



DEPARTMENT OF THE TREASURY

INTERNAL REVENUE SERVICE

1100 Commerce Street

Dallas, TX 75242

501.03-00

TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

Date: Aug. 12, 2013

Release Number: 201423029

Release Date: 6/6/2014

LEGEND

ORG - Organization name

.XX - Date Address - address

ORG

ADDRESS

**Person to Contact:**

**Badge Number:**

**Contact Telephone Number:**

**Contact Address:**

**Employer Identification Number:**

**CERTIFIED MAIL**

Dear :

This is a final notice of adverse determination that your exempt status under section 501(c)(3) of the Internal Revenue Code is revoked. Recognition of your exemption under Internal Revenue Code section 501(c)(3) is revoked effective January 1, 20XX for the following reason(s):

You are not operated exclusively for an exempt purpose as required by Internal Revenue Code section 501(c)(3). You are not and have not been engaged primarily in activities which accomplish one or more exempt purposes. You are not a charitable organization within the meaning of Treasury Regulation 1.501(c)(3)-1(d); rather, your activities further a substantial nonexempt commercial purpose and serve private rather than public interests.

Because you did not protest the proposed modification of your non-private foundation status and have indicated your agreement by signing the Form 6018 on May 08, 20XX, it is further determined that you have not exhausted your available remedies for purposes of declaratory judgment under section 7428 of the Code.

Contributions to your organization are no longer deductible.

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

It is further determined that your failure to file a written appeal constitutes a failure to exhaust your available administrative remedies. However, if you decide to contest this determination in court, you must initiate a suit for declaratory judgment in the United States Tax Court, the United States Claims Court, or the district court of the United States for the District of Columbia before the (ninety-first) 91st day after the date that this determination was mailed to you. Contact the clerk of the appropriate court for rules for initiating suits for declaratory judgment.

To secure a petition form, write to the following address: United States Tax Court, 400 Second Street, NW, Washington, DC 20217.

Please understand that filing a petition for a declaratory judgment under IRC section 7428 will not delay the processing of subsequent income tax returns and assessment of any taxes due.

You also have the right to contact the Office of the Taxpayer Advocate. However, you should first contact the person whose name and telephone number are shown above since this person can access your tax information and can help you get answers. You can call 1-877-777-4778, and ask for the Taxpayer Advocate assistance or you can contact the Advocate from the site where this issue was determined by writing to:

Taxpayer Advocate assistance cannot be used as substitute for established IRS procedures, formal appeals processes, etc. The Taxpayer Advocate is not able to reverse legal or technically correct tax determination, nor extend the time fixed by law that you have to file a petition in 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.

This letter should be kept within your permanent records.

If you have any questions, please contact the person whose name and telephone number are shown above.

Sincerely,

Nanette M. Downing  
Director, EO Examinations

Enclosures:  
Publication 892



Department of the Treasury  
Internal Revenue Service  
Tax Exempt and Government Entities Division  
230 S. Dearborn Street, MC 4923 CHI, Room 1700  
Chicago, Illinois 60604

Date:  
April 16, 2013  
Taxpayer Identification Number:

Form:

Tax year(s) ended:

Person to contact / ID number:

Contact numbers:

Manager's name / ID number:

Manager's contact number:

Response due date:

ORG  
ADDRESS

### Certified Mail - Return Receipt Requested

Dear :

#### Why you are receiving this letter

We propose to revoke your status as an organization described in section 501(c)(3) of the Internal Revenue Code (Code). Enclosed is our report of examination explaining the proposed action.

#### What you need to do if you agree

If you agree with our proposal, please sign the enclosed Form 6018, *Consent to Proposed Action – Section 7428*, and return it to the contact person at the address listed above (unless you have already provided us a signed Form 6018). We'll issue a final revocation letter determining that you aren't an organization described in section 501(c)(3).

After we issue the final revocation letter, we'll announce that your organization is no longer eligible for contributions deductible under section 170 of the Code.

#### If we don't hear from you

If you don't respond to this proposal within 30 calendar days from the date of this letter, we'll issue a final revocation letter. Failing to respond to this proposal will adversely impact your legal standing to seek a declaratory judgment because you failed to exhaust your administrative remedies.

#### Effect of revocation status

If you receive a final revocation letter, you'll be required to file federal income tax returns for the tax year(s) shown above as well as for subsequent tax years.

#### What you need to do if you disagree with the proposed revocation

If you disagree with our proposed revocation, you may request a meeting or telephone conference with the supervisor of the IRS contact identified in the heading of this letter. You also may file a protest with the

IRS Appeals office by submitting a written request to the contact person at the address listed above within 30 calendar days from the date of this letter. The Appeals office is independent of the Exempt Organizations division and resolves most disputes informally.

For your protest to be valid, it must contain certain specific information including a statement of the facts, the applicable law, and arguments in support of your position. For specific information needed for a valid protest, please refer to page one of the enclosed Publication 892, *How to Appeal an IRS Decision on Tax-Exempt Status*, and page six of the enclosed Publication 3498, *The Examination Process*. Publication 3498 also includes information on your rights as a taxpayer and the IRS collection process. Please note that Fast Track Mediation referred to in Publication 3498 generally doesn't apply after we issue this letter.

You also may request that we refer this matter for technical advice as explained in Publication 892. Please contact the individual identified on the first page of this letter if you are considering requesting technical advice. If we issue a determination letter to you based on a technical advice memorandum issued by the Exempt Organizations Rulings and Agreements office, no further IRS administrative appeal will be available to you.

**Contacting the Taxpayer Advocate Office is a taxpayer right**

You have the right to contact the office of the Taxpayer Advocate. Their assistance isn't a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate can't reverse a legally correct tax determination or extend the time you have (fixed by law) to file a petition in a United States court. They can, however, see that a tax matter that hasn't 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:

Internal Revenue Service  
Office of the Taxpayer Advocate

**For additional information**

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,

Nan M. Downing  
Director, EO Examinations

Enclosures:  
Report of Examination  
Form 6018  
Publication 892  
Publication 3498

|                         |  |  |
|-------------------------|--|--|
| Form <b>886A</b>        | Department of the Treasury - Internal Revenue Service<br><b>Explanation of Items</b> | Schedule No. or<br>Exhibit Letter 3618 |
| <b>Name of Taxpayer</b> |  | <b>Year/Period Ended</b>               |
| ORG                     |  | 20XX/12<br>20XX/12<br>20XX/12          |

LEGEND

ORG - Organization name      XX - Date      Address - address      City - city  
 State - state      County - county      CEO - CEO      BM-1 through BM-4 - 1<sup>st</sup>  
 through 4<sup>th</sup> BM      RA-1 through RA-9 - 1<sup>st</sup> through 9<sup>th</sup> RA      CO-1 through  
 CO-15 - 1<sup>st</sup> through 15<sup>th</sup> COMPANIES

**Issue**

Whether or not this organization is operating exclusively for *any* charitable, educational, or scientific reason under IRC section 501(c)(3) or for the private benefit of insiders.

**Facts**

***Organizational Information***

***The 1023 Application:***

The ORG (“Fund”) was incorporated under the nonprofit corporation statutes of the state of State on July 18, 20XX. The Fund submitted a Form 1023 application (*Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*) dated July 30, 20XX. The application was signed by CEO<sup>1</sup> as CEO [chief executive officer]. The application stated that the Fund’s present and future activities were:

- procure, compile and sell criminal history reports;
- solicit contributions; and
- locate and evaluate candidates to receive grants.

The application also stated

*“We have commenced an aggressive campaign to resell reports procured from the CO-1 which we procure at a cost of \$ per. There appears to be significant demand at the \$ – price level. We devote % of our energies to this purpose.”*

Sources of financial support, in order of size, were listed as follows:

- sale of criminal history reports

\* \* \* \*

<sup>1</sup> From 20XX to 20XX, CEO was a primary shareholder in CO-2 (“CO-2”). CO-2 primary business activity was collecting criminal background reports for a plethora of businesses, individuals or other interested parties. This activity was conducted in the 48 contiguous states of the USA. CEO’s father, BM-1, served on the Board of CO-2. In June 20XX, CO-2 filed for Chapter 11 bankruptcy. RA-1 was listed as one of the 20 creditors holding the largest unsecured claims for CO-2 in that filing. Notices of the bankruptcy filings were issued to CO-4, CEO, BM-1 and CO-5 along with many others. **(Exhibit A)**

|                         |  |  |
|-------------------------|--|--|
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| ORG                     |  | 20XX/12<br>20XX/12<br>20XX/12          |

- contributions
- interest income.

On October 10, 20XX, the Tax Law Specialist ("Specialist") who reviewed the application submitted a letter to the Fund requesting additional information. The Specialist informed the Fund that the activity of buying and selling criminal history reports did not have an exempt purpose. The Specialist further questioned the activity, the composition of the Board, the incomplete articles of incorporation and the legitimacy of the bylaws. The Fund was required to respond to the follow-up letter by October 31, 20XX.

In or around November 20XX, the Fund engaged the legal services of RA-2 of CO-6 to respond to the Specialist's follow-up letter.

On February 6, 20XX, RA-2 officially responded to the Specialist's letter. RA-2 made the following statements in his response:

*"First, CEO ("CEO") is the son of BM-2 ("BM-2"). Although CEO signed the original Form 1023, BM-2 is the driving force behind the organization and will continue to be involved with the Fund, whereas CEO will not. BM-2 asked CEO to complete the Form 1023."*

*"Second and more importantly, the charitable purpose of the Fund will be to make grants to charities that benefit children in State. The Fund will not purchase or sell criminal history reports. Instead as one means (among others) of raising Funds from which to make grants to children's charities, the Fund will perform a service for for-profit enterprises that do sell criminal history reports. The Fund will charge a fee for performing that service. The service involves obtaining criminal history records over the internet. Such work will be performed **solely [emphasis added]** by volunteers, and at no time will such volunteer (or any director or officer) of the Fund receive any compensation (direct or indirect) as a result of the performance of such service."*

*Because all work involved in carrying out such activity will be performed by volunteers without compensation, such activity will not be an unrelated trade or business within the meaning of Section 513.*

*"This information gathering service performed by the Fund is not directly related to the charitable activities of the Fund; rather, it is only a means to raise Funds for the charitable activities of the Fund."*

In addition to addressing the activity of the Fund, the following items were changed:

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|-------------------------|--|--|
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| ORG                     |  | 20XX/12<br>20XX/12<br>20XX/12          |

- the Board was changed to include BM-2, BM-3 and BM-4<sup>2</sup>;
- articles of incorporation were amended to include a purpose clause, political prohibition clause, private benefit and inurement clause and the dissolution; and
- new bylaws were adopted.

A copy of the February 6, 20XX letter was issued to BM-2.

On February 23, 20XX, the Specialist issued a second letter to the Fund. The Specialist:

- requested a list of all expenses required to operate the organization for 20XX, 20XX and 20XX;
- asked for clarification on the cost of criminal reports where the application stated that cost was \$ - \$ and the 2/6/20XX letter said \$;
- asked for a clear explanation about whether criminal history reports will be aggressively sold as stated in the application where the 2/6/20XX letter said that reports are not purchased and sold;
- wanted documentation and information regarding the fee charged to for-profit businesses and why a company would pay the Fund to do work it can do itself
- wanted to know how grants are awarded if all of the reports are not sold;
- requested citation of any court cases or rulings supporting its request for exemption and
- inquired about the facilities where activities are conducted, facility owner, any leasing arrangements and shared costs.

The Fund, via RA-2, responded to the Specialist's request on March 8, 20XX. In that response, it stated

*"ORG ("FUND") provides this service for criminal background reporting companies solely as a means to raise money to make grants for other children's charities. After*

\* \* \* \*

<sup>2</sup> BM-4 was the wife of CEO when the organization was created and during the 20XX examination year. BM-4, CEO and BM-2 are all related by marriage or birth.

|                         |  |  |
|-------------------------|--|--|
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| ORG                     |  | 20XX/12<br>20XX/12<br>20XX/12          |

*obtaining its 501(c)(3) determination letter, FUND will also begin soliciting grants from foundations and individuals for its grant making purposes."*

RA-2 provided more details on how orders for criminal histories are requested from the CO-1 ("CO-1") for for-profit companies and how the Fund handles the request and how much it receives as a result of the process.

He provided expense information for the years requested and stated that all of the data gathering activities are conducted from the personal residence of BM-2 at Address in City, State without any charges for rent or other costs to the Fund.

BM-2 was a carbon copy ("cc") recipient of the February 23, 20XX correspondence.

***About the Bylaws***

The bylaws that were originally submitted and later revised gave the indication that regular, special and annual meetings would be conducted; officers had specific duties and would be elected by the Board and other business matters would be conducted in the public interest.

***When was exempt status granted?***

Based upon the information supplied in the application, an advanced ruling of exemption was granted to the Fund on April 2, 20XX under Internal Revenue Code section 501(c)(3), as other than a private foundation under section 509(a)(2). The advanced ruling period commenced on July 24, 20XX and expired on December 31, 20XX.

***The Examination***

***What was reported on the Form 990?***

An examination was initiated on the Fund's 20XX Form 990 return in 20XX. The organization reported the following items as revenue and expenses:

|                |  |
|----------------|--|
| Total revenue  |  |
| Total expenses |  |

Because the Fund operated on a cash basis, the return was prepared from a spreadsheet, which was prepared by BM-2, which reported the deposits and withdrawals listed on the Fund's lone CO-7 ("CO-7") checking account (-xxxx-). Associated with this account was a CO-7 check card (-xxxx-xxxx-) that was linked to any other debit or credit activity.



|                             |   |                                     |
|-----------------------------|---|-------------------------------------|
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| <b>Name of Taxpayer</b>     |   | <b>Year/Period Ended</b>            |
| ORG                         |   | 20XX/12                             |
|                             |   | 20XX/12                             |
|                             |   | 20XX/12                             |

All of the revenue reported was classified as contributions on Part I line 8 (*Summary*), and Part VIII Line 1f (*Statement of Revenue*). The Form 990 Schedule A, Part I item 9 (*Reason for Public Charity Status*), was checked stating that the organization normally receives (1) more than % of its support from contributions, membership fees, and gross receipts related to its exempt activity – subject to exceptions and (2) no more than % of its support from gross investment income and unrelated business taxable income (less section 511 tax) from businesses acquired by the organization after June 30, 19XX.

The public support schedules listed under Part II and Part III of Schedule A were left completely blank. Additionally, Schedule B – (Schedule of Contributors) was also left blank.

Expenses were classified as grants to other organizations (\$) and other expenses (\$).

The spreadsheet was used by BM-2 to prepare the Form 990 return. The return was signed by BM-2 on 3/6/20XX as the Fund’s president.

Review of the bank statements showed that the organization actually received the following amounts:

|                   |    |
|-------------------|----|
| Total deposits    | \$ |
| Total withdrawals | \$ |

The \$ deposits included a \$ refund of an insufficient funds charge (“NSF”).

***What was the activity?***

The only income generating activity was derived from reimbursements from a for-profit business for the cost of background checks that were acquired from the CO-1 (“CO-1”) criminal history report database.

***About CO-1***

CO-1 serves as the central repository for all criminal records in State and provides detailed in-state criminal history reports (“reports”). Criminal history record screenings cost \$ per search and can be accessed via the internet or by completing a record check form.

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Tax-exempt organizations are granted access to the CO-1 database through the assignment of a user identification number ("ID") and password. The organization that is assigned the ID and password can secure reports for \$ per search. Password related requests are required to be secured through the internet. CO-1 also requires the recipient organization to operate within the State of State. ID's and passwords are not transferrable.

The Fund was granted access to the database in 20XX when it was assigned its initial user ID and password. It maintained access in 20XX, but was re-issued another ID and password when CO-1 upgraded its systems. Both ID's and passwords were issued and assigned to BM-2, who was the President of the Fund from 20XX through part of 20XX. (**Exhibit B**)

***How was CO-1 paid?***

From January to early July of 20XX, anytime the ID and password was used to request a report, the cost of that report would be invoiced by CO-1 on a monthly basis. Thus, reports generated in January would be invoiced and due in February. The invoice would only reflect the total dollar amount of all history reports that were pulled in a prior month. The Fund had copies of invoices, but did not maintain or provide records supporting any itemized request.

From early July 20XX and thereafter, CO-1 changed its billing policy and started withdrawing the cost of any report directly from the Fund's CO-7 checking account via the CO-7 check card (-xxxx-xxxx-). In several instances, the ID and password were not used and the Fund was charged \$ for that report. Nevertheless, the bank statement would list every \$ or \$ charge made during the month.

***Where did the revenue come from in 20XX?***

The Fund's bank statements showed that 100% of amounts reported as contributions were directly deposited from a single source (xxxx-xxxx). That lone source was a CO-7 business checking account that was owned by CO-8 ("CO-8"). CO-8 is the for-profit 1120-S corporation owned by then president BM-2 and his wife RA-3. CO-8's primary business activity is consulting. BM-2 and RA-3 are the signatories on the CO-7 account and the sole shareholders of CO-8. (**Exhibit C**)

Roughly once or twice a month, a direct deposit from CO-8's account (xxxx-xxxx-) would be made into the checking account of the Fund. The payments were supposed to be reimbursements of the cost for each history report secured plus an additional \$ user fee per search.

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In 20XX, CO-8 directly deposited \$ in the account of the Fund. The Fund did not provide any documentation that supported that all charges made to its account by CO-1 were reimbursed by CO-8 and such reimbursement included the additional \$ user fee.

In years prior to 20XX, CO-8 had issued the Fund a Form 1099 Miscellaneous in the amounts that were reimbursed for the history reports. The Form 1099 nearly matched or was exactly the same amount reported as contribution income on the Fund's Form 990 return. For the same years that CO-8 issued a Form 1099 Miscellaneous to the Fund, it reported very similar amounts as cost of goods sold on its filed Form 1120-S. See below.

|                             | 20XX  | 20XX  | 20XX  | Exhibit |
|-----------------------------|-------|-------|-------|---------|
| Form 1099 from<br>CO-8      | \$    | \$ \$ | \$ \$ | D       |
| Form 990 of the<br>Fund     | \$    | \$ \$ | \$ \$ |         |
| Form 1120-S CGS<br>for CO-8 | \$ \$ | \$ \$ | \$ \$ | E       |

No Forms 1099 were issued by CO-8 to the Fund in 20XX or anytime thereafter.

From 20XX to 20XX, when CO-8 paid % to % of the Fund's income, its cost of goods sold was noted as follows:

|                                | 20XX | 20XX | Exhibit |
|--------------------------------|------|------|---------|
| Form 990<br>Form 1120-S<br>CGS |      |      | F       |

Per a verbal response to inquiries made in Information Document Request ("IDR") 003 – Business Relationships, BM-2 had stated that he had no related business transactions with the Fund. RA-4, Representative, stated that CO-2 ("CO-2") deposits funds into the organization's account.

***How was the money spent in 20XX?***

The Fund paid \$\$ (a total of 10 checks to CO-1 totaling \$\$ and had \$\$ directly withdrawn from its checking account) for 17,198 criminal reports. Of that total, 17,191 were paid for at a cost of \$ each and 7 were paid for at a cost of \$ each. Expenses paid to CO-1 represented % of total costs. (**Exhibit G**)

|                             |   |  |
|-----------------------------|---|--|
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| <b>Name of Taxpayer</b>     |   | <b>Year/Period Ended</b>               |
| ORG                         |   | 20XX/12                                |
|                             |   | 20XX/12                                |
|                             |   | 20XX/12                                |

Monies in excess of the cost of paying for criminal history reports were used to issue "grants" to other charitable organizations. The Fund had no written grant making procedures. Grants to other organizations totaled \$ in 20XX and represented roughly % of total operations.

***Who was the governing body in 20XX?***

The return listed the following individuals as officers/directors.

1. RA-5
2. RA-6
3. CEO
4. BM-2

However, BM-2 managed all financial and operational decisions alone. The Board has never had any meetings. CEO paid all of the bills, prepared and signed all of the Form 990 returns since inception, was the lone signatory on the Fund's accounts, and was responsible for all receipts of monies into the Fund's account.

The representative RA-4, stated that meetings were not necessary because their "*only transactions was making grants*".

***What changes happened for 20XX?***

On January 14, 20XX, a registration statement was filed with the State Secretary of State Division of Public Charities. The statement was filed to change the name of the registered agent and Chief Financial Officer ("CFO") as well as the mailing address of the Fund for 20XX and thereafter. The new registered agent/CFO was changed to RA-2. The new address of the Fund was Address, City, State The new address was actually a post office box.

In addition to the registered agent and address change, the Fund acquired a new Board of Directors. The new board had addresses residing in City, City, and City, State as well as City, State.

The registration statement was signed by RA-2 as Chief Executive Officer on 11/30/XX and as Chief Financial Officer on 1/6/XX. RA-2 legally resides in City, State. (**Exhibit H**)

***Who was the governing body in 20XX?***

|                             |  |  |
|-----------------------------|--|--|
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RA-2<sup>3</sup> stated that he assumed leadership of the Fund at the end of November 20XX or early December 20XX.

The 20XX return listed the following individuals as board members:

1. RA-2
2. RA-7
3. RA-8
4. RA-9

According to RA-2, the other board members were placed in service on January 20XX. They became a part of the board because *"he asked them if they wanted to be on the board of a charity"*. They were specifically requested because *"they were his friends."* RA-2 also stated that none of the listed members performed any specific duties as per the Fund's bylaws. The Fund did not provide copies of any meeting minutes because it had not conducted any Board meetings during 20XX or anytime thereafter.

***Where did the money come from in 20XX?***

The Fund continued to conduct the same activity and operate on a cash basis. Therefore, income and expenses were reported from the bank statements. The 20XX Form 990 reported the following items as revenue and expenses related to its activity.

|                |  |
|----------------|--|
| Total revenue  |  |
| Total expenses |  |

The bank accounts showed that the Fund received direct deposits from four (4) different CO-7 accounts noted as follows:

|                     |  |
|---------------------|--|
| CO-7 acct ending w/ |  |
| CO-7 acct ending w/ |  |
| CO-7 acct ending w/ |  |

\* \* \* \*

<sup>3</sup> From 20XX to 20XX, RA-2 derived Form W-2 wages from CO-2. CO-2 had a State address. In 20XX, his Form W-2 was issued by CO-9. CO-2 is one of the subsidiaries . During 20XX, CO-2 filed for Chapter 11 bankruptcy.  
(Exhibit I)

|                         |  |  |
|-------------------------|--|--|
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| <b>Name of Taxpayer</b> |  | <b>Year/Period Ended</b>               |
| ORG                     |  | 20XX/12<br>20XX/12<br>20XX/12          |

|                          |  |
|--------------------------|--|
| CO-7 acct ending w/      |  |
| Total 20XX bank deposits |  |

The CO-7 account ending with # was the business checking account of CO-8. CO-8 is the 1120-S business of BM-2 and RA-3. The CO-7 accounts ending with # and # were the personal checking accounts of BM-2. No information was secured for the account ending in #. (**Exhibit J**)

Of the \$\$ deposited, \$\$ or % was received from BM-2 (either directly or indirectly) as reimbursements for the cost of history reports that had been charged to the Fund.

All of this revenue was reported as contribution income.

***How was the money spent in 20XX?***

Of the total expenses reported (\$), the Fund disbursed (via direct debit) \$ to CO-1 for criminal reports. (**Exhibit K**) reports cost the Fund \$ each and 9 were paid for at \$ each. This expense activity was approximately % of total operating costs.

Monies in excess of the cost of paying for criminal history reports were used to issue "grants" to other charitable organizations or minor bank charges. Grants paid to other organizations totaled \$ and reflected % of total operating costs.

***Who prepared the return?***

The 20XX Form 990 return was prepared by CO-10, which is located in City, State. It was signed by RA-2 as president on May 11, 20XX.

***What happened in 20XX?***

RA-2 assumed control of the Fund late November or early December 20XX. On or about December 28, 20XX, RA-2 opened another CO-7 business checking account (-xxxx-) in the name of Fund with a slight variation in the name. The address for this additional account was the same as that which was referenced in the January 14, 20XX registration statement. Associated with this account was another check card (-xxxx-xxxx-). The second account was initially funded with a \$ transfer from the original CO-7 account-xxxx-. RA-2 was the only signatory on this account.

During 20XX, the Fund's ID, password, (which had been previously assigned to BM-2), and bank card was still being used to pull reports from CO-1's database. Around March 20XX, CO-

|                                    |  |   |
|------------------------------------|--|---|
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I charged the Fund for searches that caused the xxxx-xxxx- account to become overdrawn, resulting in additional fees and interest being charged for uncollected accounts.

RA-2 filed claims with the CO-7 stating that CO-1 had doubled, tripled or quadrupled charges for the same search. As a result of that claim, CO-1 refunded a portion of the charges and overdraft fees. However, in or around March/April 20XX, CO-1 discontinued the Fund's ID and password granting access to its database at the reduced \$ cost. Criminal report search activity came to a virtual cessation thereafter.

In or around 12/20/20XX, RA-2 opened a third CO-7 CO-11 account -xxxx-. This account had the same address as the prior two accounts. There was no check card associated with this account. The account was initially funded from a \$ ATM transfer from an account located in County of City, State. That transfer was returned NSF within the same week. A second deposit of \$ was made on 12/27/20XX from an account in the same county. RA-2 was the lone signatory on this account. RA-2 did not provide any documentation identifying the "depositor" and claimed ignorance to the source of those deposits.

***What was reported on the 20XX Form 990?***

The 20XX Form 990 return was prepared by CO-10 ("CO-10"), which is located in City, State. CO-10 was appointed by RA-2 to prepare the return. The return showed the following amounts as revenue and expenses.

|                |  |
|----------------|--|
| Total revenue  |  |
| Total expenses |  |

RA-2 signed the return as CEO June 11, 20XX.

***Where did the money come from?***

Because the Fund did not provide a general ledger or return workpapers, revenue was not accurately verified. Nevertheless, the bank statements of the three (3) CO-7 accounts showed deposits from several different sources as noted below:

| Type   | Description         | Amount | Total |
|--------|---------------------|--------|-------|
| income | CO-7 acct ending w/ |        |       |
| income | CO-7 acct ending w/ |        |       |

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| income     | Unidentified deposit               |  |  |
| income     | Deposit from state ATM (3)         |  |  |
| income     | Transfer from County acct          |  |  |
| income     | Wire transfer from BM-2            |  |  |
| non-income | Other credit adjustments from CO-1 |  |  |
| non-income | Interbank transfer from            |  |  |
| non-income | NSF ATM deposit                    |  |  |
|            | Total 20XX bank deposits           |  |  |

Of the \$\$ deposited, \$\$ was deemed to be income. Of that \$\$, \$\$ or % was received from CO-7 accounts ending with # and #. Those two accounts were the business checking accounts of CO-12<sup>4</sup>. ("CO-12"). (**Exhibit L**) CO-12 is one of several for-profit businesses of RA-2. (**Exhibit M**) The deposits of CO-12 represent partial reimbursement for the cost of history reports that were withdrawn or incurred during the year.

The \$ wire transfer was stated to be a loan from BM-2 and his son CEO. The wire transfer came directly from BM-2 on 3/29/20XX. The "loan" was intended to cover the cost of history reports that resulted in a significant deficiency in the Fund's xxxx-xxxx-# account. The Fund provided no supporting loan documents or any written items supporting the loan classification. (**Exhibit N**)

CO-8 Form 1120-S return for 20XX reported a bad debt of \$. The resulting net loss was carried over to BM-2 and RA-3's Form 1040 return. (**Exhibit O**)

The remaining \$ included an \$ ATM deposit from City, State, a \$ ATM deposit from City, State, a \$ transfer from an account in County County, which is also in City, State and an

\* \* \* \*

<sup>4</sup> CO-5 ("CO-12") was created as a State profit corporation on October 11, 20XX. BM-1 was the registered agent and listed president. The corporation's principal business address was Address, City, State. CO-12 has only filed on Form 1120 for the year ending 20XX. As of 9/23/20XX, CO-12 has been administratively dissolved by the State of State for failing to file its annual report.



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unidentified deposit of \$. The specific source of the ATM deposits or transfers was stated to be from a business account of RA-2.

Nevertheless, all revenue reported was classified as contribution income.

***How was the money spent in 20XX?***

Of the total bank disbursements of \$ (rounding), only \$<sup>5</sup> was deemed to be direct expenses related to business operations.

The Fund paid \$ to CO-1 for 6,748 reports. This expense represents approximately % of total operating costs.

However, from the \$\$ that was originally deposited in the Fund's xxxx-xxxx-# account from CO-12, \$ (rounding) was transferred back into CO-12's two business checking accounts. In response to an email inquiry, on October 24, 20XX the representative stated:

*"As you know there was an issue wherein the CO-1 (CO-1) drafted ORG's account for charges that ORG did not agree with. Those charges drained ORG's bank account. BM-2 was afraid it would happen again so he transferred \$ to an account he controlled and then purchased a cashier's check for \$ and gave it to the CO-13<sup>6</sup>. A copy of the cashier's check is attached." (Exhibit P)*

The documentation that was provided to support the transfers back to CO-12 was a copy of a \$ cashier's check. The cashier's check was written on 3/30/20XX and was drawn from one of CO-12's account. The cashier's check written by CO-12 to the CO-13 Foundation was never reported on CO-13's 20XX Form 990- PF return. (Exhibit Q)

Additionally, \$ was withdrawn from the CO-7 account #-xxxx-# using the check card -xxxx-xxxx-. Per an email response to information document request ("IDR") 004a, item #7, it was stated, "RA-2 was the only person that had a debit card." The Fund did not have a copy of the withdrawal slip, an invoice or any other information that supported the business purpose of this withdrawal.

\* \* \* \*

<sup>5</sup> Gross disbursements less non-income items or \$ - \$.

<sup>6</sup> CO-13 is a recognized 501(c)(3) private foundation. It was created in January 19XX under the nonprofit laws of the State of State. Its present business address is Address, City. That address is the BM-1 private residence. The foundation filed a Form 990-PF for 20XX. The return bore a signature bearing RA-3 s name. She is listed as the Treasurer of the Foundation. For 20XX, the 990PF return only reported \$ as dividend and interest income. The cashier's check written by CO-5 to the Foundation on 3/30/20XX was not reported on CO-13's 20XX Form 990- PF return.

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Along with the direct debits and ATM withdrawals, a check for \$ from the Fund's CO-7 account #-xxxx-# and a check for \$ from the Fund's CO-7 account #-xxxx-# were withdrawn. The Fund did not have copies of cancelled checks, invoices or any other documentation supporting the exempt purpose of these withdrawals. Per an email response to information document request ("IDR") 004a, item #5, it was stated, "We do not have the cancelled check copies you requested. . . ."

The balance of the expenses included total payments of \$ for CO-14 or CO-15, \$ interest charged on uncollected accounts and a total of \$ in bank fees for NSF or overdrawn accounts.

As a result, \$ or % of total operating costs was disbursed without documentation supporting an exempt business purpose from one or more of the Fund's three accounts. See below.

| Description                         | Amount | Total |
|-------------------------------------|--------|-------|
| Transfers back to CO-12 accts # & # |        |       |
| ATM withdrawals                     |        |       |
| Check withdrawals                   |        |       |
| Check card charges for CO-14/CO-15  |        |       |
| Total                               |        |       |

## LAW

*Section 501(c)(3) of the Code* exempts from federal income tax organizations organized and operated exclusively for charitable, educational, and other exempt purposes, provided no part of the organization's net earnings inures to the benefit of any private shareholder or individual.

*Section 1.501(c)(3)-1(a)(1) of the regulations* provides in order to be exempt as an organization described in *section 501(c)(3) of the Code*, the organization must be one that is both organized and operated exclusively for one or more of the purposes specified in that section.

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

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

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

#### Primary Purpose; Substantial Nonexempt Purpose

In *Better Business Bureau of Washington, D.C. v. United States*, 326 U.S. 279, 283, 66 S. Ct. 112, 90 L. Ed. 67, 1945 C.B. 375 (1945), the United States Supreme Court stated that "the presence of a single . . . [non-exempt] purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly . . . [exempt] purposes."

In making the appropriate analysis, it is necessary to focus on the purpose rather than the nature of the organization's activities, est of *Hawaii v. Commissioner*, 71 T.C. 1067 (1979); *B.S.W. Group, Inc. v. Commissioner*, 70 T.C. 352 (1978); *Golden Rule Church Association v. Commissioner*, 41 T.C. 719 (1964); see *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578, 44 S. Ct. 204, 68 L. Ed. 458, T.D. 3548 (1924); *San Francisco Infant School v. Commissioner*, 69 T.C 957 (1978). An organization whose activities constitute a trade or business or generate a profit may still be exempt, provided that those activities accomplish an exempt purpose. *Sec. 1.501(c)(3)-1(e)(1), Income Tax Regs.*; *B.S.W. Group, Inc. v. Commissioner, supra*. Compare *Randall Foundation v. Riddell*, 244 F.2d 803 (9th Cir. 1957), [\*\*11] with *Passaic United Hebrew Burial Association v. United States*, 216 F. SUPP. 500 (D. N.J. 1963).

However, in *Living Faith Inc. v. Commissioner*, 950 F.2d 365, 372 (7th Cir. 19XX), affg. T.C. Memo. 1990-484, an organization's purposes may be inferred from its manner of operations; its "activities provide a useful indicia of the organization's purpose or purposes."

In *B.S.W. Group, Inc. v. Commissioner*, 70 T.C. 358 (1978), the Court states that "Factors such as the particular manner in which an organization's activities are conducted, the commercial hue of those activities, and the existence and amount of annual or accumulated profits are relevant evidence of a forbidden predominant purpose."

*KJ's Fund Raisers v. Commissioner*, T.C. Memo 19XX-424, aff'd 166 F.3d 1200 (2nd Cir. 19XX), petitioner also operated for the substantial private benefit of KJ's Place and its owners.

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A substantial nonexempt purpose thus characterizes its operation, disqualifying it from exemption under *sections 501(a) and 501(c)(3)*. Citing *Better Business Bureau v. United States*, 326 U.S. at 283; *Copyright Clearance Center, Inc. v. Commissioner*, 79 T.C. at 803.

In *Church by Mail v. Commissioner*, 765 F.2d 1387 (9th Cir. 1985) aff'g TCM 1984-349 (1984), the Court noted that Church by Mail, Inc. ('Church') paid Twentieth Century Advertising Agency ('Twentieth') for services provided. Twentieth was owned and controlled by the two individuals who ran Church. The Tax Court had found it unnecessary to consider the reasonableness of payments made by the applicant to a business owned by its officers. In addressing whether Church operated for a substantial non-exempt purpose the 9th Circuit Court of Appeals, in affirming the Tax Court's decision, stated: ". . . The critical inquiry is not whether particular contractual payments to a related for-profit organization are reasonable or excessive, but instead whether the entire enterprise is carried on in such a manner that the for-profit organization benefits substantially from the operation of the Church, est of *Hawaii v. Commissioner*, 71 T.C. at 1080-81; see also *Presbyterian & Reformed Publishing Co. v. Commissioner*, 743 F.2d 148, 155 (3d Cir. 1984) (courts must look to all objective indicia from which a corporate actor's intent may be discerned); *United States v. Dykema*, 666 F.2d 1096, 1100 (7th Cir. 1981), cert. denied, 456 U.S. 983, 72 L. Ed. 2d 861, 102 S. Ct. 2257 (1982) (it is necessary and proper for the I.R.S. to survey all of the activities of an organization to determine whether a non-exempt purpose is furthered).

In *American Campaign Academy v. Commissioner*, 92 T.C. 1053, 1065-1066 (1989), the court stated that when an organization operates for the benefit of private interests . . . the organization by definition does not operate exclusively for exempt purposes. Prohibited private benefits may include an "advantage; profit, fruit; privilege; gain; [or] interest." Occasional economic benefits flowing to persons, as an incidental consequence of an organization pursuing exempt charitable purposes will not generally constitute prohibited private benefits. Thus, should [the organization] be shown to benefit private interests, it will be deemed to further a nonexempt purpose under *section 1.501(c)(3)-1 (d)(1)(ii)* . . . This nonexempt purpose will prevent [the organization] from operating primarily for exempt purposes absent a showing that no more than insubstantial part of its activities further private interests or any other nonexempt purposes.

In *Housing Pioneers v. Commissioner*, T.C. Memo 1993-120, 65 T.C.M. (CCH) 2191 (19 XX), aff'd, 49 F.3d 1395 (9th Cir. 19XX), amended 58 F.3d 401 (9th Cir. 1985) ("Housing Pioneers"), the Tax Court concluded that an organization did not qualify as a *section 501(c)(3)* organization. The organization could describe only a vague charitable function of surveying tenant needs.

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### Inurement and Private Benefit

In *American Campaign Academy v. Commissioner*, 92 T.C. 1053, (1989), the Court addressed the operational test and illuminates the difference between private benefit, derived by private interests where such private benefit is adverse to exemption under *Section 501(c)(3)*, from inurement, derived by insiders, which also is adverse to exemption under *Section 501(c)(3)*. It states:

... To establish that it operates primarily in activities which accomplish exempt purposes, petitioner must establish that no more than an insubstantial part of its activities does not further an exempt purpose. *Sec. 1.501(c)(3)-1(c)(1), Income Tax Regs.* The presence of a single substantial nonexempt purpose destroys the exemption regardless of the number or importance of the exempt purposes. *Better Business Bureau v. United States*, 326 U.S. 279, 283, 66 S. Ct. 112, 90 L. Ed. 67, 1945 C.B. 375 (1945); *Copyright Clearance Center v. Commissioner*, 79 T.C. 793, 804 (1982).

... We have consistently recognized that while the prohibitions against private inurement and private benefits share common and often overlapping elements, *Church of Ethereal Joy v. Commissioner*, 83 T.C. 20, 21 (1984), *Goldsboro Art League, Inc. v. Commissioner*, 75 T.C. 337, 345 n. 10 (19XX), the two are distinct requirements which must independently be satisfied. *Canada v. Commissioner*, 82 T.C. 973, 981 (1984); [\*22] *Aid to Artisans, Inc. v. Commissioner*, 71 T.C. at 215. Nonetheless, we have often observed that the prohibition against private inurement of net earnings appears redundant, since the inurement of earnings to an interested person or insider would constitute the conferral of a benefit inconsistent with operating exclusively for an exempt purpose. *Western Catholic Church v. Commissioner*, 73 T.C. 196, 209 n. 27 (1979), *affd.* in an unpublished opinion 631 F.2d 736 (7th Cir. 1980). See also *sec. 1.501(c)(3)-1(c)(2), Income Tax Regs.* In other words, when an organization permits its net earnings to inure to the benefit of a private shareholder or individual, it transgresses the private inurement prohibition and operates for a nonexempt private purpose.

... The absence of private inurement of earnings to the benefit of a private shareholder or individual does not, however, establish that the organization is operated exclusively for exempt purposes. Therefore, while the private inurement prohibition may arguably be subsumed within the private benefit analysis of the operational test, the reverse is not true. Accordingly, when the Court concludes that no prohibited inurement of earnings exists, it cannot stop there but must inquire further and determine whether a prohibited private benefit is conferred. See *Aid to Artisans, Inc. v. Commissioner*, 71 T.C. at 215; *Retired Teachers Legal Fund v. Commissioner*, 78 T.C. 280, 287 (1982).

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In *People of God Community v. Commissioner*, 75 T.C. 127 (1980) the Court, in examining the compensation arrangement of an insider, noted that it is an established principle that the organization is entitled to pay reasonable compensation to an insider but the burden of establishing the reasonableness of the compensation fell upon the organization.

In *Founding Church of Scientology v. United States*, 412 F.2d 1197, 188 Ct. Cl. 490 (Ct. Cl. 1969), cert. den., 397 U.S. 1009, 90 S. Ct. 1237, 25 L. Ed. 2d 422 (1970). The Court determined that the different arrangements between the organization and its founder, such as payment of ten percent or gross revenues, lending of money to him and his family, payment of expenses on their behalf, rental of property at inflated prices, resulted in inurement. The Court rejected the reasonable compensation defense. It stated: If in fact a loan or other payment in addition to salary is a disguised distribution or benefit from the net earnings, the character of the payment is not changed by the fact that the recipient's salary, if increased by the amount of the distribution or benefit, would still have been reasonable.

*Section 4958 of the Code*, effective September 14, 1995, was added to the Internal Revenue Code by the Taxpayer *Bill of Rights 2* bill in 1996 (P.L. 104-168, enacted July 30, 19XX). In *Caracci v. Commissioner*, 118 T.C No. 25 (2002), the Court noted: "With the enactment of *section 4958*, however, the issue whether the tax-exempt status of . . . tax-exempt entities should be revoked now must be considered in the context of the 'intermediate sanction' provisions. . . . the intermediate sanction regime was enacted in order to provide a less drastic deterrent to the misuse of a charity than revocation of that charity's exempt status. The legislative history explains that 'the intermediate sanctions for 'excess benefit transactions' may be imposed by the IRS in lieu of (or in addition to) revocation of an organization's tax-exempt status.' H. Rept. 104-506, supra at 59, 19XX-3 C.B. at 107. A footnote to this statement explains: 'In general, the intermediate sanctions are the sole sanction imposed in those cases in which the excess benefit does not rise to a level where it calls into question whether, on the whole, the organization functions as a charitable or other tax-exempt organization'. Id. n. 15, 19XX-3 C.B. at 107. Although the imposition of *section 4958* excise taxes as a result of an excess benefit transaction does not preclude revocation of the organization's tax-exempt status, the legislative history indicates that both a revocation and the imposition of intermediate sanctions will be an unusual case." (emphasis added)

Net earnings may inure to the benefit of private individuals in ways other than by the actual distribution of dividends or payment of excessive salaries. *General Contractors' Ass'n v. United States*, 202 F.2d 633 (7th Cir. 1953) -- reports and surveys furnished to members; *Chattanooga Auto. Club v. Commissioner*, 182 F. 2d 551 (6th Cir. 1950) -- service to members; *Underwriters' Laboratories, Inc. v. Commissioner*, 135 F. 2d 371 (7th Cir.), cert, denied, 320

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U.S. 756, 64 S. Ct. 63, 88 L. Ed. 450 (1943) -- reports and studies furnished; Spokane Motorcycle Club v. United States, 222 F. Supp. 151 (E.D. Wash. 1963) -- goods, services, and refreshments given. That the benefit conveyed may be relatively small does not change the basic fact of **inurement**. Spokane Motorcycle Club v. United States, *supra*.

In *est of Hawaii v. Commissioner*, 71 T.C. 1067 (1979), *aff'd* in unpublished opinion 647 F. 2d 170 (9th Cir. 1981) ("*est of Hawaii*"), several for-profit est organizations exerted significant indirect control over *est of Hawaii*, a non-profit entity, through contractual arrangements. The Tax Court concluded that the for-profits were able to use the nonprofit as an "instrument" to further their for-profit purposes. The fact that amounts paid to the for-profit organizations under the contracts were reasonable did not affect the court's conclusion. Consequently, *est of Hawaii* did not qualify as an organization described in section 501(c) (3).

***Insider:***

In defining who is an insider, the court in *United Cancer Council, Inc. v. Commissioner*, 165 F. 3d 1173, 1176 (7th Cir. 1999), stated: "The term "any private shareholder or individual" in the **inurement** clause of Section 501(c)(3) of the Internal Revenue Code has been interpreted to mean an insider of the charity. *Orange County Agricultural Society, Inc. v. Commissioner*, 893 F.2d 529, 534 (2d Cir. 1990); *Church of Scientology v. Commissioner*, *supra*, 823 F.2d at 1316-19; *Church by Mail, Inc. v. Commissioner*, 765 F.2d 1387, 1392 (9th Cir. 1985); *American Campaign Academy v. Commissioner*, 92 T.C. 1053, 1066 (1989). A charity is not to siphon its earnings to its founder, or the members of its board, or their families, or anyone else fairly to be described as an insider, that is, as the equivalent of an owner or manager. The test is functional. It looks to the reality of control rather than to the insider's place in a formal table of organization. The insider could be a "mere" employee -- or even a nominal outsider, such as a physician with hospital privileges in a charitable hospital, *Harding Hospital, Inc. v. United States*, 505 F. 2d 1068, 1078 (6th Cir. 1974). . ."

***Books and Records:***

*Internal Revenue Code (Code) Section 7602(a)* provides the authority "to examine any books, papers, records, or other data which may be relevant or material" for the purpose of ascertaining the correctness of any return. . . .

*Regulation Section 1.6033-2(i)(2)* provides that, "Every organization which is exempt from tax, whether or not it is required to file an annual information return, shall submit such additional

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information as may be required by the Internal Revenue Service for the purpose of inquiring into its exempt status and administering the provisions of subchapter F (Section 501 and following), chapter 1 of subtitle A of the Code, Section 6033, and chapter 42 of subtitle D of the code."

Section 6001 of the code provides, "Notice or Regulation Requiring Records, Statements, and Special Returns" provides, in part: "Every person . . . shall keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary may from time to time prescribe."

Regs. 1.501(c) (3)-1(d) (1)(ii) provides that the burden of proof is upon the organization to establish that it is not organized or operated for the benefit of private interests.

Income Tax Regulation (Regulation) Section 1.274-5 addresses the substantiation requirements with respect to the business purpose of an expense. If the substantiation requirements are not met no deduction is allowed with respect to that expense.

Regulation Section 1.274-5T (b) identifies the elements that the taxpayer must substantiate with respect to the expenditure: (i) amount, (ii) time and place of travel, entertainment, amusement, recreation, or use of the facility or property, (iii) business purpose, and (iv) the business relationship to the taxpayer of each person entertained, using the facility or property, or receiving the gift. Section 1.274-5T(c) notes that a taxpayer must substantiate each element of expenditure by adequate records or by sufficient evidence corroborating taxpayer's own statement. Section 274(d) contemplates that a taxpayer will maintain and produce such substantiation as will constitute clear proof of an expenditure referred to in Section 274. It states that a record of the elements of expenditure made at or near the time of expenditure, supported by sufficient documentary evidence, has a high degree of credibility not present with respect to a statement prepared subsequent thereto when generally there is a lack of accurate recall. It states that the corroborative evidence required to support a statement not made at or near the time of the expenditure "must have a high degree of probative value to elevate such statement and evidence to the level of credibility reflected by a record made at or near the time of the expenditure supported by sufficient documentary evidence". It states that to obtain a deduction for travel, etc., a taxpayer must substantiate each element of the expenditure.

### Taxpayer's Position



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The Taxpayer has not formally advocated a position. However, the representative has stated that the organization did everything that they said they were going to do in their original application. Consequently, they are not in agreement with the proposed revocation.

### Government's Argument

The Internal Revenue Service has long recognized an organization as exempt from federal income tax when it has been duly organized under current State law as such and continues to operate exclusively for charitable, educational, and other exempt purposes, provided no part of the organization's net earnings inures to the benefit of any private shareholder or individual. *IRC section 501(c)(3) and related regulations.*

However, when an organization is created that provides an insubstantial benefit to the public, in comparison to the benefit gained by insiders, then that organization has not merited exemption or has ceased to operate as exempt.

When the ORG ("Fund") submitted its original Form 1023 application, it did say that it was going to solicit criminal history reports from CO-1, sell them to for-profit entities and make grants to other charitable organizations. What the application failed to disclose was that the for-profit entities were the personal businesses of then CEO and BM-2 and later RA-2. CEO and BM-2 and later RA-2 were key insiders, Prior to the creation of the Fund, CEO was a shareholder in the for-profit business CO-2 ("CO-2") and remained a shareholder in 20XX when CO-2 filed for bankruptcy. CO-2 primary business activity was pulling criminal history reports for various employers throughout the United States. State was only one of those states where these types of reports could be secured at a rate significantly lower than fair market value. But in order to benefit from a low cost inventory item, an exempt organization would have had to been created.

CO-8, the 1120-S corporation of BM-2 and RA-3, was also in existence at the time the application was submitted. Even though its business code indicates that it is a consulting business, pulling history reports became a key part of that business as it reported that cost as its cost of goods sold in 20XX through 20XX.

Thus, both BM-2 and CEO were very much aware of the pecuniary profits that could be derived from creating a tax-exempt organization within the State of State.

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| ORG                     |  | 20XX/12<br>20XX/12<br>20XX/12          |

To effectively pull off the scheme, CEO and BM-2 had to paint an illusion that the primary purpose of the Fund was going to be charitable through the issuance of grants to children's organizations in State and State. Thus submissions to the application claimed that criminal history reports were only one of the fundraising vehicles used "*solely as a means to raise money to make grants for other children's charities*".

What became apparent, through the examination, was that getting reimbursements for criminal reports was the only income generating activity since creation and issuing grants to other charities was only a by product of the real purpose of creating the organization.

However, in the application stage, the plan was almost derailed when the Tax Law Specialist began seriously questioning the activity and the intentions of CEO and BM-2. It was at that time that a representative was hired who in subsequent submissions to the application carefully modified language, made changes to organizational documents and tried to lend some credibility that the grant making activity was the Fund's primary purpose.

Once exemption was granted criminal history reports could now be obtained at \$ per search using the exempt organization as its purchasing conduit. To complete this process, the final step was to file an application with CO-1 indicating that it was officially tax-exempt. This filed application provided the Fund a user ID and password which were assigned to BM-2. Now criminal history reports could be sold at a higher rate to a requester and substantial profits could be generated.

This continued until the leadership roles changed in the latter part of November or early December of 20XX when RA-2 became president. CO-1 never assigned the ID or password to RA-2. The information was given to him (as if in selling a business) by BM-2.

To keep the ruse going that the Fund was a legitimate charitable organization operated under State's nonprofit laws, a post office box was set up by RA-2 with a City, State address for any and all correspondence. Consequently, business could continue as usual. CO-1 would be none the wiser in knowing that the Fund was now a foreign organization operating within its borders.

***Who were the primary beneficiaries?***

The real beneficiaries of the creation of the Fund were CEO through CO-2, BM-2 through CO-8 and later RA-2 through CO-12 and CO-2. While the Fund never produced any income sharing agreements that might have existed between CO-2 or CO-8, it is likely that some type of arrangement did indeed exist in the earlier years of operation. RA-2 was an employee of CO-2

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during that time, until he became President and CO-8 reported its reimbursements to the Fund as cost of goods sold.

Nevertheless, in 20XX, the Fund paid for 17,198 background checks for a total cost of \$\$\$. 17,191 were paid for at the \$ rate and 7 were paid for at the \$ rate. The Fund received \$ from the for-profit business of BM-2 via CO-8. If CO-8 had paid for all 17,198 of the background checks at the rate of \$ each, it would have paid \$ to CO-1 in 20XX. Instead, CO-8 benefited from the use of the Fund's exempt status in its ability to acquire the reports at a lower rate, to the tune of \$. See below.

|  |               |
|--|---------------|
| Total # of background checks paid for @ \$ in 20XX.....  | <u>17,191</u> |
| Cost of background checks to for-profit entities (CO-8)  |               |
| Interim cost of background checks to for-profit entities |               |
| Plus: 7 background checks paid for @ \$ each             |               |
| Total cost of background checks to a for-profit entity   |               |
| Less: amount reimbursed to the EO.....                   |               |
| Net benefit to past/current presidents                   |               |

The selling of report activity reflects % of verified gross income and % of verified gross expenses. Any charitable contributions made in 20XX only constituted % of total operations.

In 20XX, the Fund paid for 20,549 background checks for a total cost of \$. 20,540 were paid for at the \$ rate and 9 were paid for at the \$ rate. The Fund received \$\$ from the for-profit business of BM-2 via CO-8. If CO-8 had paid for all 20,549 of the background checks at the rate of \$ each, it would have paid \$ to CO-1 in 20XX. Instead, CO-8 benefited from the use of the Fund's exempt status in its ability to acquire the reports at a lower rate, to the tune of \$. See below:

|  |  |
|--|--|
| Total # of background checks paid for @ \$ in 20XX.....  |  |
| Cost of background checks for for-profit entities (CO-8) |  |
| Interim cost of background checks to for-profit entities |  |
| Plus: 9 background checks paid for @ \$ each             |  |
| Total cost of background checks for-profit entities      |  |
| Less: amount reimbursed to the EO.....                   |  |
| Net benefit to past/current presidents                   |  |

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The selling of report activity reflects % of gross income and % of gross expenses. Any charitable contributions made in 20XX only constituted % of total operations.

In 20XX, the Fund paid for 6,748 background checks for a total cost of \$. All of the reports were paid for at the \$ rate. The Fund received a netted reimbursement of \$ (\$\$) from the for-profit business of RA-2 via CO-12. If CO-12 had paid for all 6,748 of the background checks at the rate of \$ each, it would have paid \$ to CO-1 in 20XX. Instead, CO-12 benefited from the use of the Fund's exempt status in its ability to acquire the reports at a lower rate, to the tune of \$. See below:

Total # of background checks paid for @ \$ in 20XX.....  
 Cost of background checks for for-profit entities (i.e. CO-12)  
 Interim cost of background checks to for-profit entities  
 Plus: 0 background checks paid for @ \$ each  
 Total cost of background checks for-profit entities  
 Less: amount reimbursed to the EO.....  
 Net benefit to past/current presidents

The February 6, 20XX response in the original application stated that

*“Second and more importantly, the charitable purpose of the Fund will be to make grants to charities that benefit children in State. The Fund will not purchase or sell criminal history reports. Instead as one means (among others) of raising Funds from which to make grants to children’s charities, the Fund will perform a service for for-profit enterprises that do sell criminal history reports. The Fund will charge a fee for performing that service. The service involves obtaining criminal history records over the internet. Such work will be performed solely [emphasis added] by volunteers, and at no time will such volunteer (or any director or officer) of the Fund receive any compensation (direct or indirect) as a result of the performance of such service.”*

The fact is that both BM-2 and RA-2 have directly and indirectly been “compensated” for work performed.

BM-2 has been compensated directly and indirectly through profits or losses that were generated from classifying reimbursement of the criminal reports as cost of goods sold on his 1120-S corporation return. Any gain or loss would have rolled over to his Form 1040 return.

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RA-2 received Form W-2 wages from CO-2 as a direct result of the purchasing and selling activity in earlier years and later direct disbursements from one or more of the Fund's account to his for-profit business in 20XX.

***Insubstantial or negligible charitable activities***

The Fund did issue grants to other tax-exempt organizations in 20XX and 20XX. However, those distributions maxed at % of the Fund's total operating expenses. The lion's share of expenses was for criminal reports.

However, in 20XX, there were zero grants issued to any tax-exempt organization. The \$ cashiers check that was written from CO-12's account on 3/30/20XX to CO-13 was not a direct or indirect 170(c) charitable contribution of the Fund. CO-13 never reported receipt of the "contribution" by reflecting it on the filed Form 990-PF for the year ending 12/31/20XX.

**(Exhibit Q)**

Amounts were disbursed either for the history reports or for unsubstantiated purposes to RA-2.

***No true governing body***

The bylaws of the organization were created solely for the purpose of complying with the organizational test for tax-exempt organizations. The conditions of the bylaws were never implemented and most likely never intended to be. There were never any meetings, no officer was ever elected and operations were controlled by one person – the president – whether it was the former or the latter.

The Fund was operated as if it was the private business of the original insider BM-2 and once he grew weary of the work, he later sold it to RA-2.

These individuals had only one goal in mind and that was to enrich themselves at the expense and abuse of a tax-exempt organization.

***No charitable, educational or other exempt purpose supported***

The lack of an independent governing body, the disproportionate benefits to key insiders, coupled with the insubstantial or negligible charitable activities are not the basis under which tax-exempt organizations retain exemption.

**Conclusion**

|                                    |  |   |
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Based upon cited court cases, the regulations and Code, we hold that the ORG is **not** operated exclusively for *any* charitable, educational, or scientific purpose. Additionally, excessive private benefit exists with respect to the creators, officers and other primary insiders, thereby, defeating the retention of exemption.

Therefore, we have concluded that you do not qualify for exemption from Federal income tax as an organization described in section 501(c)(3) of the Code.

Revocation of your exempt status will be effective as of January 1, 20XX. In accordance with this determination, you are required to file Federal income tax returns on Form 1120. Contributions to your organization are no longer deductible by donors under section 170(c)(2) of the Code.

In accordance with the provisions of section 6104(c) of the Code a copy of this letter will be sent to the appropriate State officials.

On December 2, 20XX, the D.C. Circuit ruled that the Service will disclose our denials and revocations under section 6110 effective August 1, 20XX. *Tax Analysts v. IRS*, 350 F.3<sup>rd</sup> 100 (D.C. Cir. 20XX)