(2) of this section.

(iii) The application of the factors in paragraph (f)(2)(ii) of this section to these facts is as follows. Beginning in Year 3, O does not engage primarily in regular and ongoing activities that further exempt purposes because a substantial portion of O's activities consists of purchasing art from its trustees and dealing in such art in a manner similar to a commercial art gallery. The size and scope of the excess benefit transactions collectively are significant in relation to the size and scope of any of O's ongoing activities that further exempt purposes. O has been involved in multiple excess benefit transactions, namely, purchases of art from its trustees at more than fair market value. O has not implemented safeguards that are reasonably calculated to prevent such improper purchases in the future. The excess benefit transactions have not been corrected, nor has O made good faith efforts to seek correction from the disqualified persons who benefited from the excess benefit transactions (the trustees). The trustees continue to control O's Board. Based on the application of the factors to these facts, O is no longer described in section 501(c)(3) effective in Year 3.

Example 2. (i) The facts are the same as in *Example 1*, except that in Year 4, O's entire board of trustees resigns, and O no longer offers all exhibited art for sale. The former board is replaced with members of the community who are not in the business of buying or selling art and who have skills and experience running charitable and educational programs and institutions. O promptly discontinues the practice of purchasing art from current or former trustees, adopts a written conflicts of interest policy, adopts written art valuation guidelines, hires legal counsel to recover the excess amounts O had paid its former trustees, and implements a new program of activities to further the public's appreciation of the arts.

(ii) O's purchases of art from its former trustees at more than fair market value constitute excess benefit transactions between an applicable tax-exempt organization and disqualified persons under section 4958. Therefore, these transactions are subject to the applicable excise taxes provided in that section. In addition, O's purchases of art from its trustees at more than fair market value violate the proscription against inurement under section 501(c)(3) and paragraph (c)(2) of this section.

(iii) The application of the factors in paragraph (f)(2)(ii) of this section to these facts is as follows. In Year 3, O does not engage primarily in regular and ongoing activities that further exempt purposes. However, in Year 4, O elects a new board of trustees comprised of individuals who have skills and experience running charitable and educational programs and implements a new program of activities to further the public's appreciation of the arts. As a result of these actions, beginning in Year 4, O engages in regular and ongoing activities that further exempt purposes. The size and scope of the excess benefit transactions that occurred in Year 3, taken collectively, are significant in relation to the size and scope of O's regular and ongoing exempt function activities that were conducted in Year 3. Beginning in Year 4, however, as O's exempt function activities grow, the size and scope of the excess benefit transactions that occurred in Year 3 become less and less significant as compared to the size and scope of O's regular and ongoing exempt function activities. O was involved in multiple excess benefit transactions in Year 3. However, by discontinuing its practice of purchasing art from its current and former trustees, by replacing its former board with independent members of the community, and by adopting a conflicts of interest policy and art valuation guidelines, O has implemented safeguards that are reasonably calculated to prevent future violations. In addition, O has made a good faith effort to seek correction from the disqualified persons who benefited from the excess benefit transactions (its former trustees). Based on the application of the factors to these facts, O continues to meet the requirements for tax exemption under section 501(c)(3).

Example 3. (i) O conducts educational programs for the benefit of the general public. Since its formation, O has employed its founder, C, as its Chief Executive Officer. Beginning in Year 5 of O's operations and continuing to the present, C caused O to divert significant portions of O's funds to pay C's personal expenses. The diversions by C significantly reduced the funds available to conduct O's ongoing educational programs. The board of trustees never authorized C to cause O to pay C's personal expenses from O's funds. Certain members of the board were aware that O was paying C's personal expenses. However, the board did not terminate C's employment and did not take any action to seek repayment from C or to prevent C from continuing to divert O's funds to pay C's personal expenses. C claimed that O's payments of C's personal expenses represented loans from O to C. However, no contemporaneous loan documentation exists, and C never made any payments of principal or interest.

(ii) The diversions of O's funds to pay C's personal expenses constitute excess benefit transactions between an applicable tax-exempt organization and a disqualified person under section 4958. Therefore, these transactions are subject to the applicable excise taxes provided in that section. In addition, these transactions violate the proscription against inurement under section 501(c)(3) and paragraph (c)(2) of this section.

(iii) The application of the factors in paragraph (f)(2)(ii) of this section to these facts is as follows. O has engaged in regular and ongoing activities that further exempt purposes both before and after the excess benefit transactions occurred. However, the size and scope of the excess benefit transactions engaged in by O beginning in Year 5, collectively, are significant in relation to the size and scope of O's activities that further exempt purposes. Moreover, O has been involved in multiple excess benefit transactions. O has not implemented any safeguards that are reasonably calculated to prevent future diversions. The excess benefit transactions have not been corrected, nor has O made good faith efforts to seek correction from C, the disqualified person who benefited from the excess benefit transactions. Based on the application of the factors to these facts, O is no longer described in section 501(c)(3) effective in Year 5.

Example 4. (i) O conducts activities that further exempt purposes. O uses several buildings in the conduct of its exempt activities. In Year 1, O sold one of the buildings to Company K for an amount that was substantially below fair market value. The sale was a significant event in relation to O's other activities. C, O's Chief Executive Officer, owns all of the voting stock of Company K. When O's board of trustees approved the transaction with Company K, the board did not perform due diligence that could have made it aware that the price paid by Company K to acquire the building was below fair market value. Subsequently, but before the IRS commences an examination of O, O's board of trustees determines that Company K paid less than the fair market value for the building. Thus, O concludes that an excess benefit transaction occurred. After the board makes this determination, it promptly removes C as Chief Executive Officer, terminates C's employment with O, and hires legal counsel to recover the excess benefit from Company K. In addition, O promptly adopts a conflicts of interest policy and new contract review procedures designed to prevent future recurrences of this problem.

(ii) The sale of the building by O to Company K at less than fair market value constitutes an excess benefit transaction between an applicable tax-exempt organization and a disqualified person under section 4958 in Year 1. Therefore, this transaction is subject to the applicable excise taxes provided in that section. In addition, this transaction violates the proscription against inurement under section 501(c)(3) and paragraph (c)(2) of this section.

(iii) The application of the factors in paragraph (f)(2)(ii) of this section to these facts is as follows. O has engaged in regular and ongoing activities that further exempt purposes both before and after the excess benefit transaction occurred. Although the size and scope of the excess benefit transaction were significant in relation to the size and scope of O's activities that further exempt purposes, the transaction with Company K was a one-time occurrence. By adopting a conflicts of interest policy and new contract review procedures and by terminating C, O has implemented safeguards that are reasonably calculated to prevent future violations. Moreover, O took corrective actions before the IRS commenced an examination of O. In addition, O has made a good faith effort to seek correction from Company K, the disqualified person who benefited from the excess benefit transaction. Based on the application of the factors to these facts, O continues to be described in section 501(c)(3).

Example 5. (i) O is a large organization with substantial assets and revenues. O conducts activities that further its exempt purposes. O employs C as its Chief Financial Officer. During Year 1, O pays $2,500 of C's personal expenses. O does not make these payments pursuant to an accountable plan, as described in §53.4958-4(a)(4)(ii). In addition, O does not report any of these payments on C's Form W-2, "Wage and Tax Statement," or on a Form 1099-MISC, "Miscellaneous Income," for C for Year 1, and O does not report these payments as compensation on its Form 990, "Return of Organization Exempt From Income Tax," for Year 1. Moreover, none of these payments can be disregarded as nontaxable fringe benefits under §53.4958-4(c)(2) and none consisted of fixed payments under an initial contract under §53.4958-4(a)(3). C does not report the $2,500 of payments as income on his individual Federal income tax return for Year 1. O does not repeat this reporting omission in subsequent years and, instead, reports all payments of C's personal expenses not made under an accountable plan as income to C.

(ii) O's payment in Year 1 of $2,500 of C's personal expenses constitutes an excess benefit transaction between an applicable tax-exempt organization and a disqualified person under section 4958. Therefore, this transaction is subject to the applicable excise taxes provided in that section. In addition, this transaction violates the proscription against inurement in section 501(c)(3) and paragraph (c)(2) of this section.

(iii) The application of the factors in paragraph (f)(2)(ii) of this section to these facts is as follows. O engages in regular and ongoing activities that further exempt purposes. The payment of $2,500 of C's personal expenses represented only a de minimis portion of O's assets and revenues; thus, the size and scope of the excess benefit transaction were not significant in relation to the size and scope of O's activities that further exempt purposes. The reporting omission that resulted in the excess benefit transaction in Year 1 occurred only once and is not repeated in subsequent years. Based on the application of the factors to these facts, O continues to be described in section 501(c)(3).

Example 6. (i) O is a large organization with substantial assets and revenues. O furthers its exempt purposes by providing social services to the population of a specific geographic area. O has a sizeable workforce of employees and volunteers to conduct its work. In Year 1, O's board of directors adopted written procedures for setting executive compensation at O. O's executive compensation procedures were modeled on the procedures for establishing a rebuttable presumption of reasonableness under §53.4958-6. In accordance with these procedures, the board appointed a compensation committee to gather data on compensation levels paid by similarly situated organizations for functionally comparable positions. The members of the compensation committee were disinterested within the meaning of §53.4958-6(c)(1)(iii). Based on its research, the compensation committee recommended a range of reasonable compensation for several of O's existing top executives (the Top Executives). On the basis of the committee's recommendations, the board approved new compensation packages for the Top Executives and timely documented the basis for its decision in board minutes. The board members were all disinterested within the meaning of §53.4958-6(c)(1)(iii). The Top Executives were not involved in setting their own compensation. In Year 1, even though payroll expenses represented a significant portion of O's total operating expenses, the total compensation paid to O's Top Executives represented only an insubstantial portion of O's total payroll expenses. During a subsequent examination, the IRS found that the compensation committee relied exclusively on compensation data from organizations that perform similar social services to O. The IRS concluded, however, that the organizations were not similarly situated because they served substantially larger geographic regions with more diverse populations and were larger than O in terms of annual revenues, total operating budget, number of employees, and number of beneficiaries served. Accordingly, the IRS concluded that the compensation committee did not rely on "appropriate data as to comparability" within the meaning of §53.4958-6(c)(2) and, thus, failed to establish the rebuttable presumption of reasonableness under §53.4958-6. Taking O's size and the nature of the geographic area and population it serves into account, the IRS concluded that the Top Executives' compensation packages for Year 1 were excessive. As a result of the examination, O's board added new members to the compensation committee who have expertise in compensation matters and also amended its written procedures to require the compensation committee to evaluate a number of specific factors, including size, geographic area, and population covered by the organization, in assessing the comparability of compensation data. O's board renegotiated the Top Executives' contracts in accordance with the recommendations of the newly constituted compensation committee on a going forward basis. To avoid potential liability for damages under state contract law, O did not seek to void the Top Executives' employment contracts retroactively to Year 1 and did not seek correction of the excess benefit amounts from the Top Executives. O did not terminate any of the Top Executives.

(ii) O's payments of excessive compensation to the Top Executives in Year 1 constituted excess benefit transactions between an applicable tax-exempt organization and disqualified persons under section 4958. Therefore, these payments are subject to the applicable excise taxes provided under that section, including second-tier taxes if there is no correction by the disqualified persons. In addition, these payments violate the proscription against inurement under section 501(c)(3) and paragraph (c)(2) of this section.

(iii) The application of the factors in paragraph (f)(2)(ii) of this section to these facts is as follows. O has engaged in regular and ongoing activities that further exempt purposes both before and after the excess benefit transactions occurred. The size and scope of the excess benefit transactions, in the aggregate, were not significant in relation to the size and scope of O's activities that further exempt purposes. O engaged in multiple excess benefit transactions. Nevertheless, prior to entering into these excess benefit transactions, O had implemented written procedures for setting the compensation of its top management that were reasonably calculated to prevent the occurrence of excess benefit transactions. O followed these written procedures in setting the compensation of the Top Executives for Year 1. Despite the board's failure to rely on appropriate comparability data, the fact that O implemented and followed these written procedures in setting the compensation of the Top Executives for Year 1 is a factor favoring continued exemption. The fact that O amended its written procedures to ensure the use of appropriate comparability data and renegotiated the Top Executives' compensation packages on a going forward basis are also factors favoring continued exemption, even though O did not void the Top Executives' existing contracts and did not seek correction from the Top Executives. Based on the application of the factors to these facts, O continues to be described in section 501(c)(3).

(3) *Applicability.* —The rules in paragraph (f) of this section will apply with respect to excess benefit transactions occurring after March 28, 20XX.

(g) *Applicability of regulations in this section.* —The regulations in this section are, except as otherwise expressly provided, applicable with respect to taxable years beginning after July 26, 1959. For the rules applicable with respect to taxable years beginning before July 27, 1959. see 26 CFR (1939) 39.101(6)-1 (Regulations 118) as made applicable to the Code by Treasury Decision 6091, approved August 16, 1954 (19 F.R. 5167; C.B. 1954-2, 47). [Reg. §1.501(c)(3)-1.]

[*T.D.* 6391, 6-25-59. *Amended by T.D.* 6525, 1-10-61; *T.D.* 6939, 12-11-67; *T.D.* 7428, 8-13-76; *T.D.* 8308, 8-30-90 *and T.D.* 9390, 3-27-08 (*corrected* 4-28-20XX).]

ISSUE # 1 – REVOCATION BASED ON INUREMENT ISSUES

TAXPAYER'S POSITION

According to the written response dated October 21, 20XX from President's Attorney, Attorney, the organization does not agree that any excess benefit or inurement transactions occurred. The response stated that President had repaid the organization for "loans" previously taken by him in periods outside of those under review by paying organizational expenses using personal funds. The response included the assertion that the organization's revenues came from the performance of grants and contracts that were subject to meaningful oversight by entities that did not question ORG' use of the funding provided. The related response referenced in the letter from Attorney, dated October 21, 20XX, acknowledged President's responsibility for poor recordkeeping practices, and stated that President had a poor record of accomplishment for hiring competent bookkeepers to maintain the organization's books and records.

The response from Attorney dated October 21, 20XX, stated that should the Service decide not to revoke the ORG's exempt status, President would agree to employ his best efforts to do the following:

- To recruit at least three unrelated additional members to the Board of Directors;
- To resign from the Board once the new members have been duly elected;
- To work closely with his accountant to retain a qualified professional bookkeeper to manage the organization's finances;
- To propose for adoption by the organization's Board of Directors a conflict of interest policy based on a sample policy developed by the Service;
- To attend educational symposia sponsored by the State Association of Non-Profits and similar organizations in order to learn better administrative, organizational and financial management skills.

GOVERNMENT'S POSITION

We propose revocation of the organization's exempt status based on "**inurement**" issues revealed during the course of our examination. Regulations 1.501(c)(3)-1(c)(2) explains the prohibition against private inurement as follows; "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 individuals". Any transaction between an organization and a private individual in which the individual appears to receive a disproportionate share of the benefits of the exchange, relative to the charity served, constitutes an inurement issue. The ORG's records showed that the organization's President, President, consistently utilized the organization's income for private purposes. As ORG is a one-person organization with a family-based governing board, sufficient safeguards have not been put in place to prevent future violations and the organization has not made good-faith efforts to seek correction from the disqualified person, as in this case, the organization ***is*** the disqualified person.
The related response referenced in the letter from Attorney dated October 21, 20XX, stated that President had a poor record of accomplishment for hiring competent bookkeepers. According to the abovementioned response, in the years under review, President "had to retain (and dismiss) no fewer than 4 different individuals" who provided bookkeeping services to the organization. Attorney contends that it was just such turnover that led to the issues revealed by our examination. We contend that the change in bookkeepers was unrelated to President's demonstrated use of organizational funds for private purposes.

The ORG is a one-person organization operated by its President, President with a governing board consisting of President, his Wife and his Father. A governing board that consists solely of immediate family members does not constitute an independent body, and has an inherent conflict of interest when placed in a position to approve financial transactions involving other family members. The organization does not have a conflict of interest policy. The records of the organization evidenced the fact that operating under the control of one person or a small, related group suggests that an organization operates primarily for non-exempt private purposes, rather than exclusively for public purposes, which is the basis for exemption of any 501(c)(3) organization.

Our examination revealed that President consistently engaged in excess benefit transactions throughout the three-year period under review.

Fig. 1 Itemization of Automatic Excess Benefit Transactions - The following graphic provides an itemization of the automatic excess benefit transactions (ABTs) in which President engaged with the ORG in tax years 20XX, 20XX and 20XX:

TABLE DELETED

The detail provided above evidences the size and scope of the excess benefit transactions at issue, and indicates that the ORG primarily served the interests of the GB rather than the public interest in the years under review. In addition to the above amounts received by President in the form of Automatic Excess Benefit Transactions, President also received annual compensation and an additional loan from the organization for $ in tax year 20XX.

The size and scope of the excess benefit transactions were significant in relation to the size and scope of the organization's regular and ongoing activities that further exempt purposes.

Fig. 2 Analysis of Automatic Excess Benefit Transactions as a Percentage of the Organization's Total Revenues - The following graphic shows the automatic excess benefit transactions (ABTs) at issue plus the additional loan taken by President in 20XX, the repayment of which has also not been substantiated, as a percentage of the ORG's total revenues:

TABLE DELETED

Fig. 3 Analysis of Automatic Excess Benefit Transactions as a Percentage of President's Compensation - The following graphic shows the automatic excess benefit transactions (ABTs) at issue plus the additional loan taken by President in 20XX as a percentage of the compensation that President **also** received from the organization in payment for his services:

TABLE DELETED

*** In 20XX the F990 reported President's compensation as $ of that amount was an additional "loan" secured by President in 20XX, which he omitted from his 20XX F1040**

The written response dated October 21, 20XX from President's Attorney, stated that President had repaid the organization for "loans" previously taken by him. President claims that he repaid the "loans" in periods *outside* of those under review, specifically *after* the examination began in tax years 20XX and 20XX, by paying various organizational expenses using personal funds. We were unable to ascertain the veracity of his assertion. However, in any event, Regulation § 53.4958-7 states that a disqualified person corrects an excess benefit transaction ***only*** by making a payment in cash or cash equivalents, excluding payments by a promissory note, ***to the applicable tax-exempt organization equal to the correction amount*** as defined in paragraph (c) of this section. While President claims to have repaid the "loans" in periods *outside* of those under review, he disagrees that the multiple remaining transactions constitute excess benefit transactions and has not indicated that any attempt at repayment has occurred regarding those transactions. On the 20XX Form 990 return, filed after the examination began, President reduced his debt to the organization by $K after claiming to have transferred his sport fishing boat to the organization. No such transfer occurred, and in any event, Reg. § 53.4958-7(b)(2)'s "Anti-abuse rule" states that a disqualified person will not satisfy the correction requirements if the Commissioner determines that the disqualified person engaged in one or more transactions with the applicable tax-exempt organization to circumvent the requirements of this correction section. To date, there has been no correction (within the meaning of 4958(f)(6) and § 53.4958-7)of any of the excess benefit transactions at issue.

In an attempt to show that President had repaid the "loans" by paying organizational expenses using personal funds, he submitted documentation in support of approximately 15 relatively recent transactions. The submission of a group of hand-selected transactions from periods *outside* of those under review, viewed in isolation, did not evidence repayment of President's outstanding "loans" but simply allowed the Service to view "one side of the coin". While Attorney stated that the transactions submitted by President allegedly, constituted cash payments on the "loan", his response did not take into account, President's consistent utilization of the "loans to officers" account. Nor did his response consider President's demonstrated history of commingling business and personal activities using the organization's checking accounts and credit cards. These are key factors in the determination of whether President was in a position to repay any portion of his *20XX* "loan" from the organization.

In his response dated October 21, 20XX, Attorney asserted that the organization's revenues came from the performance of grants and contracts that were subject to meaningful oversight by entities that did not question ORG' use of the funding provided. While a portion of the organization's revenues came from the USDA and the United States Forest Service, the organization received the balance of its revenues from other non-profit organizations far less likely to maintain the level of expenditure responsibility required by the Government.

In summary, the relevant facts and circumstances with regard to the proposed revocation are as follows:

§1.501(c)(3)-1(f)(2)(ii)(A), "*the size and scope of the organization's regular and ongoing activities that further exempt purposes before and after the excess benefit transactions occurred*". Our Examination revealed that the President of the ORG, a one-person organization, engaged in multiple private benefit transactions consistently throughout the three-year period under review. President engaged in excess benefit transactions on such a consistent basis that it is impossible to distinguish periods where such transactions did not occur.

§1.501(c)(3)-1(f)(2)(ii)(B), "*the size and scope of the excess benefit transactions in relation to the size and scope of the organization's regular and ongoing activities that further exempt* *purposes*". The size and scope of these transactions appears to overshadow whatever exempt accomplishments a reasonable person might expect to gain from any *one-person* organization (See Fig. 2). Due to a complete lack of financial oversight (See Fig. 1), the cost of furthering this organization's exempt purpose appears to outweigh the benefits received.

§1.501(c)(3)-1(f)(2)(ii)(C), as to "*whether the organization has been involved in multiple excess benefit transactions with one or more persons*". The ORG is a one-person organization operated by President, and all of the transactions at issue benefited President and/or the GB.

§1.501(c)(3)-1(f)(2)(ii)(D), as to "*whether the organization has implemented safeguards that are reasonably calculated to prevent excess benefit transactions*". No safeguards have been implemented to date that would prevent further excess benefit transactions. When the examination began, the Board consisted of immediate family members who had approved and/or did not prevent these private benefit transactions from occurring, and the composition of the Board has not changed since the examination began in November of 20XX. According to the written response dated October 21, 20XX from Attorney, President intends to implement various safeguards in the future, in the event that the Service does not revoke the organization's exempt status. Once President has employed his best efforts to populate the Board with additional members unrelated to him; has resigned from the Board after doing so; has found competent financial help; has adopted a conflict of interest policy; and has attended educational symposia to improve his management skills, as proposed in Attorney's letter of October 21, 20XX, the new organization could then reapply for exemption. The new application would require President to update the organization's exempt purpose to one more applicable to the organization's current activities, most of which are *not* directly related to the purpose under which the organization first applied.

§1.501(c)(3)-1(f)(2)(ii)(E), as to "*whether the excess benefit transaction has been corrected (within the meaning of 4958(f)(6) and § 53.4958-7), or the organization has made good faith efforts to seek correction from the disqualified person who benefited from the excess benefit transactions*". There has been no correction of the excess benefit transactions, within the meaning of 4958(f)(6) or § 53.4958-7, and this one-person organization has not made good faith efforts to seek correction from President, the one-person who benefited from these transactions. President disagrees that the transactions at issue constituted excess benefit transactions. As stated in §1.501(c)(3)-1(f)(2)(iii) correction *after* the excess benefit transactions have been discovered by the Commissioner, by itself, is never a sufficient basis for continuing to recognize exemption.

Given the size and scope of the inurement issues revealed by our examination, the ORG is not operated exclusively for exempt purposes, and does not qualify for exemption under IRC § 501(c)(3). Based on the facts and circumstances, the ORG is not operated exclusively for exempt purposes and, therefore, does not qualify for exemption under IRC § 501(c)(3).

CONCLUSION:

It is the Service's position that the organization and its family-run Board engaged in multiple and repeated private benefit and inurement transactions, for which there has been no correction, with the organization's President, a Disqualified Person, under IRC § 4958, and as a result, is no longer eligible for exemption from federal income tax under IRC § 501(c)(3).

Accordingly, the organization's exempt status is revoked effective January 1, 20XX.

Form 1120 returns should be filed for tax periods ending on or after December 31, 20XX.