

Internal Revenue Service  
Appeals Office  
1000 Liberty Avenue  
Room 816  
Pittsburgh, PA 15222

Department of the Treasury

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

Tel: \*\*\*\*\*  
Fax: \*\*\*\*\*

Tax Periods Ended:  
December 31, 20XX  
December 31, 20XX  
December 31, 20XX

UIL: 0501.03-30

Release Number: 201417024  
Release Date: 4/25/2014  
Date: January 31, 2014

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**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"). It is determined that you do not qualify as exempt from Federal income tax under section 501(c)(3) of the Code effective January 1, 20XX.

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

Section 1.501(c)(3)-1(a)(1) of the Federal Tax Regulations provides that, in order to be exempt as an organization described in IRC 501(c)(3), 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. Because your organization has operated primarily for the personal benefit of your Trustee, you have failed to demonstrate that you are operated exclusively for tax-exempt purposes described in Section 501(c)(3) of the Code. As such, you are not an organization described in Section 501(c)(3) and the favorable determination letter issued to you on November XX, 19XX regarding your exempt status is hereby revoked.

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

You are required to file Federal income tax returns on Forms 1041 for the tax periods stated in the heading of this letter 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).

We will make this letter and the proposed adverse determination letter available for public inspection under Code section 6110 after deleting certain identifying information. We have provided to you, in a separate mailing, Notice 437, *Notice of Intention to Disclose*. Please review the Notice 437 and the documents attached that show our proposed deletions. If you

disagree with our proposed deletions, follow the instructions in Notice 437.

You have waived your right to contest this determination under the declaratory judgment provisions of Section 7428 of the Code.

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 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,

/s/  
Appeals Team Manager

Enclosure: Publication 892

cc: \*\*\*\*\*

**Internal Revenue Service  
Tax Exempt and Government Entities Division**

**Department of the Treasury**

**PO Box 12307 M/S 1112  
Ogden, UT 84412**

Date: January 6, 2011

**ORG  
ADDRESS**

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

**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 is necessary.

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

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

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

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

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

You have the right to contact the office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States court. The Taxpayer Advocate can, however, see that a tax matter that may not

have been resolved through normal channels gets prompt and proper handling. You may call toll-free 1-877-777-4778 and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate at:

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

Thank you for your cooperation.

Sincerely,

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
<b>Name of Taxpayer</b>  ORG EIN: EIN		<b>Year/Period Ended</b> 12/31/20XX 12/31/20XX & 12/31/20XX

**LEGEND**

ORG - Organization name      EIN - ein      XX - Date      Address - address  
City - city      State - state      Country - country      Trustee - trustee  
Donor - donor      DIR -, DIR-2 & DIR-3 - 1<sup>ST</sup>, 2<sup>ND</sup> & 3<sup>RD</sup> DIR      RA-1 THROUGH RA-11 - 1<sup>ST</sup> THROUGH 11<sup>TH</sup> RA      CO-1 THROUGH CO-19 - 1<sup>ST</sup> THROUGH 19<sup>TH</sup> COMPANIES

**PRIMARY ISSUE:** Whether the IRC § 501(c)(3) tax exempt status of the ORG should be revoked because it is not operated exclusively for tax exempt effective January 1, 19XX..

**FACTS:**

**I. Trust Instrument**

The ORG (the "Organization") was created on October 1, 19XX. The Declaration of Trust (Declaration) shows that Trustee and Donor were the donors. While the Organization has a governing board made up of five directors or what the Declaration refers to as "members", Trustee is the sole "Trustee" of the Organization. The original Declaration named CO-1 as the primary charity but it was amended on October 1, 19XX, to name CO-2 d/b/a CO-3 as the primary charity. That was the only amendment made to the original Declaration. The Organization included the amendment to the Declaration in its application for recognition of tax exempt status. The Service recognized the Organization as an tax exempt organization described in Sections 501(c)(3) and 509(a)(3) of the Code in a letter dated, November 20, 19XX.

The Declaration states that it shall be irrevocable, and that the donor expressly waived the right and the power to alter, amend, revoke, or terminate the Trust or the terms of Declaration. The Declaration also provides that the donor renounced any power to determine or control, by alteration, amendment, revocation, termination, or otherwise, and that the donor renounces any interest in, either vested or contingent, including any reversionary interest or possibility of reverter, the income or principle of the trust estate.

The Declaration requires each year for Trustee to distribute % of the adjusted net income of the Trust to the CO-2 d/b/a CO-3, the named Primary Charity. In addition to this distribution the Declaration states that Trustee shall distribute a total of % of the adjusted net income to one or more identified charitable organizations or to the Primary Charity as directed by a majority of the Board of Directors (the "Board"). There are 105 charitable organizations identified on Schedule A to the Declaration.

The Declaration provides that upon winding up and dissolution of the Organization, after paying or adequately proving debts and obligations of the

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Organization, the remaining assets shall be distributed to a non-profit fund, foundation or corporation, which is organized and operated exclusively for charitable, educational, religious, and/or scientific purposes and which has established its tax exempt status under section 501(c)(3).

The Declaration provides that the Board shall be the governing body of the Trust and are referred to as "directors" or "members" as Trustee is the sole trustee of the Organization. The Declaration provides that the members of the Board shall be determined as follows:

- One Board member shall be appointed by the Primary Charity.
- Two Board members shall be from the class consisting of Trustee and Donor and their descendants (the "Family").
- The other members of the Board shall be appointed by the majority vote of the remaining members of the board. DIR-1 and DIR-2 were named in the Declaration as the initial remaining board members.

The Organization's application for exemption, dated December 23, 19XX, listed DIR-1 as one of the Organization's board members, along with Trustee and Donor, DIR-1 and DIR-2. DIR-1 was also a board member of the CO-1 at the same time and was the director appointed by the Primary Charity. DIR-1 is an attorney who provided legal advice to Trustee and Donor about section 4958 issues (the latter section of this RAR discusses this advice in greater detail). DIR-2s' relationship with the Organization and its trustee and donors is unclear. Even though the Service made numerous requests asking the Organization to provide information on the board members and their relationship to the Organization and the donors, the Organization failed to provide any such information.

The Amended Declaration of Trust, dated October 1, 19XX, and the Forms 990 for 20XX, 20XX and 20XX, the relevant tax years, identified the following individuals as Board members:

Trustee, substantial contributor and disqualified person  
Donor, spouse of Trustee and a disqualified person  
DIR-3, appointed by CO-4  
DIR-1, Treasurer of CO-4  
DIR-2

The board's meeting minutes show that there were several replacements throughout the years of different board members in other tax years. However, Trustee and Donor and DIR-1 always remained board members.

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service <b>Explanation of Items</b>	Schedule No. or Exhibit
<b>Name of Taxpayer</b>  ORG EIN: EIN		<b>Year/Period Ended</b> 12/31/20XX 12/31/20XX & 12/31/20XX

## II. Attorney Letter

The administrative file contains a letter from the law firm of CO-5, signed by DIR-1, one of the Organization's board members, and addressed to Trustee and Donor. The letter is dated March 13, 19XX and it discusses the law with respect to I.R.C. § 4958. It mentions the term "disqualified persons" and that excess benefit transactions will result in the imposition of excise taxes with respect to disqualified persons, including founders and organizational managers. It then discusses how legislative history reveals that Congress intended to create a kind of "safe harbor." According to the letter, the "safe harbor" in 4958 is that it contains a rebuttable presumption that a compensation arrangement between a disqualified person and an organization is reasonable and not subject to excise taxes if the arrangement is approved by the board of directors or trustees that:

1. Was composed entirely of individuals unrelated to and not subject to the control of the disqualified person(s) involved in the arrangement;
2. Obtained and relied upon appropriate data as to comparability such as surveys or reports from other similarly situated organizations, both taxable and tax-exempt; and
3. Adequately documented the basis for its determination, such as an evaluation of the person whose compensation is being established and setting forth the basis for determining that the person's compensation was reasonable.

The letter goes on to state the following:

*"A similar rebuttable presumption would arise with respect to the reasonableness of the valuation of property sold or transferred (or purchased) by the organization to (or from [sic]) a disqualified person, provided the board of directors or trustees followed the same requirements mentioned above [emphasis added]."*

The letter also cautions the Organization to maintain extensive records of any compensation or loans between the disqualified person and the Organization as proof of the reasonableness of any such transactions.

### Operations

The Service determined that the Organization qualified for tax exempt status based on the representations made in its application and supplemental materials. The

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service <b>Explanation of Items</b>	Schedule No. or Exhibit
<b>Name of Taxpayer</b>  ORG EIN: EIN		<b>Year/Period Ended</b> 12/31/20XX 12/31/20XX & 12/31/20XX

Organization did not disclose that it would lend any funds to disqualified persons or make payments to disqualified persons. It also represented that it would receive \$ in contributions by the end of 19XX to fund its operations and use all of those funds to exclusively support the publicly supported organizations named in its Declaration and Schedule A. The Service was unable to verify whether the Organization received this amount by the end of 19XX. From the documentation that the Service did review, it appears that the Organization received \$ from October 1, 19XX to 19XX.

A review of the Organization's board minutes from 19XX to 20XX, reveals that the Organization's board only met once a year, with the exception of 20XX when it met twice. From 19XX to 20XX, the minutes showed the following significant points of note:

At the only board meeting held in 19XX, on December 22, 19XX, the board approved the following:

- The Organization's purchase of a % partnership interest in CO-6. The LP was wholly owned by the CO-7 (CO-7). The purchase price was \$. The minutes state that the value of that purchase was to be validated by an independent appraiser. The Organization failed to provide any proof of an appraiser report even though the Service requested it numerous times.

At the 19XX board meeting held on April 12, 19XX, the Board approved the following:

- The Board of the Organization voted to invest \$ in CO-7. Trustee made the presentation from a financial and marketing package prepared by DIR-1, a principle of CO-7 (a company operating out of State) and a former Organization board member.
- Extension of a line of credit to CO-8 ("CO-8") and CO-6 in the amount of \$. CO-8 is a partnership with only one partner, Trustee. Trustee and Donor both recused themselves from voting on this matter. According to the minutes, the credit was to accrue interest at a "prevailing industry rate," and that the line of credit would be personally guaranteed by Trustee and that it would be "documented by a mutually agreed law firm to protect the interests of the Foundation in such a manner as is acceptable in the industry." The Organization failed to provide any documentation of the terms of this line of credit despite the Service's repeated requests.
- The Organization's purchase of %% interest in CO-6 for \$. The minutes state that the value of this purchase price was to be validated later by an

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service	Schedule No. or Exhibit
<b>Explanation of Items</b>		
<b>Name of Taxpayer</b>		<b>Year/Period Ended</b>
ORG		12/31/20XX
EIN: EIN		12/31/20XX & 12/31/20XX

independent appraisal. There is no documentation showing whether such an appraisal was ever obtained. The Organization also failed to provide proof of any documentation related to the purchase. There are no sales documents, no proofs of transfer of shares, etc. . . ., despite the Service's repeated requests for such documents.

- o Trustee then presented the board with the opportunity for the Organization to invest \$ in CO-9. The board unanimously voted to approve this investment. The Organization did not provide any information about CO-9's ownership.
- o Trustee also presented a request to extend \$ in loans to RA-1, RA-2, CO-8, and the ORG. Trustee and Donor recused themselves from voting on this matter and the remaining board members voted to approve this loan. The board minutes in later years show that RA-2 became a board member of the Organization but he was not a board member at the time of this loan. The Organization failed to provide any information about both RA-2 and RA-1. The Service repeatedly requested information on RA-1's and RA-2's relationship with the Organization, its founders, and the primary charity but the Organization failed to provide any such information.
- o Trustee made a presentation for a loan of \$ to CO-10 ("CO-10"). CO-10 is a partnership whose only two partners are Trustee and Donor. According to the minutes, the loan was to be made at an interest rate of %, payments would be due semi annually and that it was secured by the underlying property located at Address, City State. The Service has no further information about this alleged loan.

The Organization's next board meeting was held on April 8, 19XX. The board meeting minutes of that meeting showed the following:

- o Trustee made a proposal suggesting that the Organization purchase % interest in CO-6 (hereinafter the "Partnership") for \$\$ from the CO-7. He also told the board that the Partnership is a % owner of CO-8 and provided various financial records as it pertains to CO-8. He also represented that the value of the purchase price would be confirmed by an independent appraiser. Trustee and Donor both recused themselves from voting on the matter and remaining board members approved the purchase.

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service <b>Explanation of Items</b>	Schedule No. or Exhibit
<b>Name of Taxpayer</b>  ORG EIN: EIN		<b>Year/Period Ended</b> 12/31/20XX 12/31/20XX & 12/31/20XX

- o RA-3, a controller and accountant for CO-8 and another entity called CO-11 ("Development"), was present at the meeting and made a presentation to the board asking that the Organization extend a line of credit to CO-8 and Development for \$\$\$. The Organization failed to provide any information on Development's ownership, but the Service was able to determine the owners as Trustee and Donor and two of their children, RA-4 & RA-5. According to the minutes, the terms of the credit line will be that it would accrue interest at the prevailing rate in the industry and that Trustee would personally guarantee the credit and that it would be "documented by a mutually agreed law firm to protect the interests of the Foundation in such a manner as is acceptable in the industry." Again, Trustee and Donor both recused themselves from voting on the matter and the remaining board members approved this matter. The Organization failed to provide any documentation of the terms of this line of credit or any other information related to the line of credit despite the Service's repeated requests.

The board meeting minutes for the one board meeting held in 19XX, on April 9, 19XX, showed the following:

- o RA-3, a controller and accountant for CO-8 was present at the meeting and made a presentation to the board asking that the Organization extend a line of credit to CO-8 for \$\$\$. According to the minutes, the terms of the credit line will be that it will accrue interest at the prevailing rate in the industry, that Trustee would personally guarantee the credit, and that it would be "documented by a mutually agreed law firm to protect the interests of the Foundation in such a manner as is acceptable in the industry." Again, Trustee and Donor both recused themselves from voting on the matter and the remaining board members approved this matter. The Organization failed to provide any documentation related to the terms of this line of credit despite the Service's repeated requests.
- o Trustee then requested that the board approve a loan to CO-10 in the amount not to exceed \$, to be secured by the property at Address, City State.

The one board meeting held in 20XX, on April 7, 20XX, showed the following:

- o RA-3, a controller and accountant for CO-8 was present at the meeting and made a presentation to the board asking that the Organization extend a line of credit to CO-8 for \$\$\$. According to the minutes, the terms of the credit line will be that it would accrue interest at the prevailing rate in the industry and that Trustee would personally guarantee the credit and that it would be "documented

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<b>Name of Taxpayer</b>  ORG EIN: EIN		<b>Year/Period Ended</b> 12/31/20XX 12/31/20XX & 12/31/20XX

by a mutually agreed law firm to protect the interests of the Foundation in such a manner as is acceptable in the industry." Trustee and Donor both recused themselves from voting and the remaining board members approved this matter. The Organization failed to provide any documentation of the terms of this line of credit despite the Service's repeated requests.

- o Trustee then requested that the board approve a loan to RA-6 in the amount not to exceed \$\$\$. The board unanimously approved this loan. The minutes have no mention of the terms of the loan. The Service was not provided any further information about this loan. The Organization failed to provide any information on RA-6 or what his relationship was to the Organization, its founders, or its board members despite repeated requests.

Other records show that in the 20XX tax year, CO-8 received \$\$\$ from the Organization as follows:

- \$\$\$ Total alleged loan from the Organization to CO-8 since the Organization's inception to 12-31-19XX per its 19XX Form 990.
- \$\$\$ Total alleged loan from the Organization to CO-8 since the Organization's inception to 12-31-20XX per the Organization's own accounting records.
- \$\$\$ Difference. This is the amount that CO-8 received from the Organization as alleged loans/credit in tax year 20XX.

There are no records to show that this amount was ever paid back to the Organization.

Organization's one board meeting for 20XX was held on April 6, 20XX. The board minutes show the following:

- o The board members discussed the line of credit extended to CO-8, Development, and CO-10 in past years. Those loans were in excess of \$\$. Trustee represented that he was working to have the lines and loan paid off in full so that the board could forgo "collection efforts." The Organization failed to provide any payment records for the alleged loans and credit extensions.
- o Trustee represented that he would pay the loans totaling in excess of \$\$ by "using stock" that he or CO-8 were receiving from CO-12 ("CO-12"). The board agreed to forego collection efforts in anticipation of said pay-offs. DIR-1 (board member), as legal counsel, was directed to monitor said situation and advise the board accordingly.

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service <b>Explanation of Items</b>	Schedule No. or Exhibit
<b>Name of Taxpayer</b>  ORG EIN: EIN		<b>Year/Period Ended</b> 12/31/20XX 12/31/20XX & 12/31/20XX

- o CO-12 is a publicly traded corporation listed on the CO-13 Automated Quotation Bulletin Board System, under the symbol "CO-12," in which Trustee is the Chief Operating Officer and Director. The corporation's current business plan is to build multiple observation ferris wheels ("Observation Wheels"). Currently proposed sites for construction of Observation Wheels include City, State; Country (COUNTRY) and Country.
- o The Organization approved a loan to RA-7, RA-2 and RA-8 in the aggregate amount not to exceed \$\$\$. RA-2 was listed as a board member on the April 6, 20XX board meeting minutes. The Service also repeatedly requested information about RA-7 and RA-8's relationship to the Organization, its founders, and the primary charity but the Organization again failed to provide any such information. The minutes state that the loan was approved unanimously and there is nothing to indicate that RA-2 recused himself from voting on this loan.

The first of two board meetings during 20XX was held on April 12, 20XX. The board meeting minutes show the following:

- o RA-2 resigned as a board member and was replaced by DIR-3 of the CO-3 upon unanimous vote of the board. Trustee then gave a general report of the Organization's finances including reports on the Organization's various investments, the details of which are not specified in the minutes. DIR-1 then lead a discussion pertaining to the "workout of various obligations associated with Trustee" that was owed the Organization. Again, the details of those workouts were not detailed in the minutes. The Board then agreed to allow these discussions to continue with the target resolution date of June 20XX.

The second and last board meeting of 20XX was held on June 21, 20XX. The minutes of that board meeting shows the following:

- o That there were various delinquencies associated with the various alleged loans from entities related to Trustee and Donor. Trustee apparently gave the board some solutions to this issue, which are not specified in the minutes and also suggested that he would convey some stock to satisfy this obligation. Both Trustee and Donor recused themselves from voting on any resolutions related to these matters. The remaining three board members then adopted the following resolutions:
- o It accepted Trustee' contribution of \$ common shares of CO-12 stock allegedly valued at \$ per share. If CO-12 stock was worth \$ per share, then the total value of this contribution would be \$\$\$. The board agreed to accept this in satisfaction

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<b>Name of Taxpayer</b>  ORG EIN: EIN		<b>Year/Period Ended</b> 12/31/20XX 12/31/20XX & 12/31/20XX

of a total obligation of \$\$ that RA-9, RA-10, RA-11 and CO-8 owed. According to the board minutes, RA-9, RA-10 and RA-11 are related to Trustee but the Service was unable to determine the nature of their relationship to Trustee. There are no records showing any alleged loans to RA-9, RA-10 or RA-11 from the Organization. The only record of any alleged loans are to CO-8 from previous board minutes. The minutes also show that the total original "loan" obligation to the Organization was \$\$ [it is not known how this amount was derived]. This amount was then discounted by a write-off of \$ in uncollectible obligations from CO-9 (which apparently had filed bankruptcy) and \$\$ in discount of interest obligations. There is no explanation of why interest was discounted. There is also no explanation for why the Organization's bad investment in CO-9 for \$ would be written off of a purported loan obligation that third parties, RA-9, RA-10, RA-11 and CO-8 had to the Organization. The minutes further state that Trustee agreed to forego a purported loan the Organization owes him in the amount of \$\$\$. There are no records of any such loan from Trustee to the Organization. According to the board minutes, the Organization was thus owed \$\$ (\$\$ less \$\$, the total alleged loan that the Organization owed Trustee), the total alleged value of CO-12 stock given in satisfaction to pay off all of the alleged loans. Despite repeated requests for loan documents in relation to CO-8 and the Organization as the lender, the Organization failed to provide any such documents. There is also no documentation of a loan \$\$ that the Organization allegedly borrowed from Trustee. The Service also repeatedly requested evidence of the value of CO-12 stock at the time of the alleged transfers. The Organization failed to provide any such proof.

- o The board also approved the transfer of 70,000 common shares on CO-12 allegedly valued at \$ per share by the CO-7 in satisfaction of an alleged loan it took out from the Organization for \$\$.

The one board meeting held in 20XX was on April 9, 20XX. The board meeting minutes showed the following:

- o Trustee gave a general report of the business and finances of the Organization and gave a report on the financial status of CO-12 and the anticipated building of the first of what was to be several large-scale Observation Wheels in City. The board unanimously agreed to hold on CO-12 stock in anticipation of it increasing in value.

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service	Schedule No. or Exhibit
<b>Explanation of Items</b>		
<b>Name of Taxpayer</b>		<b>Year/Period Ended</b>
ORG		12/31/20XX
EIN: EIN		12/31/20XX & 12/31/20XX

The Form 10-KSB, an annual report for publicly traded small business companies that is required to be filed with the Securities and Exchange Commission (SEC), for the year ended December 31, 20XX, listed the value of CO-12 as follows:<sup>1</sup>

	20XX		20XX	
	Low	High	Low	High
1 <sup>st</sup> Quarter	\$	\$\$	Not Trading	Not Trading
2 <sup>nd</sup> Quarter	\$\$	\$\$	\$\$	\$\$
3 <sup>rd</sup> Quarter	\$\$	\$\$	\$\$	\$\$
4 <sup>th</sup> Quarter	\$\$	\$\$	\$	\$\$

During 20XX, there was one board meeting held on April 9, 20XX. Those meeting minutes show the following:

- o Trustee gave a general report of the business and finances of the Organization. The president of CO-12, RA-8, (as the Organization refused to provide any information, it is not known if this "RA-8" is RA-8, who received an alleged loan from the Organization as reflected in the board meeting minutes of April 6, 20XX) joined the meeting telephonically and gave a report on CO-12's.
- o The board voted to hold onto its CO-12 stock for another 12 months and agreed that in the event that the stocks do not show a significant increase, the Organization consider dissolving and donating all of the assets to its primary beneficiary, CO-3/The CO-3.

During 20XX, there was one board meeting held on August 13, 20XX. Those meeting minutes show the following:

- o Trustee proposed that the Organization be liquidated. The minutes do not detail any of the points of a discussion that apparently ensued after the proposal. The minutes listed the Organization's assets as the following:

1. The quotations reflect inter-dealer prices, without retail mark-up, markdown or commission, and may not represent actual transactions.

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service	Schedule No. or Exhibit
<b>Explanation of Items</b>		
<b>Name of Taxpayer</b>		<b>Year/Period Ended</b>
ORG		12/31/20XX
EIN: EIN		12/31/20XX & 12/31/20XX

1. \$ shares of common stock of CO-12 (allegedly transferred to it by Trustee back in 20XX to satisfy an alleged loan from RA-9, RA-10, and RA-11 and CO-8).
2. shares of common stock of CO-12 (allegedly transferred to it by CO-7)
3. Interest in CO-8 (per the past board minutes from 19XX and 19XX should amount to % partnership shares).
4. Certain rights in an oil painting with a value of \$\$.

The board also unanimously agreed to liquidate all of the Organization's assets and to donate the said assets to The CO-3. The Organization also provided a letter, dated January 10, 20XX, from the CO-3 acknowledging receipt of the assets as mentioned on 1-4 above.

Curiously, the 20XX minutes do not state the other investments and loans that were documented in the previous years' board minutes that can not be accounted for with the alleged transfers of CO-12 stock.

The Organization's Forms 990 for tax years ending 20XX, 20XX, 20XX (the tax years with open statutes for assessment ) reflect the following:

	TY 20XX	TY 20XX	TY 20XX
Contributions, gifts, grants (Direct public support)			\$
Interest on savings and temporary cash investments			
Dividends	\$	\$	
Other investment income			
Total revenue	\$		
Grants	\$		
Other expenses	\$		
Total Expenses	\$		



Form <b>886A</b>	Department of the Treasury - Internal Revenue Service <b>Explanation of Items</b>	Schedule No. or Exhibit
<b>Name of Taxpayer</b>  ORG EIN: EIN		<b>Year/Period Ended</b> 12/31/20XX 12/31/20XX & 12/31/20XX

TY 20XX

None

**APPLICABLE LAW:**

IRC § 501(c)(3) exempts from Federal income tax: 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 for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.

Regulation section 1.501(c)(3)-1(c)(1) provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Regulation section 1.501(c)(3)-1(c)(2) provides that an organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals. The words "private shareholder or individual" refer to persons having a personal and private interest in the activities of the organization.

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

In Better Business Bureau v. United States, 326 U.S. 279 (1945), the United States Supreme Court held that regardless of the number of truly exempt purposes, the presence of a single substantial non-exempt purpose will preclude exemption under section 501(c)(3).

In Founding Church of Scientology v. U.S., 412 F. 2d 1197 (Ct. Cl. 1969), the court stated that loans to an organization's founder or substantial contributor can

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service <b>Explanation of Items</b>	Schedule No. or Exhibit
<b>Name of Taxpayer</b>  ORG EIN: EIN		<b>Year/Period Ended</b> 12/31/20XX 12/31/20XX & 12/31/20XX

constitute inurement that is prohibited under section 501(c)(3). In that case, the church made loans to its founder and his family and failed to produce documentation that demonstrated that the loans were advantageous to the church. The church also failed to produce documentation to show that the loans were repaid. Significantly, the court stated that "the very existence of a private source of loan credit from an organization's earnings may itself amount to inurement of benefit."

In Revenue Ruling 67-5, 1967-1 C.B. 123, it was held that a foundation controlled by the creator's family was operated to enable the creator and his family to engage in financial activities which were beneficial to them, but detrimental to the foundation. It was further held that the foundation was operated for a substantial non-exempt purpose and served the private interests of the creator and his family. Therefore, the foundation was not entitled to exemption from Federal income tax under section 501(c)(3).

Fisher v. Commissioner, 54 T.C. 905, 909 (1970). Whether a particular transaction actually constitutes a loan is determined upon consideration of all the facts. For a payment to constitute a loan, when the payments are received, the recipient must intend to repay the amounts and the transferor must intend to enforce payment. See also, Haag v. Commissioner, 88 T.C. 604, 615 (1987), aff'd without published opinion, 855 F.2d 866 (8<sup>th</sup> Cir. 1988); Beaver v. Commissioner, 55 T.C. 85, 91 (1970).

In Greg R. Vinikoor v. Commissioner, T.C. Memo 1998-152, the Tax Court provided the following factors to determine whether a transfer was made with a real expectation of repayment and an intention to enforce the debt:

- (1) There was a promissory note or other evidence of indebtedness;
- (2) Interest was charged;
- (3) There was security or collateral;
- (4) There was a fixed maturity date;
- (5) A demand for repayment was made;
- (6) Any actual repayment was made;
- (7) The transferee had the ability to repay;
- (8) Any records maintained by the transferor and/or the transferee reflected the transaction as a loan; and
- (9) The manner in which the transaction was reported for Federal tax purposes is consistent with a loan.

### **TAXPAYER'S POSITION:**

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service <b>Explanation of Items</b>	Schedule No. or Exhibit
<b>Name of Taxpayer</b>  ORG EIN: EIN		<b>Year/Period Ended</b> 12/31/20XX 12/31/20XX & 12/31/20XX

The taxpayer believes the Organization operated in accordance with the requirements of I.R.C. §§ 501(c)(3) and 509(a)(3).

**GOVERNMENT'S POSITION:**

The IRC § 501(c)(3) tax exempt status of the ORG (the "Organization") should be revoked because it is not operated exclusively for tax exempt purposes and its net earnings inure to the benefit of private shareholders and individuals.

From the documentation that the Service was able to review, it appears that the Organization was funded with approximately \$ from its inception in October 1, 19XX to 19XX. All of those funds came from Trustee & Donor either directly or through the CO-7 (CO-7) mentioned in the facts section of this RAR.

Since its inception, the Organization's main activity consisted of one thing. It made alleged "investments" in entities owned or controlled directly by Trustee and Donor or those with some connection to Trustee and Donor. The alleged investments were either in the form of transferred shares or partnership interests in those entities that Trustee and Donor controlled or in the form of alleged loans and lines of credit to those entities or other individuals with some connection to Trustee and Donor.

The following two charts list the alleged investments, loans and lines of credit per the Organization' board minutes and Forms 990:

<b>Year the alleged investment was made</b>	<b>Type of alleged Investment</b>	<b>Amount of the alleged investment</b>	<b>Proof of the value of Investment</b>	<b>Resolution of this investment after the Organization dissolved in 20XX</b>
19XX	The receipt of % partnership interests in CO-8 (only other partners are Trustee and Donor) allegedly purchased from the CO-7.	\$\$00	None*	Unknown. This investment is never addressed in the 20XX board minutes that lists all of Org's assets that were liquidated.

## Explanation of Items

Name of Taxpayer

ORG  
EIN: EIN

Year/Period Ended

12/31/20XX  
12/31/20XX &  
12/31/20XX

19XX	Uncertain if it was a purchase of shares/interest in CO-7 Course or an alleged loan as an investment	\$	None*	Unknown. This investment is never addressed in the 20XX board minutes that lists all of the Org's assets that were liquidated.
19XX	Receipt of %% of limited partnership interests in CO-8	\$.	None*	Unknown. This investment is never addressed in the 20XX board minutes that lists all of the Org's assets that were liquidated.
19XX	Alleged loan to CO-9 as an investment	\$	None*	Somehow, this investment in CO-9 was written off of a loan that CO-8 and individuals RA-9, RA-10 and RA-11 (related parties to Trustee) owed the Organization.
19XX	Receipt of % partnership interests in CO-6 (Apparently, by 19XX, this partnership was also % owner of CO-8, another partnership that back in 19XX, had only one partner, Trustee) allegedly	\$\$	None*	Unknown. This investment is never addressed in the 20XX board minutes that lists all of the Org's assets that were liquidated.

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service <b>Explanation of Items</b>	Schedule No. or Exhibit
Name of Taxpayer  ORG EIN: EIN		Year/Period Ended 12/31/20XX 12/31/20XX & 12/31/20XX

	purchased from the CO-7.			
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\*It was represented to the board that these alleged investments were to have been valued by an independent appraiser after the board approved their purchases. The Organization failed to provide any documentation that it ever obtained independent appraisals for any these alleged investments.

Year of alleged loan	Purported Borrower	Purported Lender	Amount	Resolution
19XX	CO-8 (at the time of this payment, Trustee was its sole partner) and CO-6.	Organization	\$. ("line of credit")	Unknown
19XX	RA-1, RA-2, CO-8	Organization	\$. ("loan")	Unknown
19XX	CO-10 (Trustee & Donor are its only partners)	Organization	\$. ("loan")	Unknown
19XX	CO-8 and CO-11 (According to later board minutes, by 19XX, % of CO-8 was owned by CO-6.	Organization	\$\$ ("line of credit")	Unknown as to CO-8; board minutes of 06/21/20XX shows that the board approved a transfer of CO-12 stock allegedly worth \$ from Trustee to satisfy this "loan."
19XX	CO-8	Organization	\$\$ ("line of credit")	Unknown
19XX	CO-10	Organization	\$ ("loan")	
20XX	CO-8	Organization	\$\$ ("line of credit") Records show	Unknown

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service	Schedule No. or Exhibit
<b>Explanation of Items</b>		
<b>Name of Taxpayer</b>		<b>Year/Period Ended</b>
ORG EIN: EIN		12/31/20XX 12/31/20XX & 12/31/20XX

			that the Organization paid a total of \$\$ to CO-8.	
20XX	RA-6	Organization	\$\$ ("loan")	Board minutes of 06/21/20XX state that the board approved a transfer of CO-12 stock allegedly worth from Trustee, in part, to satisfy this "loan."
20XX	RA-7, RA-2, RA-8	Organization	\$\$ ("loan")	Board minutes of 06/21/20XX state that the board approved a transfer of CO-12 stock allegedly worth \$ from Trustee, in part, to satisfy this "loan."
Unknown	Organization	Trustee	\$ \$	Unknown

The information reported on the Forms 990 from 19XX to 20XX are contradicted by what is on the Organization's own board minutes. For example, the Forms 990 from that time period only shows the following extensions of credit:

- CO-8, - \$
- CO-6 - \$
- CO-10 - \$
- Total \$

The Organization provided no documentary proof to verify this information or that this was the extent of the credit extensions.

The 19XX Form 990 reported that the Organization received \$ in interest payments from "loan receivables." The 20XX Form 990 reported interest income of \$.

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service <b>Explanation of Items</b>	Schedule No. or Exhibit
<b>Name of Taxpayer</b>		<b>Year/Period Ended</b>
ORG EIN: EIN		12/31/20XX 12/31/20XX & 12/31/20XX

The 20XX return reported interest income of \$. The Organization was not able to provide any proof to verify payments in these amounts or any other amounts, who made these payments or when these payments were made.

The 20XX Form 990 also reported the following:

The terms of the alleged loan to CO-8 were as follows:

- Line of credit at a rate of %
- Issued on January 5, 19XX
- Personally secured by Trustee.

The terms of the alleged loan to CO-6 were as follows:

- Original amount \$
- 30 year unsecured loan
- At a rate of %
- Issued on June 6, 19XX

The terms of the alleged loan to CO-10 were as follows:

- Original amount of \$
- Line of credit at a rate of %
- Issued on June 8, 19XX

This is the extent of the information the Service has of these purported loans and lines of credit. There is no documentary proof of these loans/lines of credit or any other information on the other loans detailed in the board minutes.

In June of 20XX, Trustee allegedly satisfied some of the "loans" and "lines of credit" by transferring stock in a publicly-held company, CO-12. The transfers occurred in two different transactions.

First, Trustee transferred \$ shares of CO-12, alleged to be valued at \$ per share, in an attempt to satisfy a "loan" to CO-8 and Trustee and three related parties, RA-9, RA-10 and RA-11. There have never been any records of loans made to these parties or that the board approved these alleged loans. Moreover, the board minutes April of 20XX show that the directors acknowledged that these alleged loans were in excess of \$\$., yet they inexplicably agreed that the so-called borrowers' obligation should be \$\$ in June 20XX without any proof that there were payments made during this time period. The board then further discounts this obligation by writing off as uncollectable a \$ investment in CO-9. There were no records to show that this loan

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service <b>Explanation of Items</b>	Schedule No. or Exhibit
<b>Name of Taxpayer</b>  ORG EIN: EIN		<b>Year/Period Ended</b> 12/31/20XX 12/31/20XX & 12/31/20XX

was to any of the related parties or to CO-8, so there is no explanation as to why CO-9's debt obligation is reduced from those of CO-8 or the related parties.

The alleged loan is then further discounted inexplicably by another \$ as "interest forgiveness" and then again by another \$\$\$. The \$\$\$ discount is supposed to be in satisfaction of an alleged loan that the Organization took out from Trustee. There is no evidence that the Organization ever took out such a loan from Trustee. There are no historical quotes for CO-12 stock available prior to April 7, 20XX. The only information available for the fair market value of the stock at the time of the transfer is disclosed in CO-12's 20XX and 20XX, Form(s) 10-KSB, that are filed with the Security and Exchange Commission. The Service's numerous requests for the Organization to provide proof of CO-12's \$ value at the time of the transfer were ignored. The Organization never provided any such records.

The CO-7 also transferred 70,000 shares of CO-12 stock, with an alleged valued of \$ per share, in an attempt to satisfy in one transfer, "loans" totaling \$\$\$ to Development, RA-2, RA-9, RA-8, and RA-6. Apparently the CO-7 was willing to satisfy these loans because Development and the named individuals had some sort of a relationship. This relationship was never clarified. There is also no evidence that these payments were actual loans. And again, the alleged value of these stocks could not be verified.

Most of the alleged investments, loans and lines of credit were actually just payments to Trustee and Donor. As the facts clearly show, the Organization's primary purpose was to operate as an entity to personally benefit Trustee and Donor. The Family did this by creating the Organization and then using its tax exempt status to personally enrich themselves by transferring what would otherwise be tax generating income to the Organization (hence avoiding income taxes) and then taking tax deductions as "charitable donations" for those transfers. Family then drained the Organization's funds through alleged investments and loans/lines of credit. The Organization's partnership interests in CO-5 also had an added benefit of flowing through partnership income to the Organization.

The Family tried to give the appearance of propriety by recusing themselves on the record of voting for these "loans" and "investments" (except for the purported loans and investments to which they did not have such obviously apparent interests) in an attempt to make these transactions appear as if they were done at arm's-length. For example, the board minutes all state that any investment would be accompanied by an independent appraisal of its value. The Organization was not able to provide any evidence of value appraisals for any of the alleged investments.

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service <b>Explanation of Items</b>	Schedule No. or Exhibit
<b>Name of Taxpayer</b>  ORG EIN: EIN		<b>Year/Period Ended</b> 12/31/20XX 12/31/20XX & 12/31/20XX

Further, even some of the alleged third-party loans were not even to actual third parties. Even though Trustee and Donor did not recuse themselves from approving those "loans," the payments to RA-6, RA-9, RA-8, and RA-2 appear to have been payments to the CO-7, as the CO-7 ended up "repaying" the loans to these individuals. In addition, while the board minutes and the Forms 990 would report alleged loans and state some of the loans' terms, the Organization was not able to provide any written proof of the alleged loans or any payments on these alleged loans.

The Organization issued unsecured lines of credit and loans to three partnerships wholly owned by Trustee and/or Donor. The returns indicate there was some interest payments received on the loans, but it is unclear as to how much and for which loans the payments were made. The Organization did not provide any promissory notes or other documentation to support evidence of indebtedness. There was no indication that the profitability or the income stream of the partnerships was considered prior to issuance of the loans. The loans were paid back by a donation of CO-12, (the value of which was never substantiated by the Organization), from The Trustee and Donor Remainder Trust. The facts show that the partnerships had no intention of paying back the loans and the Organization had no intention of enforcing payment.

A significant portion of Trustee' initial contributions were "loaned" back to his wholly owned partnerships and disqualified persons. The purported loans do not meet the criteria for bona-fide loan for federal income tax purposes. Facts that show a charity's investments are decided in part by the needs of private interests indicate the charity may not be operated exclusively for exempt purposes. Western Catholic Church v. Commissioner, 73 T.C. 196, 214 (1979), affd 631 F.2d 736 (7<sup>th</sup> Cir. 1980).

The facts show that the Organization is not operated exclusively for a tax exempt charitable purpose. Rather, Trustee & Donor operated the Organization for their own personal benefit. The facts also show that Family allowed his wholly owned partnerships and other private individuals to financially benefit from the assets that he transferred to the Organization.

The Organization, which is controlled by Trustee & Donor, was established and operated to enable them to engage in financial activities which are beneficial to them. Accordingly, it is operated for a substantial non-exempt purpose. See Revenue Ruling 67-5.

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 charitable assets are dedicated to exclusively furthering public purposes.

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service <b>Explanation of Items</b>	Schedule No. or Exhibit
<b>Name of Taxpayer</b>  ORG EIN: EIN		<b>Year/Period Ended</b> 12/31/20XX 12/31/20XX & 12/31/20XX

An organization is not operated exclusively for exempt purposes if its net earnings inure to the benefit of private shareholders or individuals.

A gift to a charitable organization must be a voluntary transfer of money or property without the receipt of adequate consideration, made with charitable intent. Hernandez v. Commissioner, 490 U.S. 680, 690 (1980). To claim a deduction under section 170, a donor must surrender dominion and control over the gift. United States v. Estate Preservation Services, 202 F.3d 1093, 1101 (9<sup>th</sup> Cir. 2000). The Family transferred assets to the Organization and claimed a deduction under section 170. A charity's assets are required to be irrevocably dedicated to charitable purposes. Treas. Reg. § 1.501(c)(3)-1(b)(4). The inurement prohibition serves to prevent the individuals who operate the charity from siphoning off any of a charity's income or assets for personal use. By transferring the assets back to disqualified persons, purportedly as a loan, a loan that does not meet the criteria of a bona-fide loan for federal income tax purposes, but as a distribution, the Organization breached the dedication requirement and its net earnings have inured to the benefit of the disqualified persons.

**CONCLUSION:**

Accordingly, the Organization's status as an organization described under section 501(c)(3) should be revoked because it did not operate exclusively for exempt purposes because its assets inured to, and it served the private interests of, its creators and other private persons.

This determination is effective beginning January 1, 19XX. The Organization did not disclose in its exemption application that it would be making loans with a substantial portion of its assets to disqualified persons at favorable terms. Thus, retroactive revocation is applicable.

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

Returns should be sent to the following mailing address:

**ALTERNATIVE ISSUE** : Whether the ORG should be reclassified as a private foundation.

**FACTS:**

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service <b>Explanation of Items</b>	Schedule No. or Exhibit
<b>Name of Taxpayer</b>		<b>Year/Period Ended</b>
ORG EIN: EIN		12/31/20XX 12/31/20XX & 12/31/20XX

The Organization paid out \$ or % of its total income, to the Primary Charity in 20XX. The Organization's total income for that year was \$. The Service has no record of the CO-2, the Primary Charity, filing a Form 990 for the tax year ended December 31, 20XX.

The returns and the records provided by the Organization indicate that no payments were made to the Primary Charity in 20XX or 20XX. The Organization's income for 20XX was \$. The Organization reported a net loss for the 20XX tax year.

The Forms 990 do not reflect the changes in the composition of the board of directors that purportedly took place at the board meetings.

**LAW:**

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

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

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

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

(1) *Permissible beneficiaries.* —A supporting organization will be regarded as "operated exclusively" to support one or more specified publicly supported organizations (hereinafter referred to as the "operational test") only if it engages solely in activities which support or benefit the specified publicly supported organizations. Such activities may include making payments to or for the use of, or providing services or facilities for, individual members of the charitable class benefited by the specified publicly supported organization. A supporting organization may also, for example, make a payment indirectly through another unrelated organization to a member of a charitable class benefited by a specified publicly supported organization, but only if such a payment constitutes a grant to an individual rather than a grant to an organization. In determining whether a grant is indirectly to an individual rather than to an organization the same standard shall be applied as in

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service <b>Explanation of Items</b>	Schedule No. or Exhibit
<b>Name of Taxpayer</b>  ORG EIN: EIN		<b>Year/Period Ended</b> 12/31/20XX 12/31/20XX & 12/31/20XX

§53.4945-4(a)(4) of this chapter. Similarly, an organization will be regarded as "operated exclusively" to support or benefit one or more specified publicly supported organizations even if it supports or benefits an organization, other than a private foundation, which is described in section 501(c)(3) and is operated, supervised, or controlled directly by or in connection with such publicly supported organizations, or which is described in section 511(a)(2)(B). However, an organization will not be regarded as operated exclusively if any part of its activities is in furtherance of a purpose other than supporting or benefiting one or more specified publicly supported organizations.

(2) *Permissible activities.* —A supporting organization is not required to pay over its income to the publicly supported organizations in order to meet the operational test. It may satisfy the test by using its income to carry on an independent activity or program which supports or benefits the specified publicly supported organizations. All such support must, however, be limited to permissible beneficiaries in accordance with subparagraph (1) of this paragraph. The supporting organization may also engage in fund raising activities, such as solicitations, fund raising dinners, and unrelated trade or business to raise funds for the publicly supported organizations, or for the permissible beneficiaries.

Income Tax Regulations section 1.509(a)-4(f) regarding the nature of relationships required for section 509(a)(3) organizations provides:

(1) *In general.* —Section 509(a)(3)(B) describes the nature of the relationship required between a section 501(c)(3) organization and one or more publicly supported organizations in order for such section 501(c)(3) organization to qualify under the provisions of section 509(a)(3). To meet the requirements of section 509(a)(3), an organization must be operated, supervised, or controlled by or in connection with one or more publicly supported organizations. If an organization does not stand in one of such relationships (as provided in this paragraph) to one or more publicly supported organizations, it is not an organization described in section 509(a)(3).

(2) *Types of relationships.* —Section 509(a)(3)(B) sets forth three different types of relationships, one of which must be met in order to meet the requirements of subparagraph (1) of this paragraph. Thus, a supporting organization may be:

- (i) Operated, supervised, or controlled by,
- (ii) Supervised or controlled in connection with, or
- (iii) Operated in connection with, one or more publicly supported organizations.

(3) *Requirements of relationships.* —Although more than one type of relationship may exist in any one case, any relationship described in section 509(a)(3)(B) must insure that:

(i) The supporting organization will be responsive to the needs or demands of one or more publicly supported organizations; and

(ii) The supporting organization will constitute an integral part of, or maintain a significant involvement in, the operations of one or more publicly supported organizations.

(4) *General description of relationships.* —In the case of supporting organizations which are "operated, supervised, or controlled by" one or more publicly supported organizations, the distinguishing feature of this type of relationship is the presence of a substantial degree of direction by the publicly supported organizations over the conduct of the supporting organization,

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service <b>Explanation of Items</b>	Schedule No. or Exhibit
<b>Name of Taxpayer</b>  ORG EIN: EIN		<b>Year/Period Ended</b> 12/31/20XX 12/31/20XX & 12/31/20XX

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

Income Tax Regulations section 1.509(a)-4(g)(1) provides guidance on the meaning of "operated, supervised, or controlled by" as follows:

(i) Each of the items "operated by", "supervised by", and "controlled by", as used in section 509(a)(3)(B), presupposes a substantial degree of direction over the policies, programs, and activities of a supporting organization by one or more publicly supported organizations. The relationship required under any one of these terms is comparable to that of a parent and subsidiary, where the subsidiary is under the direction of, and accountable or responsible to, the parent organization. This relationship is established by the fact that a majority of the officers, directors, or trustees of the supporting organization are appointed or elected by the governing body, members of the governing body, officers acting in their official capacity, or the membership of one or more publicly supported organizations.

(ii) A supporting organization may be "operated, supervised or controlled by" one or more publicly supported organizations within the meaning of section 509(a)(3)(B) even though its governing body is not comprised of representatives of the specified publicly supported organizations for whose benefit it is operated within the meaning of section 509(a)(3)(A). A supporting organization may be "operated, supervised, or controlled by" one or more publicly supported organizations (within the meaning of section 509(a)(3)(B)) and be operated "for the benefit of" one or more different publicly supported organizations (within the meaning of section 509(a)(3)(A)) only if it can be demonstrated that the purposes of the former organizations are carried out by benefiting the latter organizations.

Income Tax Regulations section 1.509(a)-4(h) provides guidance on the meaning of "supervised or controlled in connection with" as follows:

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

(2) A supporting organization will not be considered to be "supervised or controlled in connection with" one or more publicly supported organizations if such organization merely makes payments (mandatory or discretionary) to one or more named publicly supported organizations, even if the obligation to make payments to the named beneficiaries is enforceable under state law by such beneficiaries and the supporting organization's governing instrument contains provisions whose

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service <b>Explanation of Items</b>	Schedule No. or Exhibit
<b>Name of Taxpayer</b>		<b>Year/Period Ended</b>
ORG		12/31/20XX
EIN: EIN		12/31/20XX & 12/31/20XX

effect is described in section 508(e)(1)(A) and (B). Such arrangements do not provide a sufficient "connection" between the payor organization and the needs and requirements of the publicly supported organization to constitute supervisions or control in connection with such organizations.

Income Tax Regulations section 1.509(a)-4(i) provides guidance on the meaning of "operated in connection with" as follows:

(1) *General rule*

(i) Except as provided in subdivisions (ii) and (iii) of this subparagraph and subparagraph (4) of this paragraph, a supporting organization will be considered as being operated in connection with one or more publicly supported organizations only if it meets the "responsiveness test" which is defined in subparagraph (2) of this paragraph and the "integral part test" which is defined in subparagraph (3) of this paragraph.

....

(2) *Responsiveness test*

(i) For purposes of this paragraph, a supporting organization will be considered to meet the "responsiveness test" if the organization is responsive to the needs or demands of the publicly supported organizations within the meaning of this subparagraph. In order to meet this test, either subdivision (ii) or subdivision (iii) of this subparagraph must be satisfied.

(ii)

(a) One or more officers, directors, or trustees of the supporting organization are elected or appointed by the officers, directors, trustees, or membership of the publicly supported organizations;

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

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

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

(iii)

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

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

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

(3) *Integral part test; general rule*

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service <b>Explanation of Items</b>	Schedule No. or Exhibit
<b>Name of Taxpayer</b>  ORG EIN: EIN		<b>Year/Period Ended</b> 12/31/20XX 12/31/20XX & 12/31/20XX

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

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

(iii)

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

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

....

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

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service <b>Explanation of Items</b>	Schedule No. or Exhibit
<b>Name of Taxpayer</b>  ORG EIN: EIN		<b>Year/Period Ended</b> 12/31/20XX 12/31/20XX & 12/31/20XX

that the required degree of attentiveness will be present. However, in determining whether the amount received from the supporting organization is sufficient to insure the attentiveness of the beneficiary organization to the operations of the supporting organization (including attentiveness to the nature and yield of such supporting organization's investments), evidence of actual attentiveness by the beneficiary organization is of almost equal importance. An example of acceptable evidence of actual attentiveness is the imposition of a requirement that the supporting organization furnish reports at least annually for taxable years beginning after December 31, 1971, to the beneficiary organization to assist such beneficiary organization in insuring that the supporting organization has invested its endowment in assets productive of a reasonable rate of return (taking appreciation into account) and has not engaged in any activity which would give rise to liability for a tax imposed under sections 4941, 4943, 4944, or 4945 if such organization were a private foundation. The imposition of such requirement within 120 days after October 16, 1972, will be deemed to have retroactive effect to January 1, 1970, for purposes of determining whether a supporting organization has met the requirements of this subdivision for its first two taxable years beginning after December 31, 1969. The imposition of such requirement is, however, merely one of the factors in determining whether a supporting organization is complying with this subdivision and the absence of such requirement will not preclude an organization from classification as a supporting organization based on other factors.

(e) However, where none of the beneficiary organizations is dependent upon the supporting organization for a sufficient amount of the beneficiary organization's support within the meaning of this subdivision, the requirements of this subparagraph will not be satisfied, even though such beneficiary organizations have enforceable rights against such organization under State law.

### **GOVERNMENT'S POSITION:**

As set forth above, it is the government's primary position that the tax exempt status of the Trustee and Donor Charitable Support Foundation (the "Organization") should be revoked. Alternatively, the Organization should be reclassified as a private foundation.

Due to Congressional concerns about wide-spread abuses of their tax-exempt status by private foundations, private foundations were defined and subjected to significant regulations and controls by the Tax Reform Act of 1969. The definition of a private foundation is intentionally inclusive so that all organizations exempted from tax by IRC § 501(c)(3) are private foundations except for those specified in IRC § 509(a)(1) through(4). Roe Foundation Charitable Trust v. Commissioner, T.C. Memo. 1989-566; Quarrie Charitable Fund v. Commissioner, 603 F.2d 1274, 1277 (7<sup>th</sup> Cir. 1979). The Organization currently is excepted from private foundation status because it is currently classified as an organization described in section 509(a)(3), which defines supporting organizations.

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service <b>Explanation of Items</b>	Schedule No. or Exhibit
<b>Name of Taxpayer</b>  ORG EIN: EIN		<b>Year/Period Ended</b> 12/31/20XX 12/31/20XX & 12/31/20XX

Public charities (organizations described in section 501(c)(3) that meet the requirement of sections 509(a)(1) or (2)) are excepted from private foundation status on the theory that their exposure to public scrutiny and their dependence on public support keep them from the abuses to which private foundations are subject. Supporting organizations are similarly excepted from private foundation status. Supporting organizations are excepted if they are subject to the scrutiny of public charities that provide sufficient oversight to keep supporting organizations from the types of abuses to which private foundations are prone. Quarrie, 603 F.2d at 1277-78.

To be classified as a Section 509(a)(3) organization, the Organization must meet all of the following tests:

- 1) Organizational and Operational Tests under section 509(a)(3)(A).
- 2) Relationship Test under section 509(a)(3)(B).
- 3) Lack of Disqualified Person Control Test under section 509(a)(3)(C).

Overall, these tests are meant to ensure that a supporting organization is responsive to the needs of a public charity and intimately involved in its operations and that the public charity (or publicly supported organization) is motivated to be attentive to the operations of the supporting organization and that it is not controlled, directly or indirectly, by disqualified persons.

### Organizational and Operational Tests

The Organization is not organized to benefit one or more specified publicly supported organizations. Pursuant to Treas. Reg. § 1.509(a)-4(c)(1)(iii) and (iv), an organization's governing instrument must state the specified publicly supported organization(s) on whose behalf the organization is to be operated and cannot expressly empower the organization to support or benefit any organizations other than the specified publicly supported organization(s). The Organization's dissolution clause allows distributions to organizations other than the specified publicly supported organizations upon termination of the Organization. The possible beneficiaries are not limited to CO-2 or to the organizations specified on Schedule A of the Organization's Declaration. Therefore, the organizational test is not met. See Quarrie, supra (holding that the organizational test was not satisfied where the trustee had the power to substitute beneficiaries when, in the judgment of the trustee, the uses of the named beneficiaries became unnecessary, undesirable, impracticable, impossible or no longer adapted to the needs of the public).

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

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service <b>Explanation of Items</b>	Schedule No. or Exhibit
<b>Name of Taxpayer</b>  ORG EIN: EIN		<b>Year/Period Ended</b> 12/31/20XX 12/31/20XX & 12/31/20XX

specified publicly supported organization(s) only if it engages in activities which support or benefit the specified publicly supported organizations(s). As was discussed under the Primary Issue above, the Organization has served private interests. Therefore, it has not established that it operated exclusively for the benefit of the publicly supported organizations.

The operational test requires the Organization to exclusively engage in activities that benefit specified publicly supported organizations. In this case the Organization made a contribution to the Primary Charity that totaled % of its total income for the tax year 20XX and in 20XX and 20XX the Organization made no payments to the Primary Charity. The Declaration states the Organization will grant at least % of the net income of the Trust. The 20XX Form 990 indicates grants were made to six different Organizations one of which included the Primary Charity. The remaining five Organizations were not specified on the Declaration. The Organization made no grants in 20XX and yet received \$ in income. Inadequate grants to the Primary Charity and grants to an organization not specified to receive grants violates the operational test.

### Relationship Test

As set forth in Treas. Reg. § 1.509(a)-4(f)(2), there are three permissible relationships: (a) operated, supervised, or controlled by; (b) supervised or controlled in connection with; and (c) operated in connection with one or more publicly supported organizations.

The relationships "operated, supervised or controlled by" and "supervised or controlled in connection with" presuppose a substantial degree of direction over the policies, programs and activities of the supporting organization by a publicly supported organization. The "operated, supervised or controlled by" relationship is established by the fact that a majority of the officers, directors, or trustees of the supporting organization are appointed or elected by the governing body, members of the governing body, officers acting in their official capacity or the membership of the publicly supported organization. Only one board member out of a 3-5 member board was appointed by the supported organization so the requirements to have an "Operated, supervised, or controlled by" relationship are not met. The "supervised or controlled in connection with" relationship is established by the fact that there is common supervision or control by the persons supervising or controlling both the supporting and the publicly supported organizations (*i.e.*; that control or management of the supporting organization is vested in the same persons that control or manage the publicly supported organization). The same persons do not control or manage both organizations so this relationship is not met.

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service <b>Explanation of Items</b>	Schedule No. or Exhibit
<b>Name of Taxpayer</b>  ORG EIN: EIN		<b>Year/Period Ended</b> 12/31/20XX 12/31/20XX & 12/31/20XX

The third and final relationship possible for section 509(a)(3) organizations is the "operated in connection with" relationship which requires that the supporting organization be responsive to the needs or demands of the publicly supported organization and constitute an integral part of, or maintain a significant involvement in the affairs of, the publicly supported organization. This relationship is satisfied where the supporting organization meets both the "responsiveness" and "integral part" tests.

The Organization meets the responsiveness test. The responsiveness test guarantees that the publicly supported organization can influence the activities of the supporting organization. DIR-1 has been a Board member of the Organization since its inception and throughout that same time frame, he held the position of Treasurer of the designated charity. See subdivision (ii) of Treas. Reg. 1.509(a)-4(i)..

The integral part test ensures that the publicly supported organization will be motivated to attend to the operations of the supporting organization. The integral part test has not been met in this case. The integral part test is considered to have been satisfied if the supporting organization maintains a significant involvement in the operations of one or more publicly supported organizations and the publicly supported organizations are in turn dependent upon the supporting organization for the type of support which it provides. Treas. Reg § 1.509(a)-4(i)(3)(i). In order to meet the integral part test, either Treas. Reg. § 1.509-4(i)(3)(ii) or (iii) must be satisfied.

Treas. Reg. § 1.509(a)-4(i)(3)(ii) provides that the activities engaged in for or on behalf of the publicly supported organizations must be activities to perform the functions of, or to carry out the purposes of, such organizations and, but for the involvement of the supporting organization, would normally be engaged in by the publicly supported organizations themselves. Thus, this part of the integral part test applies in those situations in which the supporting organization actually engages in activities which benefit the publicly supported organizations as opposed to simply making grants to the publicly supported organizations. Compare to Treas. Reg. § 1.509(a)-4(i)(3)(iii) (which sets forth the rules of the integral part test applicable to supporting organizations that make payments to or for the use of publicly supported organizations), see also Roe Foundation, T.C. Memo. 1989-566; Cuddeback Memorial Fund v. Commissioner, T.C. Memo. 2000-300. The Organization does not meet this test because, while it made some grants to publicly supported organizations, it did not perform any activities for or on behalf of the publicly supported organizations.

Because the Organization did not perform any activities for publicly supported organizations, the applicable rules for satisfying the integral part test are in Treas. Reg. § 1.509(a)-4(i)(3)(iii). This section of the regulation has the following 3 basic requirements: 1) payment of substantially all of its income to publicly supported

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service <b>Explanation of Items</b>	Schedule No. or Exhibit
<b>Name of Taxpayer</b>		<b>Year/Period Ended</b>
ORG		12/31/20XX
EIN: EIN		12/31/20XX & 12/31/20XX

organizations; 2) the amount received by one publicly supported organization must be sufficient to motivate it to pay attention to the operations of the supporting organization; and 3) a substantial amount of the total support of the organization must go to those publicly supported organizations that meet the attentiveness requirement. The first and second requirements are not satisfied. Because it has not met the second requirement, it cannot meet the third requirement.

The regulations do not specify what percentage of a supported organization's support must be received from a supporting organization to meet the integral part test. The requirement is that facts and circumstances show that the support is sufficient to ensure that the supported organization is attentive to the operations of the supporting organization. Reg. 1.509(a)-4(i)(3)(iii). Treas. Reg. § 1.509(a)-4(i)(3)(iii)(b) provides that a supporting organization can meet the attentiveness requirement, even where the amount of support received by the publicly supported organization does not represent a sufficient part of the publicly supported organization's total support, if it can be demonstrated that support is earmarked for a substantial program of the publicly supported organization that would be interrupted without the supporting organization's support. And finally, Treas. Reg. § 1.509(a)-4(i)(3)(d) provides that "[a]ll pertinent factors. . . will be considered in determining whether the amount of support received by a publicly supported organization is sufficient to insure the attentiveness of such organization to the operations of the supporting organization." It goes on to note the importance of the percentage of the income received from the supporting organization is in determining if the publicly supported organization will have the requisite degree of attentiveness and concludes that evidence of actual attentiveness is almost as important.

The Organization contributed % of its income to the CO-2 in the 20XX tax year and made no contributions to the Primary Charity in the 20XX tax year. The Organization's net income for 20XX was \$. The Organization incurred a loss in 20XX.

The tax returns for the CO-2 indicate they received \$ in total revenue for the 20XX tax year and \$ in 20XX. There is no record that the CO-2 filed a tax return for the 20XX tax year.

The Organization did not produce any evidence that shows that the CO-2 would be attentive to its operations. The Forms 990 are inconsistent with what the Board minutes state in regards to who are the members of the Board of directors. There is no indication that CO-2 ever requested or received any financial reports from the Organization. The facts show that this organization was not attentive to the operations of the Organization.

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service <b>Explanation of Items</b>	Schedule No. or Exhibit
<b>Name of Taxpayer</b>  ORG EIN: EIN		<b>Year/Period Ended</b> 12/31/20XX 12/31/20XX & 12/31/20XX

### **Control Test**

Treas. Reg. § 1.509(a)-4(j)(1) provides that for purposes of section 509(a)(3)(C), an organization will be considered "controlled" if the person, by reason of his position or authority, may require the organization to perform any act which significantly affects its operations or prevents such organization from performing such act. All facts and circumstances are taken into consideration in determining whether a disqualified person controls an organization.

The facts in this case show that most of the Organization's assets are tied up in loans or investments owned and operated by the Founder, Trustee and/or his wife, Donor. Treas. Reg. § 1.509(a)-4(j) requires a consideration of the Organization's holdings to determine if a disqualified person exerts direct or indirect control. As previously stated, most of the Organization's assets are tied up in loans and/or investments with the Founder and his wife. Therefore, the control test is not satisfied in this case.

### **CONCLUSION:**

Accordingly, if its exempt status is not revoked, the Organization should be reclassified as a private foundation because it does not qualify as a supporting organization under the requirements set forth in Treas. Reg. § 1.509(a)-4(c) through (i).

This modification of private foundation status is effective beginning January 1, 20XX. It failed to disclose that it would distribute substantially all of its assets to its founder's wholly owned partnerships. Thus, retroactive reclassification is appropriate.

The effect of this determination will be that the Organization is required to file Form 990-PF Return of Private Foundation. Form 990-PF should be filed for tax years ending December 31, 20XX, 20XX, and 20XX.

Send your returns to the following mailing address:

#### **Note:**

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

Form 886A	Department of the Treasury - Internal Revenue Service	Schedule No. or Exhibit
Explanation of Items		
Name of Taxpayer		Year/Period Ended
EIN:		12/31/
		12/31/ &
		12/31/

**ISSUES:**

If the Organization is held to be a private foundation, whether the is liable for the tax on net investment income under IRC § 4940 and taxes on failure to distribute income under IRC § 4942.

**FACTS:**

The Organization's assets consist of cash, securities, and receivables that generate interest income. The income generated is supposed to be annually distributed to IRC § 501(c)(3) organizations.

The Organization's Forms 990 reflect the following:

TY

Contributions, gifts, grants  
(Direct public support)

Interest on savings  
and temporary cash  
investments  
Dividends \$

Other investment  
income

Total revenue

Grants

Other expenses

Total Expenses

Excess or (Deficit) for Year

<sup>1</sup> This amount represents unidentified investment income less the losses incurred from the Organization's partnership interests in .

<sup>2</sup> Amount received from

<sup>3</sup> The alleged losses that the Organization incurred from its partnership interests in

Form 886A	Department of the Treasury - Internal Revenue Service <b>Explanation of Items</b>	Schedule No. or Exhibit
Name of Taxpayer	Year/Period Ended 12/31/ 12/31/ & 12/31/	

**Balance Sheet**

Savings and temporary cash investments

Investments -- securities

Investments -- other

Total assets

Other liabilities

0

Total liabilities

0

Total liabilities and net assets /fund balances

The following grants to charitable organizations have been made:

TY

0

0

6  
6

Form 886A	Department of the Treasury - Internal Revenue Service	Schedule No. or Exhibit
Name of Taxpayer	Explanation of Items	Year/Period Ended 12/31/ 12/31/ & 12/31/

**LAW:**

IRC § 4940(a) imposes a tax on each private foundation which is exempt from taxation under IRC § 501(a) for the taxable year, with respect to the carrying on of its activities, a tax equal to 2 percent of the net investment income of such foundation for the taxable year.

IRC § 4940(c)(1) defines net investment income as the amount by which the sum of the gross investment income and the capital gain net income exceeds the deductions allowed by IRC § 4940(c)(3).

IRC § 4940(c)(2) defines the term "gross investment income" as the gross amount of income from interest, dividends, rents, payments with respect to securities loans and royalties, but not including any such income to the extent included in computing tax imposed by IRC § 511.

IRC § 4940(c)(3) defines deductions as all ordinary and necessary expenses paid or incurred for the production or collection of gross investment income or for the management, conservation, or maintenance of property held for the production of such income.

IRC § 4942(a) imposes a tax on the undistributed income of a private foundation for any taxable year, which has not been distributed before the first day of the second taxable year following such taxable year, a tax equal to 15 percent of the amount of such income remaining undistributed at the beginning of such second taxable year.

IRC § 4942(b) imposes an additional tax in any case in which an initial tax is imposed under IRC § 4942(a) on the undistributed income of a private foundation for any taxable year, if any portion of such income remains undistributed at the close of the taxable period, there is hereby imposed a tax equal to 100 percent of the amount remaining undistributed at such time.

IRC § 4942(c) defines the term "undistributed income" as with respect to any private foundation for any taxable year as of any time, the amount by which the distributable amount for such taxable year exceeds the qualifying distributions made before such time out of such distributable amount.

IRC § 4942(d) defines distributable amount as with respect to any private foundation for any taxable year, an amount equal to the sum of the minimum investment return plus amounts described in IRC § 4942(f)(2)(c), income modifications, reduced by the sum of the taxes imposed on such private foundation for the taxable year under IRC § 4940.

Form 886A	Department of the Treasury - Internal Revenue Service	Schedule No. or Exhibit
	<b>Explanation of Items</b>	
Name of Taxpayer		Year/Period Ended 12/31/ 12/31/ & 12/31/

IRC § 4942(e) defines minimum investment return for any private foundation for any taxable year as 5 percent of the excess of the aggregate fair market value of all assets of the foundation other than those which are used directly in carrying out the foundation's exempt purpose, over the acquisition indebtedness with respect to such assets.

Regulation section 53.4942(a)-2(c)(3) defines assets used (or held for use) in carrying out the exempt purpose as an asset that is actually used by the foundation in the carrying out of the charitable, educational, or other similar purpose which gives rise to the exempt status of the foundation, or if the foundation owns the asset and establishes to the satisfaction of the Commissioner that its immediate use for such exempt purpose is not practical (based on the facts and circumstances of the particular case) and that definite plans exist to commence such use within a reasonable period of time. Consequently, assets which are held for the production of income or for investment (for example, stocks, bonds, interest-bearing notes, endowment funds, or, generally, leased real estate) are not being used (or held for use) directly in carrying out the foundation's exempt purpose, even though the income from such assets is used to carry out such exempt purpose.

Regulation section 53.4942(a)3(b)4 defines the minimum distribution required during start-up period for private foundations created before January 1, 1972, the start-up period is the four taxable years immediately preceding the taxable year beginning in calendar year 1976. For private foundations created after December 31, 1971 (or for organizations that first become private foundations after that date), the start-up period is the four taxable years following the taxable year in which the private foundation was created (or otherwise became a private foundation). For purposes of this subparagraph (4), a private foundation will be considered "created" in the taxable year in which the private foundation's distributable amount (as determined under section 4942(d)) first exceeds \$500.

(ii) Start-up period minimum amount. The amount that a private foundation must actually distribute in cash or its equivalent during the private foundation's start-up period is not less than the sum of:

- (a) Twenty percent of the private foundation's distributable amount (as determined under section 4942(d)) for the first taxable year of the start-up period,
- (b) Forty percent of the private foundation's distributable amount for the second taxable year of the start-up period,
- (c) Sixty percent of the private foundation's distributable amount for the third taxable year of the start-up period, and

Form 886A	Department of the Treasury - Internal Revenue Service	Schedule No. or Exhibit
<b>Explanation of Items</b>		
Name of Taxpayer		Year/Period Ended
		12/31/
		12/31/ &
		12/31/

(d) Eighty percent of the private foundation's distributable amount for the fourth taxable year of the start-up period.

(iii) Timing of distributions. The requirement that a private foundation distribute the start-up period minimum amount during the start-up period is a requirement that such amount be distributed before the end of the start-up period, and is not a requirement that any portion of such amount be distributed in any one taxable year of the start-up period.

### **GOVERNMENTS POSITION**

#### **Issue**

If the Organization is held to be a private foundation, whether the Organization is liable for the tax on net investment income under IRC § 4940 and taxes on failure to distribute income under IRC § 4942.

The Organization's assets consist of cash, securities, and receivables that generate interest income. The income generated is supposed to be annually distributed to IRC § 501(c)(3) organizations.

The interest income is subject to the net investment tax of 2% imposed by IRC § 4940(a). The Organization does not qualify for the 1% rate reduction for computing the net investment tax under IRC § 4940(e) because the organization did not make any qualifying distributions in the , and tax years therefore, the Organization is liable for IRC § 4942 tax in the base years.

Form 886A	Department of the Treasury - Internal Revenue Service	Schedule No. or Exhibit
Explanation of Items		Year/Period Ended
Name of Taxpayer		12/31/ 12/31/ & 12/31/

The amounts shown in the following computations considers the above and were disclosed on the Organization's Form(s) 990 for through

The tax for IRC § 4940(a) is only applicable for the and tax years because the statute of limitations expired for the and tax years. IRC 6501(e)(1).

**IRC § 4940(a) Net Investment Income tax**

Year

Net Investment Income

Rate

**IRC § 4942(a) Taxes on failure to distribute income**

Year

Fair market value of assets

Less 1 ½ % cash deemed held for charitable activities

Net value of noncharitable-use assets

Minimum investment return rate

Minimum investment return

Less  
IRC § 4940(a)

Form 886A	Department of the Treasury - Internal Revenue Service	
Explanation of Items		
Name of Taxpayer		Year/Period/ended
		12/31/
		12/31/
		12/31

Distributable amount  
IRC § 4942(d)

Rate for start up period \_\_\_\_\_

Start up period Minimum  
distributable amount -  
Treas. Reg. 53.4942(a)3(b)4

Less expenses - 4942(g)    0            0            0            0            0            0

Adjusted  
Qualifying distributions                    0            0            0            0            0

LESS:  
Start up period Minimum  
distributable amount -  
Treas. Reg. 53.4942(a)3(b)  
excess distributions  
Carryover

Carryover amount applied to

The tax for IRC § 4942(a) and 4942(b) is only applicable for the  
tax years due because the statute of limitations expired for the  
tax years. See IRC 6501(e)(1).

and  
and

Minimum distributable  
amount less Adjusted  
qualifying distribution

Form 886A	Department of the Treasury - Internal Revenue Service	Schedule No. or Exhibit
Name of Taxpayer	Explanation of Items	Year/Period Ended 12/31/ 12/31/ & 12/31/

**Additional tax under IRC § 4942(b)**

In any case in which an initial tax is imposed under IRC § 4942(a) on the undistributed income of a private foundation for any taxable year, if any portion of such income remains undistributed at the close of the taxable period, there is hereby imposed a tax equal to 100 percent of the amount remaining undistributed at such time.

Year

Undistributed income	_____	_____	_____	_____
Total tax under IRC § 4942(b)	0	0	0	0

**CONCLUSION:**

Accordingly, the Organization is liable for the tax on net investment income under IRC §§ 4940, and 4942.