



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
TE/GE EO EXAMINATIONS
1100 COMMERCE ST. MAIL STOP 4920 DAL
DALLAS, TEXAS 75242

501-03.00

Release Number: 201323039

Release Date: 6/7/2013

DATE: July 01, 2012

LEGEND

ORG - Organization name

XX - Date Address - address

Taxpayer Identification Number:

Person to Contact:

Employee Identification Number:

Contact Numbers:

(Phone)

(Fax)

ORG

ADDRESS

CERTIFIED MAIL

Dear :

This is a final adverse determination regarding your exempt status under section 501(c)(3) of the Internal Revenue Code (the Code). Our favorable determination letter to you dated November 23, 19XX is hereby revoked and you are no longer exempt under section 501(a) of the Code effective January, 20XX.

The revocation of your exempt status was made for the following reasons:

1. You have not demonstrated that you are operated exclusively for exempt purposes within the meaning of Internal Revenue Code section 501(c) (3) and

Treasury Regulations section 1.501(c) (3)-i (d). You did not engage primarily in activities that accomplish one or more of the exempt purposes specified in section 501(c) (3). You are operated for a substantial non- exempt purpose, which is not an exempt purpose.

2. Your net earnings inure to the benefit of private shareholders and individuals, which is prohibited by IRC section 501(c) (3).

3. You are operated for a substantial private purpose rather than a public purpose, which is prohibited by Internal Revenue Code section 501(c) (3) and Treasury Regulations section 1.501(c) (3) - 1(d) (1) (ii)

Contributions to your organization are no longer deductible.

You are required to file income tax returns on Form 1120. If you have not already filed these returns and the examiner has not provided you instructions for converting your previously filed Form(s) 990 to Form(s) 1120, you should file these income tax returns 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, you may file an action for declaratory judgment under the provisions of section 7428 of the Code in one of the following three venues: United States Tax Court, the United States Court of Federal Claims, or the United States District Court for the District of Columbia. A petition or complaint in one of these three courts must be filed before the 91st day after the date this determination was mailed to you if you wish to seek review of our determination. Please contact the clerk of the respective court for rules and the appropriate forms regarding filing petitions for declaratory judgment by referring to the enclosed Publication 892. Please note that the United States Tax Court is the only one of these courts where a declaratory judgment action can be pursued without the services of a lawyer. You may write to the courts at the following addresses:

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

Mary L. Epps

Nanette M. Downing

Nanette M. Downing,
Director, EO Examinations

Enclosures:
Publication 892

Internal Revenue Service
Tax Exempt and Government Entities Division
Exempt Organizations: Examinations
575 N. Pennsylvania St.
P.O. Box 44985
Indianapolis, IN 46244

Department of the Treasury

Date: April 2, 2012

Taxpayer Identification Number:
Form:
Tax Year(s) Ended:
Person to Contact/ID Number:
Contact Numbers:
Telephone:
Fax:

ORG
ADDRESS

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 and sign and date both copies of the enclosed Form 872 within 10 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 10 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 10 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 872

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit 1 of 14
Name of taxpayer ORG	Tax Identification Number EIN	Year/Period ended December 31, 20XX

LEGEND

ORG - Organization name ORG-1 - 1st Organization name XX - Date
 EIN - ein State - state President - president Treasurer -
 treasurer CO-1 through CO-4 - 1st through 4th COMPANIES BM-1 & BM-2 -
 1st & 2nd BM RA-1 through RA-5 - 1st through 5th RA

Issue:

Whether the I.R.C. § 501(c)(3) exempt status of ORG, should be revoked effective January 1, 20XX.

Facts:

The ORG (ORG) was organized as a section 501(c)(3) organization on August 5, 19XX as the ORG-1. The organization was granted exempt status under section 501(c)(3) as a publicly supported organization described in sections 509(a)(1) and 170(b)(1)(A)(vi) per our letter dated November 23, 19XX. The name was changed to ORG with the State Secretary of State on June 5, 20XX.

ORG's Articles of Incorporation states:

The objects and purposes of the Corporation are to undertake activities that in the judgment of the Directors benefit religious, charitable, scientific, literary or educational purposes within the meaning of Section 501(c)(3) of the Internal Revenue Code of 1986 or any corresponding provision of any future United States Internal Revenue law. The Corporation has been created solely to further and encourage such purposes by means of financial aid or contributions. The Corporation wants to contribute to those causes and projects which are not being addressed by our current government. The Corporation will also accumulate and/or reinvest a portion of the contributions made to the Corporation for such periods and in such amounts as it shall deem necessary in order to best accomplish its purposes. The Corporation has been created not only to allocate its funds to administer current benefits, but also to create significant future endowments to benefit religious, charitable, scientific, literary or educational purposes by investing a portion of the contributions made to the Corporation. Any investments made by the Corporation will be facilitated in the most prudent manner possible as determined by the Board of Directors. The Corporation shall not carry on any activities not permitted to be carried on by an organization exempt from taxation.

Form 1023

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit 2 of 14
Name of taxpayer ORG	Tax Identification Number EIN	Year/Period ended December 31, 20XX

ORG stated on its Form 1023 that its primary purpose was to assist charitable organization and individuals. President is the founder of ORG and the President. He is an attorney, CPA, certified appraiser, and financial planner. The initial Form 990 shows BM-1 and BM-2, the parents of President, as the other board members.

ORG (represented by President, a Director of the organization) stated in its letter dated September 30, 19XX, to the IRS that it is soliciting various financial professionals to have their clients do charitable planning with ORG. According to President, the individual planners will have no private interest in ORG, but will merely use the organization as their charity of choice when and if they take on clients with charitable priorities. They will only be a source of clients for the organization and will receive no compensation for their efforts. ORG will actively solicit contributions from the public as well. (Exhibit A).

ORG's 20XX year was examined. In a statement during the examination, ORG stated that:

ORG's primary goal is to aid and assist any individual or tax exempt organizations who are involved in any qualified charitable, scientific, religious or educational activity. ORG markets its services through financial planners who implement charitable giving plans for their clients. They refer their clients to ORG as their designated charity in most situations. ORG has as a program where certain donors can direct their gifts to their favorite charities or charitable causes. All directed gifts are required to be distributed to organizations who qualify under one or more of the exempt categories. ORG's only material expense is the marketing/fundraising fees paid to financial advisors who refer donors to ORG. (Exhibit B-1, item 8)

20XX Form 990

In its 20XX Form 990, ORG reported \$ in income from direct public support and \$ in assets per Form 990, Part IV, Balance Sheet. It reported no grants to section 501(c)(3) organizations. It reported a total of \$ in individual grants to 15 named individuals for stated purposes including poverty, need, and education. These individual grants ranged in amounts from \$ to \$.

The 20XX Form 990 reported 3 loans outstanding in the total amount of \$ at end of the year to RA-1 (\$), RA-2 (\$) and RA-3 (\$).

The Form 990 stated that the officers and board members were still President, BM-1, and BM-2.

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit 3 of 14
Name of taxpayer ORG	Tax Identification Number EIN	Year/Period ended December 31, 20XX

President

President, ORG's Treasurer in 20XX, is the signer on the bank accounts and the POA for the audit. He provided accounting services for ORG including the preparing of the Form 990. President also provided legal services to ORG. No Form W-2 or Form 1099 was filed. (Exhibit E- items 24, 26, 28, 36, and 38) Legal and accounting fees on the Form 990 totaled \$. The examination also indicated that President had a personal accounting, legal, and appraisal service, and that receipts for these services were deposited into ORG's account. (Exhibit E- item 29)

A review of the operations showed that President was no longer on the Board in 20XX but continued as the signer on the accounts and handled the operations. There is no discussion or minutes documenting President's authority. The new treasurer, Treasurer was listed as being paid but no W-2 or Form 1099 was issued. Treasurer was also an employee at the bank used by ORG and handled all cash withdrawals and transactions at the direction of President.

Board Meetings

The only board meeting held was the annual meeting where officers were appointed. No other issues were documented and no other actions were authorized.

Grants

The \$ grants that were made by ORG to individuals in 20XX are not documented and in some cases made by ORG by withdrawing cash and purchasing cashier checks. ORG did not provide a list of procedures used to determine who qualifies and proof that the grants were used for an exempt purpose (Exhibit -E- item 42)

Loans

According to the promissory notes, ORG loaned \$ to three entities in 20XX as follows:

CO-1 \$
CO-2
CO-3

The notes provide for % interest. There was no loan agreement, no documentation of Board approval in the minutes, and no payment schedule. There is no evidence that any payments were made. (Exhibit E - item 6 and Exhibit F).

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit 4 of 14
Name of taxpayer ORG	Tax Identification Number EIN	Year/Period ended December 31, 20XX

During the period 19XX through 20XX, ORG loaned three donors approximately \$ (including accrued but unpaid interest) (Exhibit C). According to President, at the end of 20XX, ORG agreed to settle the total amount of these loans (including accrued but unpaid interest) by selling the notes back to the three donors for a combined total amount of \$ (Exhibit E – Item 16). However, the sale of the loans was not reflected on the Form 990 as of December 31, 20XX. Accordingly, these loans were included as assets on the ending balance sheet as of December 31, 20XX, but were not included on beginning balance sheet as of January 1, 20XX.

In 20XX and 20XX ORG funds were given to RA-4 (now known as RA-4), a former wife of President. According to President, they were divorced in 20XX. ORG “loaned” funds to her in 20XX. In 20XX, ORG “loaned” an additional amount of \$ to her. (Exhibit E – Item 1, 28, and 39 and Exhibit J). According to President, at the end of 20XX, all but \$ had been paid back.

Promotion of Partnership

The examination of the financial and operational records presented showed that ORG's main activity was the promotion of a program where an individual creates an entity, a LLC entity, with a % non-voting interest owned by the individual, and a 1% voting interest owned by the individual. The individual ("donor") transfers the 99% non-voting interest to ORG creating a partnership. Through the agreement creating the partnership entity, the general partner retains full control of the partnership entity. The non-voting interest cannot be sold, transferred, or substituted without the general partner's permission. The general partner can admit new non-voting interest members diluting ownership and the general partner can dispose of assets at will and on any terms and controls any distributions. In some partnership agreements, the non-voting interest assigns a power of attorney to the general partner. The individual then transfers the non-voting interest to ORG while retaining the ownership of the general partner. The individual never relinquishes control of the underlying assets. (Exhibit G). There were 95 of these partnerships involved with ORG in 20XX.

The Partnership/LLC/LP agreement that ORG has with the individuals does not allow ORG to have any control of the assets of the partnership. The General Partner (individual) has complete control of the assets. He can sell, trade, or use the assets for nonexempt purposes without consent of ORG. ORG only receives the income generated from the assets as reported on the Form 1065's and K-1's. It was also noted that several identified financial planners had setup LLC/LP with ORG and therefore created a relationship that will identify them also as an insider.

President charges a fee to set up and maintain the partnerships and to appraise the non-voting interest donated to ORG. He charges an additional annual fee based on

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit 5 of 14
Name of taxpayer ORG	Tax Identification Number EIN	Year/Period ended December 31, 20XX

the asset value. Appraisals are for around % to % of the book value even though the appraisal states that non-voting interest is not transferable and has no control. He is the founder and president (through 20XX) of ORG and is the signer on all accounts (through current). He deposits substantially all earnings to ORG accounts. Some funds are then invested into a for-profit subsidiary. This subsidiary was used to pay some of his personal expenses. Some loans and personal expenses come directly from ORG. No W-2 or 1099 has been issued. ORG has no accounting records. During the examination, it was determined that President had a personal accounting, legal and appraisal service and that receipts for those services were deposited into the ORG bank account. (Exhibit E - item 29)

ORG funds were invested in CO-4, an LLC owned in part and managed by President (Exhibit E - item 10 and 28). ORG paid fees to financial planners (sometimes referred to as fundraisers.) No contracts exist and the payments are not reported on any Form 1099. (Exhibit E - item 26, and 28 - \$) RA-5 (LLC- President stated that the fees are negotiated. (Exhibit E)

The ORG's website and marketing presentations developed and used by President promoted the tax advantages, increasing wealth, allowing wealth to transfer to heirs, and the ability to maintain control over the "charitable donations". (Exhibit - I) ORG's website had a section on acceptable business interest, any partnership or LLC must include two provisions. First it must include a right to receive mandatory distributions and secondly it must provide for an unrestricted right to sell or transfer the interest.

The LLC and partnership interests accepted by ORG that were reviewed included very few prepared by independent actors. The majority was prepared by President and all that the agent reviewed were appraised by President. Fees for the preparation and appraisals were deposited to the organization account but it was not possible to determine if the funds were part of ORG's funds or President's private practice. The agreements do not allow sales or distributions and the appraisals note that the % limited interests are completely controlled by the general partner. Payments are exclusively non-voting interests in partnerships and LLC's, a small amount of cash distributions and fees. Investments are the maintained partnership and LLC agreements and residual income.

Unreported income from the 95 partnerships in 20XX

After transfer ORG receives K-1 Forms for the allotted share (usually %) of income from the partnership. The general partner receives 1% of the income. ORG treats the income as passive income excluded from UBIT. Further it does not list the

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Name of taxpayer ORG	Tax Identification Number EIN	Year/Period ended December 31, 20XX

income on its Form 990, claiming the K-1's are late and failing to amend the returns or reporting cash only- (Exhibit E - item 35).

In 20XX, ORG failed to report on its Form 990 income from Schedules K-1 in the amount of \$. The Schedules K-1 arise from ORG's limited partnership interests resulting from non-cash transfers. The individuals claim a charitable deduction for the amounts reported as contributions on the organization's Form 990. The individuals are the general partners that retain control over the assets held by the partnerships. The income reported on the Schedules K-1 issued to ORG was not reported on its Form 990. In prior and subsequent years, the Schedules K-1 issued to the organization reported the following amounts of income:

Year	Per Schedule K-1	Per Form 990	Unreported Income
20XX			
Total			

For the years 20XX through 20XX, ORG under reported its gross income by a total of \$ - (Exhibit E - item 35, and Exhibit - H)

Law:

Section 501 of the Code provides for the exemption from federal income tax of corporations organized and operated exclusively for charitable or educational purposes, provided that no part of the net earnings of such corporations inures to the benefit of any private shareholder or individual. See § 501(c)(3).

Section 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.

Section 1.501(c)(3)-1(c)(1) of the Income Tax Regulations provides that an organization operates exclusively for exempt purposes only if it engages primarily in activities that accomplish exempt purposes specified in § 501(c)(3). An organization must not engage in substantial activities that fail to further an exempt purpose.

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Name of taxpayer ORG	Tax Identification Number EIN	Year/Period ended December 31, 20XX

Section 1.501(c)(3)-1(c)(2) of the regulations provides that an organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals

Section 1.501(c)(3)-1(d)(1)(ii) provides that an organization is not organized or operated exclusively for exempt purposes unless it serves a public rather than a private interest. To meet this requirement, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests.

Section 1.501(c)(3)-1(d)(2) defines the term "charitable" for § 501(c)(3) purposes as including the relief of the poor and distressed or of the underprivileged, and the promotion of social welfare by organizations designed to lessen neighborhood tensions, to eliminate prejudice and discrimination, or to combat community deterioration. The term "charitable" also includes the advancement of education.

Section 1.501(c)(3)-1(d)(3)(i) provides, in part, that the term "educational" for § 501(c)(3) purposes relates to the instruction of the public on subjects useful to the individual and beneficial to the community.

Section 1.501(c)(3)-1(e) provides that an organization that operates a trade or business as a substantial part of its activities may meet the requirements of § 501(c)(3) if the trade or business furthers an exempt purpose, and if the organization's primary purpose does not consist of carrying on an unrelated trade or business

In *Better Business Bureau v. United States*, 326 U.S. 279 (1945), the Supreme Court stated that the presence of a single nonexempt purpose, if substantial in nature, will preclude exemption under section 501(c)(3) of the Code, regardless of the number or importance of statutorily exempt purposes. Thus, the operational test standard prohibiting a substantial nonexempt purpose is broad enough to include inurement, private benefit, and operations that further nonprofit goals outside the scope of section 501(c)(3).

Rev. Rul. 68-489, 1968-2 C.B. 210, holds that an organization will not jeopardize its exemption under section 501(c)(3) of the Code, even though it distributes funds to nonexempt organizations, provided it retains control and discretion over use of the funds for section 501(c)(3) purposes. The revenue ruling states that the exempt organization ensures use of the funds for section 501(c)(3) purposes by limiting distributions to specific projects that are in furtherance of its own exempt purposes. It retains control and discretion as to the use of the funds and maintains records establishing that the funds were used for section 501(c)(3) purposes.

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Name of taxpayer ORG	Tax Identification Number EIN	Year/Period ended December 31, 20XX

In *Best Lock Corporation v. Commissioner*, 31 T.C. 620 (1959), the court upheld the denial of an organization that loaned funds to members of the founder's family, even though the loans were repaid. The court determined that loans to family members and unsecured loans to friends of the founder and his family promoted private rather than charitable purposes.

IRC § 6001 provides that every person liable for any tax imposed by the IRC, or for the collection thereof, shall keep adequate records as the Secretary of the Treasury or his delegate may from time to time prescribe.

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.

Treas. Reg. § 1.6001-1(a) in conjunction with Treas. Reg. § 1.6001-1(c) provides that every organization exempt from tax under IRC § 501(a) and subject to the tax imposed by IRC § 511 on its unrelated business income must keep such permanent books or accounts or records, including inventories, as are sufficient to establish the amount of gross income, deduction, credits, or other matters required to be shown by such person in any return of such tax. Such organization shall also keep such books and records as are required to substantiate the information required by IRC § 6033.

Treas. Reg. § 1.6001-1(e) states that the books or records required by this section shall be kept at all times available for inspection by authorized internal revenue officers or employees, and shall be retained as long as the contents thereof may be material in the administration of any internal revenue law.

Treas. Reg. § 1.6033-1(h)(2) provides that every organization which has established its right to exemption from tax, whether or not it is required to file an annual return of information, shall submit such additional information as may be required by the district director for the purpose of enabling him to inquire further into its exempt status and to administer the provisions of subchapter F (section 501 and the following), chapter 1 of the Code and IRC § 6033.

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

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit 9 of 14
Name of taxpayer ORG	Tax Identification Number EIN	Year/Period ended December 31, 20XX

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.

Benefiting Private Interests

Even if an organization's activities serve a charitable class or are otherwise charitable within the meaning of § 501(c)(3), it must demonstrate that its activities serve a public rather than a private interest within the meaning of Reg. § 1.501(c)(3)-1(d)(1).

Rev. Rul. 72-147, 1972-1 C.B. 147, held that an organization that provided housing to low income families did not qualify for exemption under § 501(c)(3) because it gave preference to employees of business operated by the individual who also controlled the organization. The ruling reasoned that, although providing housing for low-income families furthers charitable purposes, doing so in a manner that gives preference to employees of the founder's business primarily serves the private interest of the founder rather than a public interest.

In *KJ's Fund Raisers v. Commissioner*, T.C. Memo 1997-424 (1997), *aff'd*, 1998 U.S. App. LEXIS 27982 (2d Cir. 1998), the Tax Court held, and the Second Circuit affirmed, that an organization formed to raise funds for distribution to charitable causes did not qualify for exemption under § 501(c)(3) because its activities resulted in a substantial private benefit to its founders. The founders of the organization were the sole owners of KJ's Place, a lounge at which alcoholic beverages were served. The founders served as officers of the organization and, at times, also controlled the organization's board. The Tax Court found, and the Second Circuit agreed, that the founders exercised substantial influence over the affairs of the organization. The organization's business consisted of selling "Lucky 7" or similar instant win lottery tickets to patrons of KJ's Place. The organization derived most of its funds from its lottery ticket sales. The organization solicited no public donations. The lottery tickets were sold during regular business hours by the owners of the lounge and their employees. From the proceeds of the sales of the lottery tickets, the organization made grants to a variety of charitable organizations. Although supporting charitable organizations may be a charitable

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit 10 of 14
Name of taxpayer ORG	Tax Identification Number EIN	Year/Period ended December 31, 20XX

activity, the Tax Court nevertheless upheld the Commissioner's denial of exemption to the organization on the ground that the organization's operation resulted in more than incidental private benefit. The Tax Court held, and the Second Circuit affirmed, that a substantial purpose of KJ's activities was to benefit KJ's place and its owners by attracting new patrons, by way of lottery ticket sales, to KJ's Place, and by discouraging existing customers from abandoning KJ's Place in favor of other lounges where such tickets were available. Thus, the organization was not operated exclusively for exempt purposes within the meaning of § 501(c)(3).

An organization does not serve a public rather than a private interest within the meaning of Reg. 1.501(c)(3)-1(d)(1) if any of its assets or earnings inure to the benefit of any insiders (or disqualified persons). Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii). Inurement is any transfer of charitable assets to the organization's insiders for which the organization does not receive adequate consideration. Inurement can take many forms.

Excessive compensation for services is a form of inurement. For example, in *Mabee Petroleum Corp. v. U.S.*, 203 F. 2d 872, 875 (5th Cir. 1953), the Fifth Circuit held that the organization's payment of a full-time salary for part-time work was inurement.

The use by insiders of the organization's property for which the organization does not receive adequate consideration is a form of inurement. See, e.g., *The Founding Church of Scientology v. U.S.*, 412 F.2d 1197, 1201 (Ct. Cl. 1969) (holding that the insiders' use of organization-owned automobiles and housing constituted inurement); *Spokane Motorcycle Club v. U.S.*, 222 F.Supp. 151 (E.D. Wash. 1963) (holding that the organization's provision of goods, services and refreshments to its members constituted inurement).

Loans that are financially advantageous to insiders from the organization's funds (particularly unexplained, undocumented loans) are a form of inurement. For example, in *The Founding Church of Scientology*, 412 F.2d at 1200-01, the Claims Court listed unexplained loans to and from insiders among the examples of inurement. In *Church of Scientology v. Commissioner*, 823 F.2d 1310, 1314-15, 1318 (9th Cir., 1987), the Ninth Circuit held that "debt repayments" in the form of 10 percent of the organization's income made to the organization's founder, allegedly to compensate the founder for the organization's past use of his personal income and capital, constituted inurement. In *Airlie Foundation v. Commissioner*, 283 F. Supp. 2d 58 (D.D.C., 20XX), the court held that forgiveness of interest was a form of inurement.

Leasing arrangements that favor disqualified persons to the detriment of the organization are a form of inurement. In *The Founding Church of Scientology*, 412 F.2d at 1201-02, the Claims Court treated the organization's payment of rent to the founder's wife as inurement in the absence of any showing that the rental was reasonable or that

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the arrangement was beneficial to the organization. See also *Texas Trade School v. Commissioner*, 272 F.2d 168 (5th Cir. 1959) (holding that inflated rental prices constitute inurement).

Payment to one person for services performed by another (or for services presumed to be performed, without any proof of performance) is a form of inurement. In *Church of Scientology*, 823 F.2d at 1314, 1317-18, the court listed royalties received by the organization's founder on the sale of publications written by others among the improper benefits received by the founder from the organization. In *The Founding Church of Scientology*, 412 F.2d at 1202, the court held that the payment of salary to the founder's daughter without any proof that she actually performed any services for the organization constituted inurement.

A number of courts have held that unaccounted for diversions of a charitable organization's resources by one who has complete and unfettered control can constitute inurement. *Parker v. Commissioner*, 365 F.2d 792, 799 (8th Cir. 1966); *Kenner v. Commissioner*, 318 F.2d 632 (7th Cir. 1963); *Church of Scientology*, 823 F.2d at 1316-17, 1319.

The provision of inurement can be direct or indirect. In *Church of Scientology*, 823 F.2d at 1315, the organization transferred in excess of \$8.5 million to a for-profit corporation incorporated by the organization's founder and his wife. The directors of the corporation were high-ranking members of the Church of Scientology. The directors approved the founder's decision to transfer \$2 million from the corporation's account to the ship Apollo aboard which the founder and his family lived. The Ninth Circuit held that the funds funneled through the for-profit corporation constituted inurement to the founder and his family. *Church of Scientology*, 823 F.2d at 1318.

In *Church by Mail, Inc. v. Commissioner*, 765 F.2d 1387 (9th Cir. 1985), the Ninth Circuit held that a church that conducted its activities by mail did not qualify for exemption under § 501(c)(3) because a substantial purpose of its activities was to benefit a for-profit corporation controlled by the church's insiders. The church employed an advertising agency controlled by its insiders to provide all of the printing and mailing services for the church's mass mailings. The advertising agency devoted approximately two-thirds of its time to the work for the church. The majority of the church's income was paid to the advertising agency. Although the advertising agency claimed to have clients unrelated to the church, it did not advertise its services and refused to identify its other clients. The Ninth Circuit held that the church was operated for the substantial non exempt purpose of "providing a market for [the advertising agency's] services" and, thus, primarily served the private interests of the advertising agency and its owners rather than a public purpose. In so holding the Ninth Circuit rejected the church's argument that the income paid by the advertising agency should not be included in the

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determination of reasonableness and treated this income as indirect inurement of the church's earnings to the church's insiders.

The prohibition on inurement in § 501(c)(3) is absolute. The Service has the authority to revoke an organization's exempt status for inurement regardless of the amount of inurement. See, *Spokane Motorcycle Club*, supra; *The Founding Church of Scientology*, 412 F.2d at 1202.

Government's Position:

ORG does not qualify as an organization described in IRC 501(c)(3) because (1) it is not operated for an exclusive exempt purpose; (2) it substantially benefits private interests and (3) its net earnings inure to the benefit of private shareholders and individuals.

Not operated for an exclusive exempt purpose

ORG does not engage in any charitable activities. According to its 20XX Form 990, it provided grants totaling \$ to 15 individuals. The organization stated in its letter dated November 3, 20XX that ORG selects grantees based on need. The organization did not provide any documentation to support the claim that monies are awarded based on need. The organization did not have any specific guidelines and procedures to determine whether an individual qualified (as a charitable class) for a charitable or educational grant. There was no independent group of individuals who were charged the task of making the grant selections. The organization did not have a follow-up procedure to determine that the grant was used for the intended purpose. Therefore, the grants awarded do not qualify as an exempt function expense and is considered to be a private benefit to the individuals who received the funds.

In 20XX, as shown in promissory notes, ORG made three loans to individuals in the total amount of \$. The organization made several loans to individuals despite the fact that, in 20XX, the outstanding balances due from prior loans were sold for substantially less than the reported outstanding balance. Interest was accrued but not collected, and there were no payments made against the outstanding balances from the initial issuance of the loans to the date the loans were sold back to the borrower in 20XX. ORG was therefore on notice as to the risk of loans. As for the 20XX loans, there were no interest collected or a schedule of payments provided. No payments have been made on the loans. It is our position that is a private benefit to the individuals who received the loans.

ORG's main activity in 20XX was the promotion of partnerships with "donors." There were 95 partnerships. ORG operates a program that (1) allows individuals,

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partnerships, limited partnerships, and LLC's to claim a section 170 deduction for asset(s) transferred to ORG, but allows the "donor" to retain control and subsequently purchase the asset(s) back at a value that is substantially less than the charitable amount initially claimed. These transactions do not exclusively serve an exempt purpose described in section 501(c)(3) and provides substantial private benefit to persons who do not belong to a charitable class (including the organization's founder)

It is the Service's position that the "donor" does have advisory and/or control of monies/assets contributed only by him (not over the entire general fund and segregated as the organization seems to be stating) and even though the organization claims there is no segregated fund recorded, the facts are that the funds are identified when transferred. These transactions are structured to improperly shift income from taxable entities to a tax exempt organization for the purpose of deferring or avoiding taxes. These transactions have the same economic effect as the transaction described in Notice 20XX-30, IRB 20XX-17, April 26, 20XX.

The Partnership/LLC/LP agreement that ORG has with its "donors" does not allow ORG to have any control of the assets of the partnership. The General Partner ("Donor") has complete control of the assets. He can sell, trade, or use the assets for nonexempt purposes without consent of ORG. ORG only receives Schedules K-1 reflecting its share of the income generated from the assets as reported on the Forms 1065. It was also noted that several identified financial planners had setup LLC/LP with ORG and therefore created a relationship that will identify them also as an insider.

It is our position that the partnership activities, which were the main activities of ORG, had a substantial non-exempt purpose. In addition, the partnership activities provided a private benefit to the "donors."

The organization has also failed to meet the reporting requirements (Failed to report gross revenues from it's partnership activities - this understatement exceeded 25% of the reported gross receipts), correct balance sheet amounts (notes receivable), and it's accrued interest earned under IRC § 6001 and 6033 to be recognized as exempt from federal income tax under IRC § 501(c)(3).

Inurement

The last loan made was to the former RA-4 who President states was unrelated to the organization. RA-4 was married to President at the time the initial loan was made (20XX). RA-4 made the payment checks payable to President instead of ORG. However, it was noted that the checks were deposited into ORG's checking account. RA-4 did not pay back the entire loan. President states that he paid the loan back by

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reducing the amount he claims to have donated to ORG. It is our position that this was inurement and therefore revocation of the organization's exempt status is proposed.

Taxpayer's position:

The organization states that its primary purpose is to take the gifts received from their Partnership/LLC/LP interest and make charitable contributions to various exempt organizations who qualify under section 501(c)(3). The organization states that ORG will have complete control over the funds and that the donor can not direct where the donated monies or other assets can go. However, the organization stated in their letter dated November 3, 20XX (item 2) the following:

As a donor directed organization, ORG directs dollars received from donors to the donor's preferred charitable organization. However, ORG does not hold dollars in a separate segregated fund, nor does ORG accept gifts to that end. All cash contributions received are either immediately distributed to charitable organizations or held in ORG's general fund. The same policy applies for both cash gifts and non-cash gifts. The assets held in ORG's general fund are completely controlled by ORG and no donor has any advisory privileges in regard to the assets of ORG.

Conclusion:

It is the IRS's position that ORG failed the operational test as described in Income tax Regulations 1.501(c)(3)-1(d)(i) and 1.501(c)(3)-1(d)(ii). ORG was not operated exclusively for an exempt purpose. It serves private rather than public interests. Its net earnings inured to the benefit of private shareholders and individuals. ORG has also failed to meet the reporting requirements (Failed to report gross revenues from it's partnership activities - this understatement exceeded % of the reported gross receipts), correct balance sheet amounts (notes receivable), and its accrued interest earned under IRC § 6001 and 6033 to be recognized as exempt from federal income tax under IRC § 501(c)(3). Accordingly, the organization's exempt status should be revoked, effective January 1, 20XX.