



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
TEGE EO Examinations Mail Stop 4920 DAL  
1100 Commerce St.  
Dallas, Texas 75242

TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

501.03-00

Date: September 26, 2011

Release Number: 201203022

Release Date: 1/20/2012

LEGEND

ORG - Organization name  
XX - Date    Address - address

ORG  
ADDRESS

Taxpayer Identification Number:  
Person to Contact:  
Employee Identification Number:  
Employee Telephone Number:  
(Phone)  
(Fax)

**CERTIFIED MAIL – RETURN RECEIPT**

Dear

This is a final adverse determination regarding your exempt status under section 501(c)(3) of the Internal Revenue Code. Our favorable determination letter to you dated February 2, 20XX is hereby revoked and you are no longer exempt under section 501(a) of the Code effective January 1, 20XX.

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

Organizations described in IRC 501(c)(3) and exempt under section 501(a) must be both organized and operated exclusively for exempt purposes. You must establish that you are operated exclusively for exempt purposes and that no part of your net earnings inures to the benefit of private shareholders or individuals. Your assets inured to the benefit of your President for his personal use. IRC 501(c)(3) precludes Federal income tax exemption if net earnings inure to the benefit of private shareholders or individuals. Because IRC 501(c)(3) prohibits inurement of earnings, your exempt status is hereby revoked effective January 1, 20XX.

Contributions to your organization are no longer deductible under IRC §170 after January 1, 20XX.

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

**Processing of income tax returns and assessments of any taxes due will not be delayed should a petition for declaratory judgment be filed under section 7428 of the Internal Revenue Code.**

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

**You also have the right to contact the Office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal Appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. You may call toll-free, 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 contact the person whose name and telephone number are shown in the heading of this letter.**

**Sincerely,**

**Nanette M. Downing  
Director, EO Examinations**

**Enclosures:  
Publication 892**



TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

**DEPARTMENT OF THE TREASURY**

Internal Revenue Service  
Tax Exempt / Government Entities  
1100 Commerce Street  
Dallas, TX 75242

April 14, 2011

ORG  
ADDRESS

Taxpayer Identification Number:

Form:

Tax Year(s) Ended:

Person to Contact/ID Number:

Contact Numbers:

Telephone:

Fax:

Certified Mail - Return Receipt Requested

Dear

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

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

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

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

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

Letter 3618 (04-2002)  
Catalog Number 34809F

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

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

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

Thank you for your cooperation.

Sincerely,

Nanette M. Downing  
Director, EO Examinations

Enclosures:  
Publication 892  
Publication 3498  
Report of Examination

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service <b>Explanation of Items</b>	Schedule No. or Exhibit
Name of Taxpayer <b>ORG</b>		Year/Period Ended December 31, 20XX

**LEGEND**

ORG - Organization name      XX - Date      State - state      City - city  
 President - president      Vice-President - vice president      CO-1, CO-2 & CO-3  
 = 1<sup>st</sup>, 2<sup>nd</sup> & 3<sup>rd</sup> COMPANIES

**ISSUE:**

Is ORG, Inc operating exclusively for charitable purposes described in Internal Revenue Code (IRC) § 501(c)(3)?

**FACTS:**

ORG was incorporated on November 29, 20XX in the state of State. Their Articles of Incorporation were stamped by the Secretary of State of State on November 29, 20XX. The Organization was recognized as being exempt from the Federal income under section 501(c)(3) of the Internal Revenue Code on February 2, 20XX, with a foundation status of 509(a)(2). At the end of their advanced ruling period, their foundation status remained the same.

The purpose of the Organization is to solicit donations of clothing, household items, food and furniture for distribution to those individuals or families living below the poverty line, or in a family or financial crisis. The Organization recruits churches within the Organization's zip code (zip code) to help with collecting and distributing. The Organization prepares a weekly mailing list of all garage and estate sales in the CO-1 and CO-2, a free publication. The Organization also solicits ads to the public for their donated vehicle program. The proceeds from the sale of donated items and the motor vehicle auctions goes towards the purchase of food to restock their food bank, gift cards from local grocery stores, and their operational expenses.

Individuals that ask for assistance are first required to fill out an application. The application is then reviewed by one of the staff assistants, who then decide on how much assistance is to be given. The assistance can either be for clothing, furniture, and/or food gift cards. This was especially evident in 20XX after Hurricane Ike ravaged the greater City area. Many low-income residents lost clothing, furniture, and food due to the storm, and ORG, helped out a large number of those citizens. The applications for assistance, for calendar year 20XX, were reviewed by the examining agent. Each application showed the name, address, and what type of assistance was being requested. Attached to each approved application was the type of assistance granted, i.e., clothing, furniture, and/or food cards. ORG is a valuable source of assistance for the low income residents in the area.

Bank statements and the check register were examined during our audit the last week of September 20XX. The bank statements and check registers revealed a lot of questionable expenses. When I returned to the office I completed a work paper entering each questionable purchase. On October 6, 20XX I held a phone interview with President, and his representative, since President was not at the audit in September, and asked him about some of the charges made

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to the Organization's account. The few that I asked him about, most notably, the hospital bills, rent for an apartment, purchases at CO-3, and maid service, were purchases made by President, except for the maid services. The maid service was purchased by the late Vice President, the Vice-President of the Organization at the time. The maid service was for Vice President's personal residence. After our conversation I decided to do a more in depth review of the bank statements.

After the completion of my in depth review of the 20XX monthly bank statements I picked for months to send to the Organization's representative. I spoke with the representative on December 20, 20XX, and told her that I was faxing her the four months of transactions, and I would like to schedule another phone with her and President for January 5, 20XX. She agreed.

On January 5, 20XX I spoke with the representative only, as President was not in attendance. We discussed the expenses, and we concluded that all of the grocery store, gas station, auto parts stores, toll tag charges, and auto insurance purchases would be disregarded as personal for President because the Organization does own several trucks with which to pick-up and/or deliver furniture and clothing. The grocery store purchases were to re-supply the food bank and purchase gift cards. The auto part store purchases were made because some of the donated vehicles were not in running condition. As for the gas station, auto insurance, and toll tag purchases, these were for the Organization's vehicles. Before our conversation ended I told the representative that I would remove all aforementioned charges, and send her all twelve months of charges that needed further substantiation. The final work papers included in this report for these charges are categorized as follows: *Cash Withdrawals, Department and Supply Stores, Food and Entertainment, Loans and Pay by Phone Charges, Medical and Pharmacies, Unknown Transactions and Miscellaneous, and Utilities.*

**LAW:**

**IRC 501(a)** provides, in part, that organizations described in section 501(c) are exempt from federal income tax. Section 501(c)(3) provides in pertinent part, that an organization must be organized and operated exclusively for religious, charitable, or educational purposes and no part of its net earnings may inure to the benefit of any private shareholder or individual.

**IRC 501(c)(3)** are corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, and no part of the net earnings of which inures to the benefit of any private shareholder or individual.

**IRC 6001** provides that every person liable for any tax imposed by this title, or for the collection thereof, shall keep such records, render such statements, make such returns, and



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comply with such rules and regulations as the Secretary may from time to time prescribe. Whenever in the judgment of the Secretary it is necessary, he may require any person, by notice served upon such person or by regulations, to make such returns, render such statements, or keep such records, as the Secretary deems sufficient to show whether or not such person is liable for tax under this title.

**IRC 6033(a)(1)** provides, except as provided in IRC §6033(a)(2), every organization exempt from tax under Section 501(a) shall file an annual return, stating specifically the items of gross income, receipts and disbursements, and such other information for the purposes of carrying out the internal revenue laws as the Secretary may by forms or regulations prescribe, and keep such records, render under oath such statements, make such other returns, and comply with such rules and regulations as the Secretary may from time to time prescribe.

**Treasury Regulation §1.501(c)(3)-1(a)(1)** of the Income Tax Regulations provides that in order for an organization to be exempt under section 501(c)(3) of the Code it must be both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational or operational test, it is not exempt.

**Treasury Regulation §1.501(a)-1(b)(3)(c)** states that the words “private shareholder or individual” in section 501 refer to persons having a personal and private interest in the activities of the organization. The word “shareholder,” as used here, does not have the same meaning as it does in a for-profit corporation. An exempt organization cannot have shareholders, or it would not meet the organizational test. However, these are terms that Congress gave us.

**Treasury Regulation §1.501(c)(3)-1(b)(4)** provides that an organization is not organized exclusively for one or more exempt purposes unless its assets are dedicated to an exempt purpose. Further, it provides that an organization does not meet the organizational test if its articles or the law of the State in which it was created provide that its assets would, upon dissolution, be distributed to its members or shareholders.

**Treasury Regulation §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 such exempt purposes specified in section 501(c)(3) of the Code. An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

**Treasury Regulation §1.501(c)(3)-1(c)(2)** states 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.

**Treasury Regulation §1.501(c)(3)-1(d)(1)(ii)** states that an organization is not organized or operated exclusively for one or more of the purposes specified in subdivision (i) of this

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subparagraph unless it serves a public rather than a private interest. Thus, to meet the requirement of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests. This group of individuals is generally referred to as "insiders." This regulation places the burden of proof on the organization to demonstrate 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.

The Operational Test must meet the following three requirements:

1. Engage primarily (>50%) in activities which accomplish one or more of the exempt purposes specified in IRC section 501(c)(3) and (Treas. Reg. Section 1.501(c)(3)-1(c)(1)),
2. Not allow its net earnings to inure to the benefit of private shareholders or individuals (Treas. Reg. Section 1.501(c)(3)-1(c)(2)),
3. Not engage in substantial (>5%) lobbying activity (Treas. Reg. Section 1.501(c)(3)-1(c)(3)), and not engage in any political activity (Treas. Reg. Section 1.501(c)(3)-1(c)(3)).

If an organization fails to comply with **any** of these requirements, it will fail the operational test and lose its IRC section 501(c)(3) exemption.

**Rev. Rul. 59-95, 1959-1 C.B. 627**, concerns an exempt organization that was requested to produce a financial statement and statement of its operations for a certain year. However, its records were so incomplete that the organization was unable to furnish such statements. The Service held that the failure or inability to file the required information return or otherwise to comply with the provisions of IRC § 6033 and the regulations which implement it, may result in the termination of the exempt status of an organization previously held exempt, on the grounds that the organization has not established that it is observing the conditions required for the continuation of exempt status.

In accordance with the above cited provisions of the Code and regulations under IRC § 6001 and 6033, organizations recognized as exempt from federal income tax must meet certain reporting requirements. These requirements relate to the filing of a complete and accurate annual information (and other required federal tax forms) and the retention of records sufficient to determine whether such entity is operated for the purposes for which it was granted tax-exempt status and to determine its liability for any unrelated business income tax.

**Revenue Ruling 78-232, 1978-1, C.B.69** explains that in the instant case the money deposited by the taxpayer in the ABC church account was used or available for use for the taxpayer's benefit. The taxpayer had complete control and enjoyment of the money and it was used to maintain the taxpayer's accustomed standard of living. Under the circumstances no portion of the amounts deposited by the taxpayer in the ABC church account can be identified as for the exclusive benefit of the organization.



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**Church by Mail, Inc. v. Commissioner of Internal Revenue 1985, 765 F.2d 1387, 56 A.F.T.R.2d 85-5483, 85-2 USTC P 9549.** The dispositive issue in this case is whether the Church meets the "operational" test imposed by I.R.C. § 501(c)(3). The Treasury Regulations specify three criteria for this requirement. First, the organization must be primarily engaged in activities which accomplish one or more of the exempt purposes specified in section 501(c)(3), so that it is "operated exclusively" for exempt purposes. Treas.Reg. § 1.501(c)(3)-(1)(c)(1). Second, the organization's net earnings must not be distributed in whole or in part to the benefit of private shareholders or individuals.

The tax court upheld the Commissioner's determination, holding that (1) the Church was operated for the non-exempt purpose of providing a market for Twentieth's services, and (2) a substantial, if not principal, purpose of the Church's operations was to generate income for the private benefit of Reverend Ewing and Reverend McElrath and their respective families.

**In Church of Gospel Ministry, Inc. v. United States, 640 F. Supp. 96, 1986 U.S. Dist.,** due to the taxpayer's failure to keep adequate records, the court held that the taxpayer failed to sustain its burden to show that it was qualified for federal tax exemption as a corporation organized and operated exclusively for religious and charitable purposes, as required under IRC §501 (c)(3), and that it was further qualified to receive deductible charitable contributions under IRC §170(c)(2). The court found that as a prerequisite to an IRC §6033 filing exemption, it was necessary for the taxpayer to show it qualified as an IRC §501 (c)(3) organization, which it could not.

**John Marshall Law School v. U.S. 1981 WL 11168, 48 A.F.T.R.2d 81-5340, 81-2 USTC P 9514 (Ct.Cl. Trial Div. Jun 24, 1981) (NO. 27-78, 28-78)**

In its determination letter, the IRS stated that it had considered numerous items pertaining to the fiscal years ended August 31, 1967 to August 31, 1973, including, but not limited to, payments by John Marshall Law School (JMLS) for Fenster family: automobiles, education, and travel expenses, insurance policies, basketball and hockey tickets, membership in a private eating establishment, membership in a health spa, interest-free loans, home repairs, personal household furnishings and appliances, and golfing equipment. John Marshall Law School hereinafter (Plaintiff) argued that all the expenses incurred by the organization were ordinary and necessary in furtherance of their exempt purpose. The term 'net earnings' in the inurement-of-benefit clause of § 501(c)(3) has been construed to permit an organization to incur ordinary and necessary expenses in the course of its operations without losing its tax-exempt status. The issue, therefore, is whether or not the expenditures Plaintiff paid to or on behalf of the Fenster family were ordinary and necessary to Plaintiff operations. Also, the burden of proof was on Plaintiff to establish that the grounds set forth in determination letter and the resulting revocation of notice of exemption was erroneous.

Ultimately, the court decided that their jurisdiction was limited to a review of error for the Service's revocation of Plaintiff's favorable tax-exempt ruling. The burden of establishing

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whether the Plaintiff is an organization described in section 501(c)(3), furthermore, rests with the Plaintiff. It is the courts decision that the Commissioner of Internal Revenue's revocation of Plaintiff's notices of exemption for the years 1966 through 1973 was correct.

In **Better Business Bureau of Washington D.C., Inc. v. United States, 326 U.S. 279 (1945)**, the Supreme Court held that the presence of a single non-exempt purposes, if substantial in nature, will destroy the exemption regardless of the number or importance of truly exempt purposes. Also, the existence of a substantial nonexempt purpose, regardless of the number or importance of exempt purposes, will cause failure of the operational test. The Court found that the trade association had an "underlying commercial motive" that distinguished its educational program from that carried out by a university.

**TAXPAYER'S POSITION:**

The taxpayer has agreed to revocation, and will sign Form 6018.

**GOVERNMENTS POSITION:**

ORG, a corporation recognized by the Internal Revenue Service as being exempt from federal income tax under Internal Revenue Code section 501(c)(3) and having a foundation status of 170(b)(1)(A)(vi), must pass two tests in order to continue its exempt status. The first test, the Organizational Test, relates to the organization's organizational documents. This test can only be satisfied if the written documents prepared at the time of the organization's formation meets the requirements of the regulations. An organizational document must meet requirements in both form and language. ORG satisfied the organizational requirement by having their Articles of Incorporation formed under the State of State' non-profit corporation law. Their Articles of Incorporation were stamped received by the Secretary of State of State. ORG also satisfied the language requirement by having an acceptable purpose clause, powers clause, and although not needed in the State of State, a dissolution clause.

To establish that ORG operates primarily in activities which accomplish its exempt purposes, the Organization must establish that no more than an insubstantial part of its activities does not further an exempt purpose. Sec, 1.501 (c)(3)-1 (c)(1), Income Tax Regs. The presence of a single substantial nonexempt purpose destroys the exemption regardless of the number or importance of the exempt purposes. *Better Business Bureau v. United States*. While ORG is not an action organization, it has failed to comply with the first two conditions of the operational test because of the egregious usage of the Organization's assets for private benefit.

A 501(c)(3)'s assets are required to be irrevocably dedicated to their exempt purpose(s). Treas. Reg. § 1.501 (c)(3)-1 (b)(4). The inurement prohibition serves to prevent the individuals who operate the organization from siphoning off any of a charity's income or assets for personal use.

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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 insure that organization's assets are dedicated to exclusively 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.

Inurement can take the form of questionable transactions that have no causal relationship to the organization's exempt purposes but result in some benefit to an insider. The insider, President is in a position to exercise control over the organization's net earnings as if they were his own by using them at will rather than within the limitations of a fiduciary capacity. In effect, President is using the public's "net earnings" for his own benefit. By using the Organization's assets President has breached the private inurement prohibition. See John Marshall Law School v. U.S.

Although the requirements for finding inurement or private benefit are similar, inurement and private benefit differ in two key respects. The first is that even a minimal amount of inurement results in disqualification for exempt status, whereas private benefit must be more than quantitatively or qualitatively incidental in order to jeopardize tax exempt status. The second is that inurement only applies to "insiders" (individuals whose relationship with an organization offers them an opportunity to make use of the organization's income or assets for personal gain), whereas private benefit may accrue to anyone. ORG has failed the operational requirement (inurement), in using a substantial amount of the Organization's assets for personal gain as discussed in Treasury Regulation §1.501(c)(3)-1(d)(1)(ii). Inurement can take the form of any transaction. The transaction results in inurement because it provides a disproportionate benefit to an insider. President is considered an insider. Private inurement may be as straightforward as a cash payment to an insider when the organization has no obligation to pay. Put simply, *inurement* is the use of an exempt organization's assets to benefit an individual(s) connected to it on a personal level. As a result, such use means the organization does not exclusively serve the public. Note, that the payment of personal expenses of an insider that the organization did not characterize as compensation at the time of payment may constitute inurement even when, if added to compensation, the total amount of compensation would be reasonable.

As in the case of John Marshall Law School v. U.S., the assets of ORG inured to the private benefit of President, an Officer of ORG The Internal Revenue Code and Regulations provide that an organization exempt under IRC Section 501(c)(3) can not allow its assets to benefit private interests; an organization that allows their assets to benefit private interests is not exempt.

The "not more than an insubstantial part of its activities" standard of section 1.501(c)(3)-1(c)(1) of the regulations can be understood by reference to Better Business Bureau v. United States, 316 U.S. 279 (1945) which held that an organization which engaged in some educational activity but pursued nonprofit goals outside the scope of the statute was not exempt under section 501(c)(3) of the Code. The Court stated that an organization is not operated exclusively for charitable purposes if it has a single noncharitable purpose that is substantial in nature. This is

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true regardless of the number or importance of the organization's charitable purposes. Thus, the operational test standard prohibiting a substantial nonexempt purpose is broad enough to include inurement, private benefit, and operations which further goals outside the scope of section 501(c)(3).

There was no calendar of events for when the auctions took place, how many vehicles were sold, and the revenue received, no billing information, and no log books were kept as to where and when the pick ups and deliveries took place. IRC 6001 requires that every person liable for any tax imposed by the Code shall keep adequate records. ORG failed, or lost to keep such records as required by this Code section. Also, IRC 6033(a)(1) requires every organization exempt from tax under Section 501(a) shall file an annual return stating specifically the items of gross income, receipts and disbursements.

**CONCLUSION:**

In the case of ORG, the primary activity is to use the assets of the Organization for personal gain. ORG does not qualify for exemption from Federal Income Tax as an organization described in section 501(c)(3) of the Code because of the egregious nature as to which the assets of the Organization were used for personal gain.

Consequently, we are proposing that ORG exemption from federal income tax be revoked as of January 1, 20XX. Please file U.S. Corporation income tax return Form 1120 for tax periods ending December 31, 20XX, December 31, 20XX, and December 31, 20XX. Contributions to your organization are not deductible under IRC Code section 170.

**If you agree with our decision please sign and return Form 6018 in the enclosed envelope.**

**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.**

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**LEGEND**

ORG - Organization name      XX - Date      State - state      City - city  
 President - president      Vice-President - vice president      CO-1, CO-2 & CO-3  
 = 1<sup>st</sup>, 2<sup>nd</sup> & 3<sup>rd</sup> COMPANIES

**ISSUE:**

Is ORG, Inc operating exclusively for charitable purposes described in Internal Revenue Code (IRC) § 501(c)(3)?

**FACTS:**

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to the Organization's account. The few that I asked him about, most notably, the hospital bills, rent for an apartment, purchases at CO-3, and maid service, were purchases made by President, except for the maid services. The maid service was purchased by the late Vice President, the Vice-President of the Organization at the time. The maid service was for Vice President's personal residence. After our conversation I decided to do a more in depth review of the bank statements.

After the completion of my in depth review of the 20XX monthly bank statements I picked for months to send to the Organization's representative. I spoke with the representative on December 20, 20XX, and told her that I was faxing her the four months of transactions, and I would like to schedule another phone with her and President for January 5, 20XX. She agreed.

On January 5, 20XX I spoke with the representative only, as President was not in attendance. We discussed the expenses, and we concluded that all of the grocery store, gas station, auto parts stores, toll tag charges, and auto insurance purchases would be disregarded as personal for President because the Organization does own several trucks with which to pick-up and/or deliver furniture and clothing. The grocery store purchases were to re-supply the food bank and purchase gift cards. The auto part store purchases were made because some of the donated vehicles were not in running condition. As for the gas station, auto insurance, and toll tag purchases, these were for the Organization's vehicles. Before our conversation ended I told the representative that I would remove all aforementioned charges, and send her all twelve months of charges that needed further substantiation. The final work papers included in this report for these charges are categorized as follows: *Cash Withdrawals, Department and Supply Stores, Food and Entertainment, Loans and Pay by Phone Charges, Medical and Pharmacies, Unknown Transactions and Miscellaneous, and Utilities.*

**LAW:**

**IRC 501(a)** provides, in part, that organizations described in section 501(c) are exempt from federal income tax. Section 501(c)(3) provides in pertinent part, that an organization must be organized and operated exclusively for religious, charitable, or educational purposes and no part of its net earnings may inure to the benefit of any private shareholder or individual.

**IRC 501(c)(3)** are corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, and no part of the net earnings of which inures to the benefit of any private shareholder or individual.

**IRC 6001** provides that every person liable for any tax imposed by this title, or for the collection thereof, shall keep such records, render such statements, make such returns, and



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comply with such rules and regulations as the Secretary may from time to time prescribe. Whenever in the judgment of the Secretary it is necessary, he may require any person, by notice served upon such person or by regulations, to make such returns, render such statements, or keep such records, as the Secretary deems sufficient to show whether or not such person is liable for tax under this title.

**IRC 6033(a)(1)** provides, except as provided in IRC §6033(a)(2), every organization exempt from tax under Section 501(a) shall file an annual return, stating specifically the items of gross income, receipts and disbursements, and such other information for the purposes of carrying out the internal revenue laws as the Secretary may by forms or regulations prescribe, and keep such records, render under oath such statements, make such other returns, and comply with such rules and regulations as the Secretary may from time to time prescribe.

**Treasury Regulation §1.501(c)(3)-1(a)(1)** of the Income Tax Regulations provides that in order for an organization to be exempt under section 501(c)(3) of the Code it must be both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational or operational test, it is not exempt.

**Treasury Regulation §1.501(a)-1(b)(3)(c)** states that the words "private shareholder or individual" in section 501 refer to persons having a personal and private interest in the activities of the organization. The word "shareholder," as used here, does not have the same meaning as it does in a for-profit corporation. An exempt organization cannot have shareholders, or it would not meet the organizational test. However, these are terms that Congress gave us.

**Treasury Regulation §1.501(c)(3)-1(b)(4)** provides that an organization is not organized exclusively for one or more exempt purposes unless its assets are dedicated to an exempt purpose. Further, it provides that an organization does not meet the organizational test if its articles or the law of the State in which it was created provide that its assets would, upon dissolution, be distributed to its members or shareholders.

**Treasury Regulation §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 such exempt purposes specified in section 501(c)(3) of the Code. An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

**Treasury Regulation §1.501(c)(3)-1(c)(2)** states 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.

**Treasury Regulation §1.501(c)(3)-1(d)(1)(ii)** states that an organization is not organized or operated exclusively for one or more of the purposes specified in subdivision (i) of this

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subparagraph unless it serves a public rather than a private interest. Thus, to meet the requirement of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests. This group of individuals is generally referred to as "insiders." This regulation places the burden of proof on the organization to demonstrate 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.

The Operational Test must meet the following three requirements:

1. Engage primarily (>50%) in activities which accomplish one or more of the exempt purposes specified in IRC section 501(c)(3) and (Treas. Reg. Section 1.501(c)(3)-1(c)(1)),
2. Not allow its net earnings to inure to the benefit of private shareholders or individuals (Treas. Reg. Section 1.501(c)(3)-1(c)(2)),
3. Not engage in substantial (>5%) lobbying activity (Treas. Reg. Section 1.501(c)(3)-1(c)(3)), and not engage in any political activity (Treas. Reg. Section 1.501(c)(3)-1(c)(3)).

If an organization fails to comply with **any** of these requirements, it will fail the operational test and lose its IRC section 501(c)(3) exemption.

**Rev. Rul. 59-95, 1959-1 C.B. 627**, concerns an exempt organization that was requested to produce a financial statement and statement of its operations for a certain year. However, its records were so incomplete that the organization was unable to furnish such statements. The Service held that the failure or inability to file the required information return or otherwise to comply with the provisions of IRC § 6033 and the regulations which implement it, may result in the termination of the exempt status of an organization previously held exempt, on the grounds that the organization has not established that it is observing the conditions required for the continuation of exempt status.

In accordance with the above cited provisions of the Code and regulations under IRC § 6001 and 6033, organizations recognized as exempt from federal income tax must meet certain reporting requirements. These requirements relate to the filing of a complete and accurate annual information (and other required federal tax forms) and the retention of records sufficient to determine whether such entity is operated for the purposes for which it was granted tax-exempt status and to determine its liability for any unrelated business income tax.

**Revenue Ruling 78-232, 1978-1, C.B.69** explains that in the instant case the money deposited by the taxpayer in the ABC church account was used or available for use for the taxpayer's benefit. The taxpayer had complete control and enjoyment of the money and it was used to maintain the taxpayer's accustomed standard of living. Under the circumstances no portion of the amounts deposited by the taxpayer in the ABC church account can be identified as for the exclusive benefit of the organization.

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**Church by Mail, Inc. v. Commissioner of Internal Revenue 1985, 765 F.2d 1387, 56 A.F.T.R.2d 85-5483, 85-2 USTC P 9549.** The dispositive issue in this case is whether the Church meets the "operational" test imposed by I.R.C. § 501(c)(3). The Treasury Regulations specify three criteria for this requirement. First, the organization must be primarily engaged in activities which accomplish one or more of the exempt purposes specified in section 501(c)(3), so that it is "operated exclusively" for exempt purposes. Treas.Reg. § 1.501(c)(3)-(1)(c)(1). Second, the organization's net earnings must not be distributed in whole or in part to the benefit of private shareholders or individuals.

The tax court upheld the Commissioner's determination, holding that (1) the Church was operated for the non-exempt purpose of providing a market for Twentieth's services, and (2) a substantial, if not principal, purpose of the Church's operations was to generate income for the private benefit of Reverend Ewing and Reverend McElrath and their respective families.

**In Church of Gospel Ministry, Inc. v. United States, 640 F. Supp. 96, 1986 U.S. Dist.,** due to the taxpayer's failure to keep adequate records, the court held that the taxpayer failed to sustain its burden to show that it was qualified for federal tax exemption as a corporation organized and operated exclusively for religious and charitable purposes, as required under IRC §501 (c)(3), and that it was further qualified to receive deductible charitable contributions under IRC §170(c)(2). The court found that as a prerequisite to an IRC §6033 filing exemption, it was necessary for the taxpayer to show it qualified as an IRC §501 (c)(3) organization, which it could not.

**John Marshall Law School v. U.S. 1981 WL 11168, 48 A.F.T.R.2d 81-5340, 81-2 USTC P 9514 (Ct.Cl. Trial Div. Jun 24, 1981) (NO. 27-78, 28-78)**

In its determination letter, the IRS stated that it had considered numerous items pertaining to the fiscal years ended August 31, 1967 to August 31, 1973, including, but not limited to, payments by John Marshall Law School (JMLS) for Fenster family: automobiles, education, and travel expenses, insurance policies, basketball and hockey tickets, membership in a private eating establishment, membership in a health spa, interest-free loans, home repairs, personal household furnishings and appliances, and golfing equipment. John Marshall Law School hereinafter (Plaintiff) argued that all the expenses incurred by the organization were ordinary and necessary in furtherance of their exempt purpose. The term 'net earnings' in the inurement-of-benefit clause of § 501(c)(3) has been construed to permit an organization to incur ordinary and necessary expenses in the course of its operations without losing its tax-exempt status. The issue, therefore, is whether or not the expenditures Plaintiff paid to or on behalf of the Fenster family were ordinary and necessary to Plaintiff operations. Also, the burden of proof was on Plaintiff to establish that the grounds set forth in determination letter and the resulting revocation of notice of exemption was erroneous.

Ultimately, the court decided that their jurisdiction was limited to a review of error for the Service's revocation of Plaintiff's favorable tax-exempt ruling. The burden of establishing

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whether the Plaintiff is an organization described in section 501(c)(3), furthermore, rests with the Plaintiff. It is the courts decision that the Commissioner of Internal Revenue's revocation of Plaintiff's notices of exemption for the years 1966 through 1973 was correct.

In **Better Business Bureau of Washington D.C., Inc. v. United States, 326 U.S. 279 (1945)**, the Supreme Court held that the presence of a single non-exempt purposes, if substantial in nature, will destroy the exemption regardless of the number or importance of truly exempt purposes. Also, the existence of a substantial nonexempt purpose, regardless of the number or importance of exempt purposes, will cause failure of the operational test. The Court found that the trade association had an "underlying commercial motive" that distinguished its educational program from that carried out by a university.

**TAXPAYER'S POSITION:**

The taxpayer has agreed to revocation, and will sign Form 6018.

**GOVERNMENTS POSITION:**

ORG, a corporation recognized by the Internal Revenue Service as being exempt from federal income tax under Internal Revenue Code section 501(c)(3) and having a foundation status of 170(b)(1)(A)(vi), must pass two tests in order to continue its exempt status. The first test, the Organizational Test, relates to the organization's organizational documents. This test can only be satisfied if the written documents prepared at the time of the organization's formation meets the requirements of the regulations. An organizational document must meet requirements in both form and language. ORG satisfied the organizational requirement by having their Articles of Incorporation formed under the State of State' non-profit corporation law. Their Articles of Incorporation were stamped received by the Secretary of State of State. ORG also satisfied the language requirement by having an acceptable purpose clause, powers clause, and although not needed in the State of State, a dissolution clause.

To establish that ORG operates primarily in activities which accomplish its exempt purposes, the Organization must establish that no more than an insubstantial part of its activities does not further an exempt purpose. Sec, 1.501 (c)(3)-1 (c)(1), Income Tax Regs. The presence of a single substantial nonexempt purpose destroys the exemption regardless of the number or importance of the exempt purposes. *Better Business Bureau v. United States*. While ORG is not an action organization, it has failed to comply with the first two conditions of the operational test because of the egregious usage of the Organization's assets for private benefit.

A 501(c)(3)'s assets are required to be irrevocably dedicated to their exempt purpose(s). Treas. Reg. § 1.501 (c)(3)-1 (b)(4). The inurement prohibition serves to prevent the individuals who operate the organization from siphoning off any of a charity's income or assets for personal use.

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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 insure that organization's assets are dedicated to exclusively 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.

Inurement can take the form of questionable transactions that have no causal relationship to the organization's exempt purposes but result in some benefit to an insider. The insider, President is in a position to exercise control over the organization's net earnings as if they were his own by using them at will rather than within the limitations of a fiduciary capacity. In effect, President is using the public's "net earnings" for his own benefit. By using the Organization's assets President has breached the private inurement prohibition. See *John Marshall Law School v. U.S.*

Although the requirements for finding inurement or private benefit are similar, inurement and private benefit differ in two key respects. The first is that even a minimal amount of inurement results in disqualification for exempt status, whereas private benefit must be more than quantitatively or qualitatively incidental in order to jeopardize tax exempt status. The second is that inurement only applies to "insiders" (individuals whose relationship with an organization offers them an opportunity to make use of the organization's income or assets for personal gain), whereas private benefit may accrue to anyone. ORG has failed the operational requirement (inurement), in using a substantial amount of the Organization's assets for personal gain as discussed in Treasury Regulation §1.501(c)(3)-1(d)(1)(ii). Inurement can take the form of any transaction. The transaction results in inurement because it provides a disproportionate benefit to an insider. President is considered an insider. Private inurement may be as straightforward as a cash payment to an insider when the organization has no obligation to pay. Put simply, *inurement* is the use of an exempt organization's assets to benefit an individual(s) connected to it on a personal level. As a result, such use means the organization does not exclusively serve the public. Note, that the payment of personal expenses of an insider that the organization did not characterize as compensation at the time of payment may constitute inurement even when, if added to compensation, the total amount of compensation would be reasonable.

As in the case of *John Marshall Law School v. U.S.*, the assets of ORG inured to the private benefit of President, an Officer of ORG The Internal Revenue Code and Regulations provide that an organization exempt under IRC Section 501(c)(3) can not allow its assets to benefit private interests; an organization that allows their assets to benefit private interests is not exempt.

The "not more than an insubstantial part of its activities" standard of section 1.501(c)(3)-1(c)(1) of the regulations can be understood by reference to *Better Business Bureau v. United States*, 316 U.S. 279 (1945) which held that an organization which engaged in some educational activity but pursued nonprofit goals outside the scope of the statute was not exempt under section 501(c)(3) of the Code. The Court stated that an organization is not operated exclusively for charitable purposes if it has a single noncharitable purpose that is substantial in nature. This is



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true regardless of the number or importance of the organization's charitable purposes. Thus, the operational test standard prohibiting a substantial nonexempt purpose is broad enough to include inurement, private benefit, and operations which further goals outside the scope of section 501(c)(3).

There was no calendar of events for when the auctions took place, how many vehicles were sold, and the revenue received, no billing information, and no log books were kept as to where and when the pick ups and deliveries took place. IRC 6001 requires that every person liable for any tax imposed by the Code shall keep adequate records. ORG failed, or lost to keep such records as required by this Code section. Also, IRC 6033(a)(1) requires every organization exempt from tax under Section 501(a) shall file an annual return stating specifically the items of gross income, receipts and disbursements.

**CONCLUSION:**

In the case of ORG, the primary activity is to use the assets of the Organization for personal gain. ORG does not qualify for exemption from Federal Income Tax as an organization described in section 501(c)(3) of the Code because of the egregious nature as to which the assets of the Organization were used for personal gain.

Consequently, we are proposing that ORG exemption from federal income tax be revoked as of January 1, 20XX. Please file U.S. Corporation income tax return Form 1120 for tax periods ending December 31, 20XX, December 31, 20XX, and December 31, 20XX. Contributions to your organization are not deductible under IRC Code section 170.

**If you agree with our decision please sign and return Form 6018 in the enclosed envelope.**

**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.**