



DEPARTMENT OF THE TREASURY

Internal Revenue Service
TE/GE EO Examinations
1100 Commerce Street
Dallas, TX 75424

501-03-00

**TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION**

Release Number: **201021029**

Release Date: 5/28/10

February 24, 2010

LEGEND

ORG = Organization name

Address = address XX = Date

ORG

ADDRESS

Identification Number:

Contact Telephone Number:

In Reply Refer to: TE/GE Review Staff

EIN:

LAST DATE FOR FILING A PETITION
WITH THE TAX COURT: May 25, 20XX

Dear

This is a Final Adverse Determination Letter as to your exempt status under section 501(c)(3) of the Internal Revenue Code. Your exemption from Federal income tax under section 501(c)(3) of the code is hereby revoked effective July 1, 20XX. You have agreed to this adverse determination, per signed Form 6018, on November 5, 20XX.

Our adverse determination was made for the following reasons:

1. The ORG is not operated for an exclusive exempt purpose, as is required by IRC section 501(c)(3) and Treas. Reg. section 1.501(c)(3)-1(d).
2. A substantial part of the activities of ORG furthers non-charitable activities rather than public interests, which is prohibited by Treas. Reg. section 1.501(c)(3)-1(d)(1)(ii). The foundation failed to make financial distributions or provide any activity as a supporting organization to a specified organization.
3. The organization did not operate exclusively for exempt purposes because it was organized and operated for the purpose of stock trading and investment activities, which are not charitable activities and is prohibited by IRC section 501(c)(3).

Contributions to your organization are no longer deductible under section 170 of the Internal Revenue Code. You are required to file Federal income tax returns on Form 1041 and 990-PF. These returns should be filed with the appropriate Service Center for the year ending June 30, 20XX, and for all years thereafter.

Processing of income tax returns and assessment of any taxes due will not be delayed should a petition for declaratory judgment be filed under section 7428 of the Internal Revenue Code.

If you decide to contest this determination in court, you must initiate a suit for declaratory judgment in the United States Tax Court, the United States Claim Court or the District Court of the United States for the District of Columbia before the 91st day after the date this determination was mailed to you. Contact the clerk of the appropriate court for the rules for initiating suits for declaratory judgment.

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 and ask for Taxpayer Advocate assistance. Or you can contact the Taxpayer Advocate from the site where the tax deficiency was determined by calling: or writing to: Internal Revenue Service

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

We will notify the appropriate State Officials of this action, as required by section 6104(c) of the Internal Revenue Code.

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

Sincerely yours,

Nanette M. Downing
Acting Director, EO Examinations



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY

Internal Revenue Service
TE/GE EO Examinations
1100 Commerce Street
Dallas, TX 75242

February 24, 2010

ORG
ADDRESS

Taxpayer Identification Number:

Person to Contact/ID Number:

Contact Numbers:

Telephone:

Fax:

Dear

We are sending the enclosed material under the provisions of your power of attorney or other authorization on file with us. For your convenience, we have listed the name of the taxpayer to whom this material relates.

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

Thank you for your cooperation.

Sincerely,

Nanette M. Downing
Acting Director, EO Examinations

Enclosures:
Letter - Final

Taxpayer name: ORG

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:

Taxpayer Advocate
1301 Clay Street #1540S
Oakland, CA 94612-2715
Tel: (510)637-2703
Fax: (510)637-2715

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
Report of Examination

| | | |
|---|--|---|
| Form 886A | Department of the Treasury - Internal Revenue Service Explanation of Items | Schedule No. or Exhibit |
| Name of Taxpayer ORG EIN: | | Year/Period Ended 20XX06 & 20XX06 |

LEGEND

ORG = Organization name XX = Date State = State President =
 President Treasurer = treasurer DIR-1 = 1st Director

ISSUE:

1. Whether ORG. Qualifies for exemption under Internal Revenue Code (IRC) Section 501(c)(3)?
2. Whether ORG is liable for Chapter 42 taxes on undistributed income under section 4942 of the Internal Revenue Code?
3. Whether ORG is liable for Income tax once it becomes non exempt private foundation and at what amount?

FACTS

ORG (the “Foundation”) was incorporated in State on July 18, 20XX and received exemption as a private foundation exempt under Section 501(c)(3) on April 15, 20XX.

The Form 1023 “Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code” was mailed to IRS on Dec. 19, 20XX but it was not signed. In an attachment to Form 1023 the President explained that he and his wife decided to start a foundation and that the primary strategy for the foundation was to sell calls against stocks it owns. President stated that he used this strategy before and he expected to earn around 15% without ever having to sell the Foundation’s primary holdings. President explained that using this strategy in 20XX and 20XX caused the Foundation’s initial contribution of \$ to drop to about \$ at the time the Form 1023 was filed.

Other Information on Form 1023 included the following:
 Activities: “The organization’s primary activity will be making charitable contributions to selected individuals and organizations involved in community development... the activity will be initiated in 20XX, with the first donations being made at the end of the first quarter of 20XX. The activity will be conducted exclusively by the board. “

Sources of financial support: “Initial contributions by President & Treasurer, investment income... and ongoing contributions from President & Treasurer.” The Applicant stated that no fund raising will be conducted by the Foundation.

Foundation’s governing body: the officers and directors will be President, President/Secretary and Treasurer, Treasurer.

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Although on Form 1023 the applicant requested private foundation status, attached was also a Schedule D "Section 509(a)(3) Supporting Organizations". IRS requested clarifications regarding the foundation's status on IRS Letter 1312. The applicant replied to those questions on March 28, 20XX and provided a properly signed Page 1 of Form 1023 – signed by President President. The applicant also stated that the Foundation is not a not a 509(a)(3) supporting organization but is a private foundation. IRS' Exemption Letter 1076 advised the Foundation that it is required to file annual information returns Form 990-PF by the 15 days of the fifth month after the end of the annual accounting period and that there is a \$ daily delinquency penalty for failure to do so.

During the organization's existence the Foundation made no charitable grants; accordingly, the Foundation's forms 990-PF reported no distributions for charitable purposes. Further, Foundation's Form 990-PF as was filed for the period ending June 30, 20XX reported that \$ of excise tax under Section 4940(a) was due and payable but Foundation failed to pay the tax due.

The Foundation filed the annual information returns Forms 990-PF for Foundation's fiscal years ending June 30, 20XX, June 30, 20XX and June 30, 20XX late (the first two returns were filed on May 19, 20XX and the return for year ending June 30, 20XX was filed on May 23, 20XX. Since those returns were filed late IRS assessed late filing penalties on the Foundation in the respective amounts of \$, \$ and \$. The Foundation has not paid those penalties.

IRS specialist contacted the Foundation on 1/12/20XX and asked for clarifications what action the Foundation has taken to restore its corporate status that was suspended by the State Secretary of State after the Foundation failed to pay the State Franchise Tax Board (the "FTB") the balance due of \$ and has failed to take any action in the matter. Additionally, the Foundation failed to respond to State Attorney General's Second Notice dated October 19, 20XX requesting that the Foundation pay a \$ fee and provide specific documentation including Foundation's Articles of Incorporation, current Bylaws, and IRS Exemption letter.

The Foundation failed to provide records that IRS specialist requested such as: Foundation's minutes, contracts, statement of officers as were filed with the Secretary of State, and any records of its disbursements. The records that the Foundation provided were TD Waterhouse investments statements for the period starting March 1, 20XX through June 30, 20XX. Those records show that during the Foundation's existence the only activity was that of stock trading.

The Foundation reported the following income (reported in US Dollars) on Forms 990-PF for years 20XX06 (fiscal year ending June 30 20XX) through 20XX06:

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| Form 886A | Department of the Treasury - Internal Revenue Service Explanation of Items | Schedule No. or Exhibit |
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| YEAR | <u>20XX06</u> | <u>20XX06</u> | <u>20XX06</u> | <u>20XX06</u> | <u>20XX06</u> |
|--------------------------------|---------------|---------------|---------------|---------------|---------------|
| | | | | | Not filed yet |
| <u>Investment Income</u> | | | | | |
| Interest | 0 | 7 | 4 | 17 | |
| Dividends | 0 | | | | |
| Capital Gain(loss) | 0 | | | | |
| <i>Total Investment Income</i> | 0 | | | | |

| YEAR | <u>20XX06</u> | <u>20XX06</u> | <u>20XX06</u> | <u>20XX06</u> | <u>20XX06</u> |
|------------------------|---------------|---------------|---------------|---------------|---------------|
| | | | | | Not filed yet |
| <u>Balance Sheet</u> | | | | | |
| Cash | | | | | |
| Investments-stmt 1 FMV | | | | | |
| <i>Total Assets</i> | | | | | |

Stmt 1-FYE 20XX06:
Shares' cost: \$

Assets per Audit:

IRS agent prepared a schedule of the Foundation's assets and average monthly balances of these assets using the records that were available that included the investment statements and the information on Form 990-PF (if no investments statements were available).

These are summarized below:

LAW

Issue 1: Whether Foundation qualifies for exemption under Internal Revenue Code (IRC) Section 501(c)(3)?
Requirements for Exemption under IRC 501(c)(3):

FINAL-REG, TAX-REGS. §1.501(c)(3)-1(a)(1). Organizational and operational tests. (1) In order to be exempt as an organization described in section 501(c)(3), an organization must be both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational test or the operational test, it is not exempt.

(2) The term "exempt purpose or purposes", as used in this section, means any purpose or purposes specified in section 501(c)(3), as defined and elaborated in paragraph (d) of this section.

(d) Exempt purposes--(1) In general. (i) An organization may be exempt as an

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organization described in section 501(c)(3) if it is organized and operated exclusively for one or more of the following purposes:

- (a) Religious,
- (b) Charitable,
- (c) Scientific,
- (d) Testing for public safety,
- (e) Literary,
- (f) Educational, or
- (g) Prevention of cruelty to children or animals.

FINAL-REG, TAX-REGS , §1.501(c)(3)-1(c)(1) Operational test --(1) Primary activities. An organization will be regarded as “operated exclusively” for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3).

| <u>COMPUTATION: AVERAGE MONTHLY BALANCES</u> | | | | | |
|--|-------------------|---------------|---------------|---------------|---------------|
| | <u>20XX06</u> | <u>20XX06</u> | <u>20XX06</u> | <u>20XX06</u> | <u>20XX06</u> |
| beginning FMV | | | | | |
| Ending FMV | | | | | |
| Comments: | no stmts provided | | | | |
| data used: | from F. 990-PF | 990-PF/stmts | statements | statements | statements |
| Average Mo. Balance | | | | | |

TAXPAYER'S POSITION:

An Explanation of Issue was sent to Foundation and its Representative DIR-1, on July... 20XX. Taxpayer's rebuttal is yet to be received.

GOVERNMENT'S POSITION:

The government contends that ORG failed to meet the “operational test” under Regulations Section 1.501(c)(3)-1(a)(1) and 1.501(c)(3)-1(c)(1) because it had not operated for 501(c)(3) charitable purposes and it was not engaged primarily in activities that accomplish one or more of such exempt purposes specified in Section 501(c)(3).

The audit of the activities conducted during the year ending June 30, 20XX determined that the Foundation does not meet the “operational test” under IRC 501(c)(3) because it conducts no charitable activities. The Foundation's primary activities were stock trading and investment activities which are not charitable activity per se. Therefore, revocation of ORG exempt status is proposed effective July 1st, 20XX.

LAW:

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Issue 2: Whether Foundation is liable for Chapter 42 taxes on undistributed income under section 4942 of the Internal Revenue Code?

Internal Revenue Code 4942 imposes a two tier set of excise taxes, an "initial" tax and an "additional" tax, on the undistributed income of a private foundation.

Section 4942(a) of the Code imposes an initial tax on the undistributed income of a private foundation - tax equal to 15 percent of the amount of such income remaining undistributed at the beginning of such second (or succeeding) taxable year.

Second, 4942(b) provides for an "additional" tax equal to 100 percent of any portion of the undistributed income remaining undistributed at the close of the correction period as defined in Code section 4942(j)(2).

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

Section 4942(d) defines "distributable amount" as the amount equal to the sum of the minimum investment return, plus certain other amounts, reduced by the sum of the taxes imposed on such private foundation for the taxable year under subtitle A and section 4940.

Section 4942(j)(2) of the Code states "allowable distribution period" means, with respect to any private foundation, the period beginning with the first day of the first taxable year following the taxable year in which the incorrect valuation (described in subsection (a)(2)) occurred and ending 90 days after the date of mailing of a notice of deficiency (with respect to the tax imposed by subsection (a)).

Section 53.4942(a)-3(a)(2)(i) (a) of the Foundation and Similar Excise Taxes Regulations (regulations) provides, in pertinent part, that the term "qualifying distribution" means any amount (including program-related investments, as defined in section 4944(c), and reasonable and necessary administrative expenses) paid to accomplish one or more purposes described in section 170(c)(1) or (2)(B), other than any contribution to a private foundation which is not an operating foundation (as defined in section 4942(j)(3)).

Computation of Minimum Investment Return

The minimum investment return of a private foundation for any taxable year is the amount determined by multiplying the excess of the aggregate fair market value of all assets of the foundation over the amount of the acquisition indebtedness with respect to such assets (determined under IRC 514(c)(1), but without regard to the taxable year in which the indebtedness was incurred), by the applicable percentage for such year. For years beginning after December 31, 1975, the applicable percentage is five percent. Reg. 53.4942(a)-2(c)(5).

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The aggregate fair market value of all assets of the foundation includes--
The fair market value of all other assets except assets used (or held for use) directly in carrying out the foundation's exempt purpose. Reg. 53.4942(a)-2(c)(2):

Applicable Percentage

For purposes of determining the minimum investment return the applicable percentage is five percent; See Reg. 53.4942(a)-2(c)(5)(c).

In the case of a taxable year shorter than 12 months, the applicable percentage for the taxable year is computed by multiplying the applicable percentage for the calendar year on which the short taxable year began by a fraction the numerator of which is the number of days in the short taxable year and the denominator of which is 365. Reg. 53.4942(a)-2(c)(5)(iii).

Accounting Principles Applicable to Qualifying Distributions

An organization's qualifying distributions will be determined solely on the cash receipts and disbursements method of accounting. Reg. 53.4942(a)-3(a)(1).

Minimum Distribution Required During Start-Up Period

1. For private foundations created after December 31, 1971 (or for organizations that first become foundations after that date), the "start-up period" is the four taxable years following the taxable year in which the foundation was created or became a foundation. For these purposes, a foundation will be considered created in the taxable year in which its distributable amount (IRC 4942(d)) first exceeds \$500.

2. Start-up period minimum amount. This is the amount that a foundation must distribute in its start-up period and cannot be less than the sum of:

- a. 20% of its distributable amount for the first taxable year of the start-up period,
- b. 40% of its distributable amount for the second taxable year of the start-up period,
- c. 60% of its distributable amount for the third taxable year of the start-up period, and
- d. 80% of its distributable amount for the fourth taxable year of the start-up period.

3. The above requirement means that the total amount must be distributed before the end of the start-up period, and is not a requirement that any portion of this amount be distributed in any particular year of the start-up period.

4. Examples. Reg. 53.4942(a)-3(b)(4)(iv) provides the following examples to illustrate this principle:

a. Example (1). F, a private foundation created on January 1, 1975, uses the calendar year as its taxable year. The start-up period for F is January 1, 1976, through December 31, 1979. F has distributable amounts under section 4942(d) for taxable years 1976 through 1979 in the following amounts: 1976, \$100,000; 1977, \$120,000; 1978, \$150,000; 1979, \$200,000. F's start-up period minimum amount is the sum of the following amounts: 20% of \$100,000 (\$20,000); 40% of \$120,000 (\$48,000); 60% of \$150,000 (\$90,000); and 80% of \$200,000 (\$160,000); which equals

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\$318,000. Thus, F is required to actually distribute at least \$318,000 in cash or its equivalent during the start-up period.

FINAL-REG, TAX-REGS, §53.4942(a)-1. Taxes for failure to distribute income

(3) Payment of tax. —Payment of the excise taxes imposed by section 4942(a) or (b) is in addition to, and not in lieu of, making the distribution of such undistributed income as required by section 4942. See section 507(a)(2) and the regulations thereunder.

TAXPAYER'S POSITION

An Explanation of Issue was sent to Foundation and its Representative DIR-1. Taxpayer's rebuttal is yet to be received.

GOVERNMENT'S POSITION:

The Government contends that Section 4942 requires private foundations to distribute the distributable amount of each taxable year by the end of the succeeding taxable year. To the extent that a private foundation holds undistributed income of a taxable year at the beginning of the second succeeding taxable year, it is subject to an initial excise tax equal to 15 percent of the amount of that undistributed income. A second tier tax of 100% is assessed for any portion of the undistributed income remaining undistributed at the close of the correction period defined as ending 90 days after the date of mailing of a notice of deficiency.

Thus, as explained, ORG is required to distribute the distributable amount for each taxable year by the end of the succeeding taxable year. Therefore, the excise tax on its failure to distribute income is being proposed for tax years ended June 30, 20XX, and June 30, 20XX as ORG's distributable income remained undistributed by the end of the succeeding taxable years: the respective years ending June 30, 20XX and June 30, 20XX.

The calculation for the second tier tax is being provided as it would be imposed if Foundation failed to correct during the correction period. The excise taxes being proposed, under Section 4942 are computed and are listed on the enclosed "ATTACHMENT A".

Issue 3: Whether ORG is liable for Income tax once it becomes non exempt private foundation and at what amount?

LAW

Applicable Tax and Rates

Section 61 of the Internal Revenue Code provides that, except as otherwise provided in subtitle A (relating to income taxes), gross income means all income from whatever source derived.

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Section 4940(a) currently imposes a tax equal to two percent of the net investment income, for the taxable year, of private foundations which are exempt from taxation under section 501(a) for the taxable year with respect to the carrying on of their activities.

Section 4940(b) imposes a tax on private foundations which are not exempt from taxation under section 501(a). This tax is equal to the amount (if any) by which the sum of (A) the tax imposed by section 4940(a), computed as if 4940(a) had applied to this taxable foundation, and (B) the amount of tax which would have been imposed under section 511 (tax on unrelated business income of tax-exempt organizations) if this private foundation had been exempt from taxation under section 501(a), exceeds the federal income tax imposed on such foundation for that taxable year under subtitle A of the Code.

Section 4940(c) defined "net investment income" to include interest and states that, with specified exceptions, net investment income shall be determined under the principles of subtitle A of the Code, which relates to income taxes.

Section 4940(c)(1) of the Internal Revenue Code defines "net investment income" as the amount by which (A) the sum of the gross investment income and the capital gain net income exceeds (B) the deductions allowed by paragraph (3).

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

Regulations section 53.4940-1(b) states, "the excise tax imposed under section 4940 on private foundations which are not exempt from taxation under section 501(a) is equal to:

- (i) The amount (if any) by which the sum of:
 - (A) The tax on net investment income imposed under section 4940(a), computed as if such private foundation were exempt from taxation under section 501(a) and described in section 501(c)(3) for the taxable year, plus
 - (B) The amount of the tax which would have been imposed under section 511 for such taxable year if such private foundation had been exempt from taxation under section 501(a), exceeds
- (ii) The tax imposed under subtitle A of such private foundation for the taxable year.

Regulation Section 53.4940-1(b) excise tax on net investment income provides the following guidance:

"Example (2). Assume the facts stated in Example (1), except that the tax liability under subtitle A is \$15,000 rather than \$10,000. Because the sum of the taxes which would have been imposed under sections 4940(a) and 511 (\$11,000) does not exceed the tax that was imposed under

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subtitle A (\$15,000), there is no tax imposed under section 4940(b) with respect to such foundation.”

TAXPAYER'S POSITION

An Explanation of Issue was sent to Foundation and its Representative DIR-1. Taxpayer's rebuttal is yet to be received.

GOVERNMENT'S POSITION

The government contends that the Foundation is a non exempt private foundation effective July 1st, 20XX and therefore it is subject to income tax for that year and subsequent years. Further, as explained in Section 4940(b) if the income tax computed under Subtitle A exceeds the tax that is computed under Section 4940(a) and 511 then no excise tax under Section 4940(b) is due. In this case the tax computed under Subtitle A for the year ending June 30, 20XX is \$ and it exceeds the tax computed under Section 4940(a) of \$. The income tax under Subtitle A is computed based on corporation's tax rate which is 15% for corporate taxable income that is less than \$ (corporations are taxed on their net capital gain at the regular tax rates). The income tax for the year is \$. The income tax for the year ending June 30, 20XX is \$. The interest is not included in this computation.

The Foundation's income tax is therefore:

| <u>Income Source</u> | <u>20XX06</u> | <u>20XX06</u> |
|-----------------------|------------------------------------|---------------|
| Interest | | |
| Capital Gains | _____ | _____ |
| Total taxable income | _____ | _____ |
| | <u>Tax Rate: 15% (Corp. Rates)</u> | |
| <i>Total Tax due:</i> | _____ | |