Internal Revenue Service
Appeals Office
1375 E. Ninth Street
Cleveland, OH 44115

Number: **201004046**
Release Date: 1/29/2010

Date: November 3, 2009

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*****

Department of the Treasury

Person to Contact:
*****
Employee ID Number: *****
Tel: *****
Fax: *****
Refer Reply to:
AP:FE:CLE:KAS
In Re:
EO Revocation
Form Required to be Filed:
1041
EIN:
*****
Tax Period(s) Ended:
12/2001 12/2002
UIL: 501.33-00
Last Day to File a Petition with the United States Tax Court:
Not Applicable

Certified Mail

Dear :

This is a final adverse determination regarding your exempt status under section 501(c)(3) of the Internal Revenue Code (IRC). It is determined that you do not qualify as exempt from Federal income tax under IRC Section 501(c)(3) effective December 14, 1999.

Our adverse determination was made for the following reason(s):

> A substantial amount of your organization's assets were diverted to the personal use of the founders. Because the earnings inured to the benefit of a private shareholder or individual, the organization is not operated exclusively for exempt purposes described in section 501(c)(3) of the Code.

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

You are required to file Forms 1041, U.S. Corporation Income Tax Return, for tax periods beginning on and after January 1, 2003 with the Cincinnati Service Center, Cincinnati, OH, 45999-0012.

We will notify the appropriate State officials of this action, as required by Code section 6104(c). You should contact your state officials if you have any questions about how this determination may affect your state responsibilities and requirements.

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 is not able to reverse legally correct tax determinations, nor extend the time fixed by law that you have to file a petition in the U.S. Tax 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. If you want Taxpayer Advocate assistance, please contact the Taxpayer Advocate for the IRS office that issued this letter. See the enclosed Notice 1214, *Helpful Contacts for Your "Notice of Deficiency"*, for Taxpayer Advocate telephone numbers and addresses.

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

Sincerely,

*****
TEAM MANAGER

Enclosure:
Notice 1214 Helpful Contacts for your "Notice of Deficiency"

cc: *****

DEPARTMENT OF THE TREASURY
Internal Revenue Service

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Legend
ORG= Name of organization
EIN= EIN of organization
NN= Name of individual

ORG

Taxpayer Identification Number:
EIN
Form:

Tax Year(s) Ended:
December x, 200X & 200X
Person to Contact/ID Number:

Contact Numbers:
Telephone:
Fax:

Certified Mail - Return Receipt Requested

Dear NN,

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

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

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

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

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

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,

Marsha A. Ramirez
Director, EO Examinations

Enclosures:
Publication 892
Publication 3498
Reports of Examination

Legend

ORG = Name of organization
EIN = EIN of organization
NN = Name of individual
ST = State
BA= Bank
RR= Related organization
AT= Attorney
LC= Location
CY/PR= Country or Providence
UU= Unrelated organization
x = Amount
X = Year

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 purposes.

FACTS:

Organization's creation and structure.

ORG (the "Organization") was created with a Declaration of Trust (Declaration) by NN and NN(each being a "Founder"), with NN also being the Trustee, on December x, 199X. This trust was organized under the laws of the ST. (See exhibit A)

The Declaration provides that the trust was created for the purpose of establishing an organization which is described in IRC §§ 501(c)(3) and 509(a)(3). The Declaration provides that the Founder renounces any power to determine or control, by alteration, amendment, revocation, termination or otherwise, the income or principal of the trust estate and that the Founder renounces any interest, either vested or contingent, including any reversionary interest or possibility of reverter, in the income or principal of the trust estate. (See exhibit A)

The Declaration further provides that each year the Trustee shall distribute x% of the net income of the trust to the RR, the named Primary Charity. In addition to this distribution, each year the Trustee shall distribute a total of x% of the 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"). Schedule A of the Declaration lists x additional charities, including RR. (See exhibit A)

The Declaration provides that the Board shall contain x members, be the governing body of the trust, and that the members of the Board shall be determined as follows:

- One Board member shall be appointed by the Primary Charity
- One Board members shall be NN his successor, or a descendent of NN
- The other members of the Board shall be NN, NN, and NN

The Declaration provides that upon winding up and dissolution of the trust, the 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 § 501(c)(3). (See exhibit A)

Through their attorney, NN, (See exhibit B) and on behalf of the Organization ,the NN executed a Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, (See exhibit B-1) on December x, 199X, which was filed on December x, 199X. The Service acknowledged the application by letter dated February x, 200X. (See exhibit C) By letter dated April x, 200X, the Service recognized the Organization as exempt from Federal income tax under § 501(a) as an organization described in § 501(c)(3) and classified it as other than a private foundation because it was described in § 509(a)(3). (See exhibit D)

It should be noted that the exemption application filed with the Service by the Organization in December 199X contained financial information for the calendar year ending December x, 199X, and proposed budgets for the calendar years 200X and 200X. The application did not, however, contain any information regarding the plans NN and UU ("Promoter") had orchestrated. The plan called for the Organization to loan $x to a hybrid entity, which would then move $x to UU, which would then move $x to UU, which would then loan the money as a mortgage to NN. This plan is outlined in a flowchart (See exhibit E-3) provided to NN by Promoter in the executive summary dated November 10, 199X. It should also be noted that UU. and UU are affiliated entities, both of which are also affiliated with Promoter. The plan, with slight modifications, was later executed.

Background leading up to the creation of the Organization.
By 199X, as stated in the executive summary dated November x, 199X, NN acquired x stock options from his employer, UU. NN exercised x of these options on October x, 199X, resulting in $x of ordinary income. NN expected to exercise the remaining x options when the market reached $x per share.

NN contacted Promoter about its tax saving strategies in response to Promoter's advertisements. Promoter replied to NN's initial contact in a letter dated September x, 199X. (See exhibit E-1) In the September x, 199X letter, the promoter proposed to prepare a "comprehensive Master Financial Plan" for NN in exchange for a retainer fee of $x to be collected by the UU (Promoter's affiliated law firm in the CY,PR). The fee was due and payable before any planning would take place.

On September x, 199X, NN entered into an "Agreement for Development of Master Financial Plan" with Promoter, paying the $1x "retainer" to Promoter by check #x, dated October x, 199X. This check was drawn from NN's "NN Tax-free reserves money market portfolio" account. (See exhibit E-2) In November 199X, NN went to ST and attended a presentation by Promoter. Promoter provided NN with a November x, 199X executive summary, which served as a narrative for use during the presentation. According to this document, NN's financial goals were to minimize personal income taxes on his exercise of UU stock options, eliminate capital gains tax on the sale of his portfolio assets, and to preserve wealth through implementing estate planning techniques. Promoter proposed x strategies in its Master Financial Plan to NN to accomplish his goals: a loss of income insurance program, a supporting organization, an equity management mortgage, and estate planning techniques.

Loss of Income Insurance Policy and *Equity Management Mortgage* Strategies

In its complaint against Promoter, the Security and Exchange Commission (SEC) describes these strategies as follows – (See exhibit AF)

A Loss of Income ("LOI") policy is an agreement between Promoter's client and UU ("UU") whereby the client purchases a policy to insure against a future loss of income:

> An LOI policy is usually purchased for coverage until the earlier of a specified term, such as x year, or the date of death of the insured. The insurance company typically holds the net premium in a separate account, along with the net premiums of other LOI insurance policies. Creditors cannot access policy reserves. The insurance company guarantees a fixed return on such premiums. Most LOI policies provide that your premiums, plus a guaranteed return, will be paid back to the policy holder at the end of a specified period (usually x years).

SEC contends that, in reality, LOIs are not purchased as insurance, but as a vehicle to make offshore and tax-free investments of funds which can be repatriated as desired by the investor. No UU investor has ever filed a claim against an LOI for a loss of income. What, in fact, occurs is that the investor purchases the LOI from UU and then borrows back a percentage of the premium through a note or investment contract, usually in the form of a "mortgage," called an Equity Management Mortgage or "EMM."

The EMM is obtained through two affiliated entities of Promoter, UU and UU, which act as the mortgagee. The investor's proceeds from the EMM are then placed in an IBC and invested offshore through ST, or repatriated by the investor. The net effect of the LOI/EMM transaction is that the investor is able to deduct the premium paid for the LOI, encumber his property through a mortgage and deduct the interest on payments which are effectively made to himself on the mortgage. The investor can then invest the proceeds from the mortgage offshore through an IBC, with UU ("ST") managing the investment. The remainder of the premium left with UU is then invested to provide the investor with a fixed rate of return over the ten-year life of the policy.

In the November x, 199X executive summary provided to NN, MSA states that "the objective of the LOI Insurance Program is to create an additional investment tool where premiums grow tax-deferred, and are available through loan arrangements while insuring against loss of income." (See exhibit E-3)

Supporting Organization Strategy

In its complaint against Promoter, the SEC describes Promoter's Supporting Organization (SO) strategy --

> Contributions by investors to SOs are treated in a similar way [to that of the LOI and EMM strategy]. Under Promoter's interpretation of the tax code, a certain percentage of the income derived from the funds contributed to the SO must be donated to charity, and

the remainder maybe loaned back to the investor through an EMM. The proceeds from the EMM are then invested in the same way as the LOI and EMM strategy.

Estate Planning Strategy

Promoter's Estate Planning Strategy included transferring client assets into a living trust, and moving life insurance assets into an Irrevocable Life Insurance Trust.

In its November x, 199X, executive summary to NN, Promoter concluded that implementing these strategies could result in 199X tax savings of $x, possible 200X tax savings of $x, and possible 200X tax savings of $x. Promoter stated in the November x, 199X "Implementation Agreement" letter (Exhibit E-4), that for $x the Master Financial Plan can be put into operation. The $x fee was for the attorney's fees, the filing fees, travel expenses, first year fees, consultation services and tax filings. Flat fees and additional service fees are mentioned for the EMM, the Support Organization, the LOI policy, the Foreign Variable Annuity, and the hybrid company.

NN paid $x to Promoter as an initial retainer fee, another $x initial fee for the LOI policy (to UU "UU"), and another $x to the UU. Additionally, Promoter's Master Financial Plan that it created for NN called for the creation of a supporting organization which was named ORG ("Organization"). Per Promoter, the role of the Organization in the NN Master Financial Plan was, "to assist you in reducing capital gains on the sale of your portfolio assets. This benefit is directly related to your financial objective of reducing ordinary income tax for 199X."

The Promoter also facilitated the creation of other organizations for use by NN as part of executing the Master Financial Plan. These include NN in the CY/PR, NN, Series A Investors, Ltd, and NN Inc. Other organizations in the Promoter's family of controlled organizations used as part of the NN Master Financial Plan include the Estate Planning Institute, Ltd. and NN ("NN"). NN moved $x (See exhibit E-7) from the NN LOI policy to the Bank of CY/PR and then on to the $x (See exhibit E-8) home mortgage through UU, LLC (provider of Promoter's EMM arm of the plan). Promoter detailed this transaction to NN in the cash flow diagram section of the Master Financial Plan that it created for NN.

As mentioned, one of the products NN purchased was the creation of a supporting organization. Promoter's executive summary advises NN that the "Supporting Organization (SO) could help reduce your taxable income by $x in 199X and $x in 200X and 200X." In addition, "With a $x donation you will be able to reduce your ordinary income tax by $x" plus x% of the, "contribution is transferred out of your taxable estate. This provides asset protection from your personal liabilities and allows your estate to escape estate taxes." To execute this plan, the Form 1023 was filed with the Internal Revenue Service on December x, 199X. NN, a key seller of Promoter's products, was the Organization's contact listed on the Form 1023.

Specific Examination Findings

The Organization filed Forms 990, *Return of Organization Exempt From Income Tax*, for the tax years 199X, 200X, 200X and 200X. The Organization has not filed any of its returns for years after 200X, including its Form 990 for the period ending December x, 200X. The reason given by NN of UU, LLP was that the representative did not have enough information to file an accurate return. (See exhibit AD)

The Organization's Forms 990 reflect the following: (See exhibits AI, AJ and AK)

	TY 200X	TY 200X	TY 200X
Contributions	x	x	x
Dividends/Interest			
Gain(Loss) on Sale of Assets			
Other Inv. Inc.			
Total Revenue			
Grants			
Bank Fee			
Total Expenses			
Excess (Deficit) for Year			

	TY 200X	TY 200X	TY 200X
Savings & Temp Cash Investments	$x[1]	$x	$x
Investments-Securities (UU)	x	x	x

* * * *

[1] At the beginning of the calendar year 200X, the Form 990 reported there was $x in Savings & Temporary Cash Investments.

Investments – Other (UU)	x	x	x
Other Assets			
Total Assets	$x	$x	$x

The following grants to charitable organizations were reported on the respective Form 990 returns:

TY 200X	$x
TY 200X	$x
TY 200X	$x
Total	$x

199X and 200X Years

In 199X NN reported a deduction of $x in charitable contributions on their 199X Form 1040, *U.S. Individual Income Tax Return.* The Organization reported on its 199X Form 990 that it received $x in cash contributions in 199X ($x from NN, and $x from NN). (See exhibit AH)

In December 199X, NN purchased an LOI policy from UU for $x that, after fees of $x, resulted in $x on the UU LOI policy.

The NN purchased a house on February x, 200X, for $x, with a first mortgage of $x held by BA and a second mortgage of $x through UU (a Promoter-controlled entity). Promoter's portfolio documents include a sheet entitled "NN Mortgage Funds Breakdown," showing that the funding for this mortgage came from the Organization, in the amount of $x, and from the UU LOI policy, in the amount of $x, for a total of $x. Copies of wire transfers show that $x was wired from UU to UU on January x, 200X, and the Organization transferred $x to UU on January x, 200X. In February 200X, UU wired the $x million to UU, which then wired the $x million to the NN mortgage closing attorneys (AT) on February x, 200X. (See exhibits E-7 through E34)

The Organization's cash flow for 199X and 200X consisted of the following --

NN transferred stock and cash to the Organization in late December of 199X for which the NN claimed a charitable contribution deduction on their Form 1040 for 199X. The Organization

sold the stock for cash and the monies were placed in the x accounts titled in the name of the Organization, one at UU and one at UU.

On January x, 200X, the Organization had $ in account number x with UU. (See exhibit AL) During the month of January 200X there were withdrawals of $x from the account and a fall in market value of $x, leaving $x in the account at years end. In a meeting with agent NN, NN stated that this money was moved to a bank account in CY/PR and is owed to him by Promoter. The facts show that, contrary to NN's assertion, the monies were moved as part of the pre-arranged plan and were "lent" to the NN via UU. See below.

On January x, 200X, NN authorized a wire transfer for $x from the Organization's account with UU, account number x, to UU Funding Limited ("UU")'s BA Bank account in CY/PR. (See Exhibit AP)

A total of $x was transferred from the Organization's MML account on January x, 200X, via two separate wire transfers of $x and $x. The money was deposited in UU's account at BA in CY/PR. When asked, the Organization was unable to substantiate the exempt purposes of these transfers.

In addition to the transfer of $x from the NN LOI policy, this makes $x transferred from the Organization and the NN "loss of income" policy to UU's bank account in CY/PR in January 200X.

On February x, 200X a wire transfer for $x went from the UU's bank account in CY/PR through UU and then to AT. AT listed $x on the settlement statement prepared for the purchase of the NN new home as a loan from UU, LLC (UU). As previously stated, UU is affiliated with Promoter and with UU.

On December x, 200X, $x was wired into the Organization's UU account. This amount was also reported as a charitable contribution deduction by the NN on their Form 1040 for 200X.

On December x, 200X, $x was wired out of the Organization's UU account. When asked, the Organization was unable to substantiate an exempt purpose for this transfer.

For 200X, the total amount of disbursements made by the Organization for which it is unable to substantiate an exempt purpose is $x ($x, $x, and $x). This is the amount reported on the Organization's Forms 990 for 200X – 200X as Investments- Other and described on a Schedule as UU.

Sometime after the mortgage was signed and all the paperwork was processed, NN stopped making payments to UU on the mortgage. The Organization has received no payments from the NN for the NN use of its funds routed through UU and UU to NN. and NN.

200X Tax Year

On its Form 990 for tax year 200X, the Organization reported expenditures of $x. The Organization substantiated $x in expenditures during the examination, not all for grants:

$x to the UU;
$x to UU;
$x to the UU;
$x to various other charities;
$x to the private benefit of the NN family (vacation trip and cash).

The Organization was unable to substantiate $x in expenditures.

For tax year ending December x, 200X, the Organization's income that it reported on its Form 990 was understated by $x. As previously stated, it could not substantiate $x in disbursements. Additionally: a total of $x in expenditures were either used for the NN personal benefit or were not established as being for § 501(c)(3) exempt purposes as follows: the Organization made a payment by check, number x, in the amount of $x (See exhibit AQ-1) for a vacation at LC for the NN family; issued a check number x for $x in "cash;" See exhibit AQ-2) and $x in unsubstantiated expenditures.

The Organization could only substantiate $x in assets as of December x, 200X. The Organization reported $x in assets on its 200X Form 990 ($x in Savings and Temporary Cash Investments; $x in Investments – Securities (described as NN) and $x in Investments - Other (described as UU). The Organization was unable to substantiate $x of its assets for 200X. The Organization asserts that this amount was in an account with UU Funding Ltd. in CY/PR. When requested, the Organization was unable to provide documentation to substantiate the location and amounts of these assets. As previously shown, $x of this amount was returned to the NN via a "loan." The Organization has not accounted for $x wire-transferred out of its account on December x, 200X, x days after the $x was "contributed" to it by the NN.

200X Year

On November x, 200X, NN wrote two checks (numbers x and x) to "Cash" from the Organization's account with UU for a total of $x. (See exhibits AR-1 and AR-2) When asked, the Organization was not able to substantiate an exempt purpose for these cash withdrawals. NN annotated on check number x "food bank contributions," and on check number x "homeless shelter supplies."

In two years, in excess of x% ($x + $x0 + x + x + $x + $x) of the "contributions" to the Organization were dissipated without the Organization being able to substantiate the exempt purposes behind the expenditures. The Organization did not adequately substantiate these expenditures on its Forms 990 for 200X, 2001 or 200X. NN asserted, in a meeting with agent NN, that this money was invested in a bank in ST CY/PR and then stolen by Promoter. However, most of this money was funneled through the Organization by the NN (without any capital gains tax assessed on the stock sales and with a tax deduction for the "contributions") and used for inurement directly to the NN.

Additional

On July x, 200X, NN transferred $x from the exempt organization's UU account via check number x. When asked, the Organization was unable to substantiate the purpose or destination of the withdrawal. The Organization has been unable to account for the continued "disappearance" of its assets.

Due to the lack of records, the Organization did not file Form 990 for the period ending December x, 200X.

As of April x, 200X, the court appointed receiver of Promoter's assets began collection efforts on the loan the NN obtained through UU. The NN representative in the collection matter claimed in a letter, dated June x, 200X, to the receiver that the mortgage was funded using the assets of NN and that the mortgage was a sham. Therefore, per his representative, NN had no liability to continue to pay UU.

The NN are the only contributors to the Organization. NN is the trustee of the Organization and designates which entities receive funds from the Organization. NN is also listed on the Forms 990 as a trustee although she was not so designated in the Declaration of Trust. During a meeting with Agent NN, NN stated that no director of the Organization's Board of Directors ever did anything with or for the Organization. NN and NN controlled the Organization completely.

From 199X – 200X, the NN used the Organization as a place to move cash in and out, with the Organization being unable to substantiate, when requested, the exempt purpose for almost all expenditures and transfers, and unable to substantiate even the location where some of the funds were transferred. Approximately x% of the assets deposited into the banking accounts of the Organization have not been used for exempt purposes.

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 § 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 § 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 § 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 per Treas. Reg. sec. 1.501(a)-1(c)

Regulation § 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 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 private source of loan credit from an organization's earnings may itself amount to inurement of benefit."

In Church of World Peace, Inc. v. Commissioner, T.C. Memo. 1994-87, aff'd, 75 A.F.T.R.2d (RIA) 2082 (10th Cir. 1995), the Tax Court held that a church did not operate exclusively for religious purposes because the church facilitated a circular tax-avoidance scheme. The facts showed that individuals made contributions to the church and claimed charitable contribution deductions. The court found that the church then returned the money to the individuals claiming that the payments were for housing allowances and reimbursement of expenses. The court further found that such payments were in fact unrelated to the church's operations.

In Rev. Rul. 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 § 501(c)(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.

The facts show that the Organization is not operated exclusively for a tax exempt charitable purpose. Rather, the NN have operated the Organization for their own personal benefit. The NN have also used the Organization for tax avoidance purposes. The promotional material and the agreements that the NN entered into with UU ("Promoter") show that the NN established the Organization to obtain tax benefits in the form of avoiding capital gains and claiming deductions under § 170, without relinquishing control of the assets that they claimed to have contributed to the Organization.

Per the executive summary, the funding of the Organization was structured to obtain the maximum income tax deduction for the NN. The amount of the NN contribution to the Organization was based on an estimate of x% of the NN income for the years of their contributions.

In December of 199X, the NN transferred $x to the Organization and claimed it as a charitable contribution deduction on their income tax return (Form 1040) for 199X. In 200X, the NN transferred $x to the Organization and claimed it as a charitable contribution deduction on their income tax return (Form 1040) for 200X. In 200X, the NN transferred $x to the Organization and claimed it as a charitable contribution deduction on their income tax return (Form 1040) for 200X. Of the $x that the NN transferred to the Organization, $x was subsequently transferred to UU, an organization controlled by Promoter. Shortly after the Organization transferred the $x to UU, another entity controlled by Promoter, UU, LLC ("UU") loaned $x to the NN. The $x was comprised of $x from the Organization's funds and $x from the NN LOI policy, also purchased from an entity affiliated with Promoter. This "loan" was secured by a mortgage on real estate owned by the NN. The other $x remains unaccounted for. The Organization has not been reimbursed by the NN for the monies that were transferred for their benefit.

The timing of the transactions and other evidence in the Administrative Record demonstrates that these transactions were prearranged and facilitated by Promoter. Significantly, both UU, who received the funds from the Organization, and UU, which returned the funds (less expenses) to the NN in the form of a mortgage on the property owned by the NN, were controlled by Promoter.

Since the Organization's formation in December 199X, while being funded with $x, less than x% of that amount was distributed for documented charitable purposes.

The transfers to UU, most of which were transferred to UU and then loaned back to the NN, serve the financial interests of the NN, UU, UU and/or Promoter. 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), aff'd 631 F.2d 736 (7th Cir. 1980).

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. 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 (9th Cir. 200X). The NN 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 its assets to the NN, the Organization breached the dedication requirement and its net earnings have inured to the benefit of the NN.

Although the inurement prohibition is stated in terms of net earnings, it applies to any of a charity's assets that serve the interests of its private shareholders. Harding Hospital, Inc. v. United States, 505 F.2d 1068, 1072 (6th Cir. 1974). In this case, it appears that the Organization facilitated an integrated tax avoidance scheme for the benefit of the NN. Church of World Peace v. Commissioner, T.C. Memo. 1994-87. Tax avoidance schemes do not further an exempt purpose. Freedom Church of Revelation v. United States, 588 F. Supp 693, 696 (D.D.C.1984)

The Organization, which is controlled by the NN, was established and operated primarily to enable the NN to engage in financial activities which are beneficial to them and/or entities with whom they are transacting business, but detrimental to the Organization. Accordingly, it is operated for a substantial non-exempt purpose. See Revenue Ruling 67-5.

Promoter's implementation agreement and executive summary state that NN is supposed to move money through the supporting organization; to a hybrid corporation; to UU Funding and then to UU . This plan, as slightly modified, was implemented. The money went to NN through a mortgage used to buy a new house for NN and family. The $x came from the assets of the Organization and was used for the private benefit of NN. This is inurement and is prohibited under IRC § 501(c)(3). NN and NN are disqualified persons under IRC § 4946 as the only contributors to the Organization. In addition NN is the trustee of the Organization. He and his wife NN made all decisions about the use of the Organization's assets. NN and NN are insiders of the Organization and the diversion of funds from an IRC § 501(c)(3) to them is prohibited under the Internal Revenue Code.

The Organization, which is controlled by the NN, is operated to enable the NN to engage in financial activities which are beneficial to them and/or entities with whom they are transacting business, but detrimental to the Organization. Accordingly, it is operated for a substantial non-exempt purpose. See Rev. Rul. 67-5.

The Organization's net earnings have inured to the benefit of insiders. Treas. Reg. § 1.501(a)-1(c); Ginsburg v. Commissioner, 46 T.C. 47 (1966). The very presence of a private source of loan credit may amount to inurement. Founding Church of Scientology v. United States, 412 F.2d 1197 (Ct. Cl. 1969); Church in Boston v. Commissioner, 71 T.C. 102 (1978). Loans to disqualified persons promote private rather than charitable purposes. Best Lock Corporation v. Commissioner, 31 T.C. 1217, 1235-37 (1959).

Accordingly, the Organization's status as an organization described under § 501(c)(3) should be revoked, effective December x, 199X, because it did not operate exclusively for exempt purposes and because its assets inured to, and it served the private interests of, its creators.

Based on the Forms 990 for 199X, 200X, and 200X NN claimed contributions of $x and disbursements of $x for charitable purposes (as previously noted, not all of which were expended for charitable purposes). There have been diversions of at least $x to or for the private benefit of NN and NN and their family. The Organization is not being operated exclusively for charitable purposes. Instead, in excess of x% of the contributions have been diverted to the personal use of NN and NN, disqualified persons and insiders of the Organization.

CONCLUSION:

The Organization is not being operated as an exempt IRC § 501(c)(3) organization. The charitable exempt status should be revoked effective December x, 199X. This revocation should be effective as of December x, 199X because the Organization was never created with exempt purposes as the primary objective. Instead, the primary purpose has been to reduce the individual tax burden of NN and NN while allowing them to control and use the Organization's assets for their benefit. Revocation should be retroactive because the Organization's application contained material misrepresentations. Not only was the Organization's purpose misrepresented, the application contained no information about the Master Financial Plan that was already developed and which was later implemented whereby most of the Organization's assets were diverted back to the NN. When an application for exempt status is made and the application contains material false statements about proposed exempt organization activities, the exempt status needs to be revoked back to the initial exemption date.

ALTERNATIVE ISSUE # 1: Should The ORG (the "Organization") be reclassified as a private foundation?

FACTS:

See prior recitation of facts, along with the following;

LAW:

Income Tax Regulations § 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 §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 §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 § 1.509(a)-4(f) regarding the nature of relationships required for § 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, 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 §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 §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 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 § 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*

(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 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.

Rev. Rul. 76-208, 1976-1 C.B. 161, held that a charitable trust described in § 501(c)(3) did not satisfy the "substantially all" requirement of the integral part test set forth in § 1.509(a)-4(i)(3)(iii)(A) of the regulations and was therefore not a supporting organization. The trust instrument provided that 75 percent of the trust income was to be distributed annually to a specified church with the remaining 25 percent to accumulate until the original corpus doubled, at which time the entire annual income was to be distributed to the church. The Service also stated that for purposes of the integral part test, the term "substantially all" means 85 percent or more.

Income Tax Regulations § 1.509(a)-4(j) regarding control by disqualified persons provides:

(1) *In general.* —Under the provisions of § 509(a)(3)(C) a supporting organization may not be controlled directly or indirectly by one or more disqualified persons (as defined in § 4946) other than foundation managers and other than one or more publicly supported organizations. If a person who is a disqualified person with respect to a supporting organization, such as a substantial contributor to the supporting organization, is appointed or designated as a foundation manager of the supporting organization by a publicly supported beneficiary organization to serve as the representative of such publicly supported organization, then for purposes of this paragraph such person will be regarded as a disqualified person, rather than as a representative of the publicly supported organization. An organization will be considered "controlled", for purposes of § 509(a)(3)(C), if the disqualified persons, by aggregating their votes or positions of authority, may require such organization to perform any act which significantly affects its operations or may prevent such organization from performing such act. This includes, but is not limited to, the right of any substantial contributor or his spouse to designate annually the recipients, from among the publicly supported organizations of the income attributable to his contribution to the supporting organization. Except as provided in subparagraph (2) of this paragraph, a supporting organization will be considered to be controlled directly or indirectly by one or more disqualified persons if the voting power of such persons is 50 percent or more of the total voting power of the organization's governing body or if one or more of the total voting power of the organization's governing body or if one or more of such persons have the right to exercise veto power over the actions of the organization. Thus, if the governing body of a foundation is composed of five trustees, none of whom has a veto power over the actions of the foundation, and no more than two trustees are at any time disqualified persons, such foundation will not be considered to be controlled directly or indirectly by one or more disqualified persons by reason of this fact alone. However, all pertinent facts and circumstances including the nature, diversity, and income yield of an organization's holdings, the length of time particular stocks, securities, or other assets are retained, and its manner of exercising its voting rights with respect to stocks in which members of its governing body also have some interest, will be taken into consideration in determining whether a disqualified person does in fact indirectly control an organization.

GOVERNMENT'S POSITION:

As set forth above, it is the government's primary position that the tax exempt status of 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 § 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 (7th Cir. 1979). The Organization currently is excepted from private foundation status because it is currently classified as an organization described in § 509(a)(3), which defines supporting organizations.

Public charities (organizations described in § 501(c)(3) that meet the requirement of § 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.

Section 509(a)(3) organizations must meet all three of the following tests:

1) Organizational and Operational Tests under § 509(a)(3)(A).
2) Relationship Test under § 509(a)(3)(B).
3) Lack of Disqualified Person Control Test under § 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 the Primary Charity or to the organizations specified on Schedule A of the Organization's Declaration of Trust. 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 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 and has made payments for the benefit of NN and NN. 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. The operational test is not satisfied because the Organization made grants to organizations that were not specified in the Declaration of Trust and Schedule A thereto.

In 200X, the Organization's grants to organizations not specified on Schedule A to its Declaration were as follows:

$x to UU;
$x to the UU; and
$x to various other charities.

These grants are in violation of Treas. Reg. § 1.509(a)-4(e)(1).

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. 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).

In the present case, the facts indicate that there was no substantial control or direction over the policies or activities of the Organization by the publicly supported organizations (the Primary Charity or any Schedule A organization). The evidence developed thus far shows that the appointed representative of the Primary Charity never attended any board or trustee meetings, was a close personal friend of the NN, and may not have actually been appointed by the Primary Charity. A majority of the Organization's governance is not appointed or elected by the specified publicly supported organizations. There is no common supervision or control by the same persons over the Organization and the specified publicly supported charities. Thus, the requirements to satisfy one of the first two types of relationship have not been met.

The third and final relationship possible for § 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. Neither test has been met in this case.

In order to meet the responsiveness test, either Treas. Reg. § 1.509(a)-4(i)(2)(ii) or (iii) must be satisfied. Treas. Reg. § 1.509(a)-4(i)(2)(ii) requires that the board member appointed by the supported organization have a significant voice in the operations of the supporting organization. The Organization has claimed that they were a supporting organization to the UU. The Organization claimed that a member of the UU would be on the Board of Directors. Promoter's literature told NN that even though NN was a disqualified person, he could still control distributions by being the trustee of the Organization. He could include himself and his wife on the Board of Directors. The Organization never had any board meetings. There were no minutes to review. As a result, the Board of Directors never had a significant voice in the investment policies of the Organization. In a conversation with Agent NN, NN stated that the "board members" were just friends of his and did not want any letters mailed to them. See Roe Foundation Charitable Trust v. Commissioner; 58 T.C.M. 402 (1989).

Alternatively, the supporting organization must be a charitable trust under state law and each specified publicly supported organization must be a named beneficiary under the charitable trust's governing instrument and the beneficiary organization must have the power to enforce the trust and compel an accounting under state law. Treas. Reg. § 1.509(a)-4(i)(2)(iii). The Declaration requires the trustee to distribute x% of the net income of the trust to the RR. The Declaration also requires the trustee to distribute a total of x% of the net income to one or more of the organizations listed on Schedule A. There are x organizations listed on Schedule A that the Organization can select as grant recipients. Only one, the RR, is entitled to receive a specified portion of the Organization's net income. The Organization is not required to make any specified distributions to any of the other x. Therefore, the Organization has not established that any of these organizations are beneficiaries to the trust or that they have the power to enforce the trust under state law.

Therefore, the Organization does not meet either of the "responsiveness" tests.

While the responsiveness test guarantees that the publicly supported organization can influence the activities of the supporting organization, 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 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. 200X-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 or on behalf of publicly supported organizations aside from grants, 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 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. In the present situation, the Organization does not meet the second requirement and, therefore, it cannot meet the third requirement.

Treas. Reg. § 1.509(a)-4(i)(3)(iii)(a) provides that 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. 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.

UU in the CY,ST UU, is a x dollar annual operation per oral statements of NN priests. Per the Organization's filed Form 990s for the years ending December x, 199X, 200X and 200X, they claimed total grants paid of $x. Even if all of these grants were made to the UU, this amount is insufficient to insure its attentiveness.

The Organization did not produce any evidence that shows that the Primary Charity would be attentive to its operations. The individual who purportedly represented the Primary Charity on the

Organization's board never attended or participated in any board meeting. There is no evidence that this individual was involved in the decisions regarding investments and/or operations of the Organization. The Primary Charity never requested or received any financial reports from the Organization. The purportedly appointed representative of the Primary Charity never attended any board or trustee meetings, was a close personal friend of the NN, and may not have actually even been appointed by the Primary Charity. During a meeting with Agent NN, NN stated that no other member of the Organization's Board of Directors ever did anything with or for the Organization and that NN and NN controlled the Organization completely. Thus, it is apparent that the Primary Charity was not attentive to the operations of the Organization.

Control

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 a disqualified 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. Id. As founders, substantial contributors, board members and trustee of the Organization, NN and NN are disqualified persons. There is no evidence that any other board member had any direction over the activities of the Organization. At their discretion, the NN entered into questionable transactions using the Organization's funds for their personal benefit which significantly impeded the Organization's ability to perform its stated exempt purpose.

CONCLUSION:

Accordingly, 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 (j).

The modification of private foundation status is effective December x, 199X. Because the application did not disclose that the Primary Charity would not be involved with the activities of the Organization, that grants would be made to other than specified public charities, that the Organization would operate primarily for the benefit of the NN and that the NN would control the Organization's activities, retroactive re-classification is appropriate in this case.

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 x, 199X through December x, 200X. Subsequent returns are due no later than the x day of the x month following the close of the Organization's accounting period.

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