

**Internal Revenue Service**

Appeals Office  
312 Elm Street, Suite 2330  
Cincinnati, OH 45202

Number: **201326019**  
Release Date: 6/28/2013

Date: April 5, 2013

NAME  
ADDRESS

**Certified Mail**

NAME:

This is a final adverse determination regarding your exempt status under section 501(c)(3) of the Internal Revenue Code (the "Code"). It is determined that you do not qualify as exempt from Federal income tax under section 501(c)(3) of the Code.

You do not qualify for exemption under Section 501(c)(3) of the Code because you are not formed and operated exclusively for charitable tax-exempt purposes. You were formed and controlled by disqualified persons. Your operations inure to the benefit of private individuals and entities controlled by and significantly influenced by disqualified persons and relatives. A substantial amount of your charitable assets were used for private purposes. Therefore, you are not operated exclusively for exempt purposes described in section 501(c)(3) of the Code and are not exempt.

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

You are required to file Federal income tax returns on Forms 1120 for all open tax periods and for all tax years thereafter. File your return with the appropriate Internal Revenue Service Center per the instructions of the return. For further instructions, forms, and information please visit [www.irs.gov](http://www.irs.gov).

If you were a private foundation as of the effective date of the adverse determination, you are considered to be taxable private foundation until you terminate your private foundation status under section 507 of the Code. In addition to your income tax return, you must also continue to file Form 990-PF by the 15th Day of the fifth month after the end of your annual accounting period.

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 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: 1) United States Tax Court, 2) the United States Court of Federal Claims, or 3) the United States District Court for the District of Columbia. A petition or complaint in one of these three courts must be filed within 90 days from the date this determination letter was mailed to you. Please contact the clerk of the appropriate court for rules for filing petitions for declaratory judgment. To secure a petition form from the United States Tax Court, write to the United States Tax Court, 400 Second Street, N.W., Washington, D.C. 20217. See also Publication 892.

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 matters

**Department of the Treasury**

**Taxpayer Identification Number:**  
NUMBER  
**Person to Contact:**

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that may not have been resolved through normal channels get prompt and proper handling. If you want Taxpayer Advocate assistance, please contact the Taxpayer Advocate for the IRS office that issued this letter. You may call toll-free, 1-877-777-4778, for the Taxpayer Advocate or visit [www.irs.gov/advocate](http://www.irs.gov/advocate) for more information.

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

Sincerely Yours,

XXXXXXXX  
Appeals Team Manager

Enclosure: Publication 892



TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

Date: February 13, 2012

Contact Person:

Identification Number:

Contact Number:

FAX Number:

Employer Identification Number:

LEGEND:

C= Name of State  
D= Date  
E= Director  
F= Director  
G= Director  
H= Director  
J= Name of organization  
K= Name of organization  
L= Name of organization  
M= Name of for-profit entity  
N= Name of for-profit entity  
O= Name of individual  
P= Name of individual  
Q= Name of individual  
R= Family  
S= Date  
T= Name of for-profit entity  
U= Name of foundation  
V= Name of individual  
W= Date  
x= \$  
y= \$  
z= \$

UIL:

501.32-00  
501.33-00

Dear ,

We have considered your application for recognition of exemption from federal income tax under Internal Revenue Code section 501(a). Based on the information provided, we have

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concluded that you do not qualify for exemption under Code section 501(c)(3). The basis for our conclusion is set forth below.

**Issue**

Do you qualify for exemption under section 501(c)(3) of the Code? No, for the reasons described below.

**Alternative Issues**

If upon appeal exemption is granted, would your loan to a related for-profit entity, M, constitute an act of self-dealing? Yes for the reasons described below.

If upon appeal exemption is granted, would your loans to M constitute a jeopardizing investment? Yes, for the reasons described below.

**Facts**

You are a corporation formed on D under the laws of the state of C.

Your Certificate of Incorporation states the purposes for which you were formed are:

"To distribute funds to non-profit organizations who are tax exempt under section 501(c)(3) of the Internal Revenue Code or the foreign equivalent to support their charitable and religious activities."

Your governing body is comprised of four individuals, each titled as director: E, F, G and H. All four of your directors are related by blood/marriage as two of your directors are brothers and the other two directors are their spouses.

You adopted non profit Bylaws listing general purposes and operational procedures. Article 5 of your Bylaws outlines your Conflict of Interest policy and procedures regarding interested parties.

Under the activities description given in Form 1023 your stated activities will be the making of contributions to other organizations, the nature of whose activities is such as to qualify them under Internal Revenue Code 501(c)(3). This activity will be conducted by the directors of your organization and will be funded by unsolicited contributions from individuals and/or closely held corporations.

You indicated that directors will choose 501(c)(3) entities with no relationship to your foundation to whom donations would be made. Records will be retained with the date, names and addresses of the recipient organizations and the amount of the donation. Distributions will only be made to exempt 501(c)(3) organizations in good standing and they will be selected by their reputation as helping the community at large. Although your organizing document makes reference to making distributions to foreign entities, you have indicated your intention to not make any gifts to foreign organizations at this time.

Your correspondence provided further detail on your loan making activities. You will provide

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interest free short term loans to charitable organizations. You will also make long term loans to for-profit entities. If a for-profit entity requests a loan it will be charged interest. You have stated the purpose of the short term loans is to assist non profit organizations by providing interest free working capital and help with their charitable activities. The loans made to for profit entities were long term to generate interest income.

Loans were made to three charities (J, K and L) and one for-profit entity, M. M was not the end user of the loan. You transferred the loan funds to M because M had obligated itself to lend the money to N a for-profit LLC. After receiving the loan from you M entered into a loan agreement with N for x dollars total. y dollars of that amount was advanced to N on S and z dollars was advanced on W. V, an uncle to E and G, arranged for the financing of the transaction between N and M. V is designated as a manager of N and signed the agreement between N and M. Your loans to M were on Promissory Notes signed by E on behalf of the borrower M and were not collateralized in any manner. The loan from M to N was secured by a mortgage on certain real property.

M is partially owned by two of your board members, G and E. The majority owner of M is P, the father of G and E. Total ownership by percentage is broken down as follows:

|             |   |   |
|-------------|---|---|
| E.....      | - | % |
| O.....      | - | % |
| P.....      | - | % |
| Q.....      | - | % |
| G .....     | - | % |
| Others..... | - | % |

In total, the R family owns % of M with G and E owning %. Since P is the father of G and E, disqualified persons own more than % of M.

T is a corporation % owned and controlled by G and E and therefore % owned by your board. T, has contributed the majority of funds to you.

U is the second largest donor to you. U is a 501(c)(3) Private foundation and you indicated that you have no relationship to U. However you did indicate that T has also made substantial contributions to U.

Throughout the 20 fiscal year T donated approximately \$ to you, and U donated y dollars. E provided a loan to you which was repaid in full with no interest. Loan repayments to you totaled approximately \$

You made approximately \$ in donations, \$ in loans to other organizations, and the loans to M.

On S, U gave y dollars to you. T gave what appears to be y dollars + % to U, 4 days later. Ten days after receiving y dollars, you made a loan to M for the same amount. On the same day, M entered into the agreement with N and made an initial distribution of funds for y dollars. Thirty days later, T gave z dollars to you. On the same day another payment was made to M for

z dollars under the agreement.

### Law

Section 501(a) of the Internal Revenue Code of 1986 provides for the exemption from federal income tax for organizations described in Section 501(c)(3). Such organizations are recognized as exempt if they are organized and operated exclusively for religious, charitable, and educational purposes.

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

Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization will be regarded as operated exclusively for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3) 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.

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) of the regulations states that an organization is not organized or operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. Thus, 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.

In Salvation Navy v. Commissioner, T.C.M. 2002-275 (2002), the court found that one of the reasons why the organization did not qualify for exemption from federal income tax was because it could not provide that its net earnings would not inure to the benefit of a private individual which was its founder.

In Old Dominion Box Co. v. United States, 477 F2d 344 (4<sup>th</sup> Cir. 1973) cert. denied 413 U.S. 910 (1973), the court held that operating for the benefit of private parties constitutes a substantial non-exempt purpose.

Leon A. Beeghly v. Commissioner, 35 T.C. 490 (1960), provided that where an exempt organization engages in a transaction with a related interest and there is a purpose to benefit the private interest rather than the organization, exemption may be lost even though the transaction ultimately proves profitable for the exempt organization.

In Better Business Bureau of Washington, D.C., Inc. v. United States, 326 U.S. 179, the Supreme Court held that the presence of a single non-exempt purpose, if substantial in nature, will destroy a claim for exemption regardless of the number or importance of truly exempt purposes.

### Law Regarding Alternative Issues

Section 53-4941(d)(1) of the regulations defines self-dealing as any direct or indirect transaction described in §53.4941(d)-2. For purposes of this section, it is immaterial whether the transaction results in a benefit or a detriment to the private foundation.

Section 53-4941(d)-2(c) indicates that the lending of money or other extension of credit between a private foundation and a disqualified person shall constitute an act of self-dealing.

Section 53-4944-1(2) of the regulations indicates that an investment shall be considered to jeopardize the carrying out of the exempt purposes of a private foundation if it is determined that the foundation managers, in making such investment, have failed to exercise "ordinary business care and prudence", under the facts and circumstances prevailing at the time of making the investment, in providing for the long and short term financial needs of the foundation to carry out its exempt purposes. In the exercise of the requisite standard of care and prudence the foundation managers may take into account the expected return, the risks of rising and falling price levels, and need for diversification within the investment portfolio.

Rev. Rul. 77-161, 1977-1 C.B. 358

This ruling held that a loan by a private foundation to a disqualified person constitutes an act of self dealing but is not a taxable expenditure within the meaning of section 4945(d)(5) of the Code. The private foundation made a loan to a disqualified person to generate income to be used solely for the foundation's charitable purposes. The loan was made at a reasonable rate of interest, adequately secured and otherwise met prudent investment standards.

### Application of Law

You operate for the benefit of private interests by channeling funds from one related for-profit to another related for-profit through you. The loans you provide to the related for-profit M are used by it to operate its mortgage lending business thereby resulting in inurement to G and E its owners. Therefore you are not operated exclusively for charitable purposes as described in section 501(c)(3) of the code and fail the operational test under 1.501(c)(3)-1(a)(1) of the regulations. Since your primary purpose is to operate for the benefit of insiders you also are not as described in 1.501(c)(3)-1(c)(1) of the regulations.

You obtained funds from a related for-profit and then channeled these funds as a loan to another related for-profit which is owned by your board members and their family members.. As a result your earnings inured to your directors and you operated for the benefit of private interests such as your creators and their family. Therefore you are not as described in section 1.501(c)(3)-1(c)(2) and 1.501(c)(3)-1(d)(1)(ii) of the regulations.

As shown in Salvation Navy v. Comm. and Old Dominion v. U.S., the transactions conducted

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through you benefitted private interests. The loans that, in the normal course of business, would have been made directly to M were directed through you. The transactions generated charitable contributions, while still allowing access to the funds through loans to related for-profit entities. The loans also served the private interests of the other for-profit M owned by G and E and members of the R family by providing it funds to operate its business. The timing of the transactions, the amounts and the fact that the loans were unsecured clearly demonstrate the transactions were structured for the private benefit of insiders. In addition your investment in M was made to satisfy an obligation of M to N which was an arrangement orchestrated by V an uncle of E and G.

Similar to Leon Beeghly v. Comm., the loans you made to M were to satisfy an obligation M had to provide funding to N. Although the loans to M would generate interest income for you the purpose of these loans was to benefit the end user, N. M would also benefit from this transaction by using the funds for its own business purposes and earning interest therefrom.

As in Better Business Bureau of Washington, D.C., Inc. v. United States, 326 U.S. 179, and Sections 1.501(c)(3)-1(a)(1) and 1.501(c)(3)-1(c)(1) You are set up to operate for the non-exempt purpose of receiving funding from a for-profit entity, turning around and providing loans to another for-profit entity both of which are owned by your directors and their family. You operate to serve the private interests of these for-profit entities and also allow your income to inure to the benefit of your directors and family members by providing loans to for-profit businesses that are owned by your directors and family members. Substantially all of your income was used to provide loans to related for-profit entities, which represents a significant non-exempt purpose.

#### **Application of Law on Alternative Issues**

The loans to M clearly constitute an act of self-dealing based on Section 53-4941(d)(1) and Section 53-4941(d)-2(c) of the regulations . As in Revenue Ruling 77-161, you made a loan to a disqualified person which resulted in an act of self dealing.

The loans made by you also constitute a jeopardizing investment as described in Section 53-4944-1(2) of the regulations . Your loans to M were made to enable M to satisfy its obligation to N without consideration of your long and short term needs to carry out your exempt purposes. Also in making this investment you have failed to exercise the requisite standard of care and prudence, taking into account the expected return, the risks of falling price levels and the need for diversification of the investment portfolio. There was no diversification in your investments, the loans were unsecured, all made to a single entity which was involved in mortgage lending. Therefore it is clear that the required ordinary business care and prudence was not exercised by you in making this loan.

#### **Applicant's Position**

You indicated that the loans were never intended for M's use but rather for unrelated third party entities. The purpose of these loans, backed by mortgages on real property was to produce interest revenue for your charitable purposes. The loans were channeled through M because they had been providing mortgage loans for years and had the infrastructure necessary for

making such loans relatively quickly. All interest on the loans has been remitted entirely to you. Soon afterward you realized the problem of making loans through related entities. You immediately discontinued the practice and make all loans directly to unrelated parties.

### **Service Response to Applicant's Position**

You provided funds to M so that they can make mortgage loans on real property. M is a for-profit entity which is % owned by disqualified persons. Therefore in effect you financed M so that they could operate their mortgage business which they have been conducting for years. Therefore you operated for the private benefit of M and your earnings inured to the directors and owners of M because they were able to use your funds to operate their business and to earn profits therefrom. Your loans to M were unsecured. In addition, had you been exempt, the loans made to M would constitute self-dealing and also a jeopardizing investment. You indicate you now make loans directly to unrelated third parties. The making of loans to unrelated third parties is not an exempt purpose. You did not provide any information as to the nature of these loans and the purpose and terms of these loans.

### **Conclusion**

Based on the above facts and law we conclude that you do not qualify for exemption under Section 501(c)(3) of the Code because you are operating for a substantial non exempt purpose. Your operations result in private benefit to for-profit organizations and your earnings inure to your directors and family members who are owners of these for-profit businesses that contribute to you as well as receive funds from you.

### **Conclusion-Alternative Issues**

We further conclude that, if upon appeal exemption is granted, the lending of money to a related company results in a self-dealing transaction. In addition the lack of requisite care and prudence in making the purported investment in the related company indicates that the investment would be a jeopardizing investment.

You have the right to file a protest if you believe this determination is incorrect. To protest, you must submit a statement of your views and fully explain your reasoning. You must submit the statement, signed by one of your officers, within 30 days from the date of this letter. We will consider your statement and decide if the information affects our determination. If your statement does not provide a basis to reconsider our determination, we will forward your case to our Appeals Office. You can find more information about the role of the Appeals Office in Publication 892, *Exempt Organization Appeal Procedures for Unagreed Issues*.

*Types of information that should be included in your appeal can be found on page 2 of Publication 892, under the heading "Regional Office Appeal". The statement of facts (item 4) must be accompanied by the following declaration:*

*"Under penalties of perjury, I declare that I have examined the statement of facts presented in this appeal and in any accompanying schedules and statements and, to the best of my knowledge and belief, they are true, correct, and complete."*

*The declaration must be signed by an officer or trustee of the organization who has personal knowledge of the facts.*

*Your appeal will be considered incomplete without this statement.*

*If an organization's representative submits the appeal, a substitute declaration must be included stating that the representative prepared the appeal and accompanying documents; and whether the representative knows personally that the statements of facts contained in the appeal and accompanying documents are true and correct.*

An attorney, certified public accountant, or an individual enrolled to practice before the Internal Revenue Service may represent you during the appeal process. If you want representation during the appeal process, you must file a proper power of attorney, Form 2848, *Power of Attorney and Declaration of Representative*, if you have not already done so. You can find more information about representation in Publication 947, *Practice Before the IRS and Power of Attorney*. All forms and publications mentioned in this letter can be found at [www.irs.gov](http://www.irs.gov), Forms and Publications.

If you do not file a protest within 30 days, you will not be able to file a suit for declaratory judgment in court because the Internal Revenue Service (IRS) will consider the failure to appeal as a failure to exhaust available administrative remedies. Code section 7428(b)(2) provides, in part, that a declaratory judgment or decree shall not be issued in any proceeding unless the Tax Court, the United States Court of Federal Claims, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted all of the administrative remedies available to it within the IRS.

If you do not intend to protest this determination, you do not need to take any further action. If we do not hear from you within 30 days, we will issue a final adverse determination letter. That letter will provide information about filing tax returns and other matters.

Please send your protest statement, Form 2848, and any supporting documents to the applicable address:

Mail to:

Deliver to:

Internal Revenue Service  
EO Determinations Quality Assurance  
Room 7-008  
P.O. Box 2508  
Cincinnati, OH 45201

Internal Revenue Service  
EO Determinations Quality Assurance  
550 Main Street, Room 7-008  
Cincinnati, OH 45202

You may fax your statement using the fax number shown in the heading of this letter. If you fax your statement, please call the person identified in the heading of this letter to confirm that he or she received your fax.

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

Sincerely,

Lois G. Lerner  
Director, Exempt Organizations

Enclosure, Publication 892