

Internal Revenue Service
Appeals Office
4050 Alpha Road
Suite 517, MC:8000NWSAT
Dallas, TX 75244

Date: AUG 11 2010

Number: **201044024**
Release Date: 11/5/2010

Department of the Treasury

Person to Contact:

Employee ID Number:

Tel:

Fax:

Refer Reply to:

In Re:

Employer Identification No:
Form Required to be Filed:

Tax Period(s) Ended:

UIL: 509.02-00

Certified Mail

Dear :

We considered your appeal of the adverse action proposed by the Director, Exempt Organizations, Rulings and Agreements. Your exemption from Federal income tax under Internal Revenue Code (IRC) section 501(c)(3) is confirmed.

Your foundation status has been modified to that of a private operating foundation as described in IRC section 4942(j)(3) effective January 17, 2002. You have agreed to this modification of your foundation status.

Contributions to your organization remain deductible under section 170 of the Code

You have waived your right to contest this determination under the declaratory judgment provisions of Section 7428 of the Code by your execution of Form 906, Closing Agreement Concerning Specific Matters, an executed copy of which is being sent to you under separate cover.

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

See the enclosed Notice 1214, Helpful Contacts for Your "Notice of Deficiency" for additional 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,

Karen A. Skinder
Appeals Team Manager

Enclosure:
Notice 1214

Cc:

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

LEGEND

ORG = Organization name XX = Date City = city State = state
County = county President = president Secretary = secretary BM-1,
BM-2 & BM-3 = 1ST, 2ND & 3RD BOARD MEMBER MGR = MGR RA-1, RA-2 & RA-3 =
1ST, 2ND & 3RD RA CO-1, CO-2, CO-3. CO-4 & CO-5 = 1ST, 2ND, 3RD, 4TH & 5TH
COMPANIES

PRIMARY ISSUE

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

FACTS

A. Corporate Information:

1. Articles of Incorporation:

The ORG ('Foundation') was incorporated under the Nonprofit Public Benefit Corporation law of the State of State on January , 20XX. Its stated purpose was that it would:

- operate exclusively for charitable, education, scientific and other charitable purposes;
- that it will not, "*except to an insubstantial degree*", engage in any activities or exercise any powers that are not in the furtherance of the purposes of this corporation . . .";
- that no substantial part of the activities shall consist of carrying on propaganda, or otherwise attempting to influence legislation;
- that the property of this corporation is irrevocably dedicated to educational, scientific, and charitable purposes;
- no part of the net earnings shall inure to the benefit of its directors, trustees, officers, private shareholders or to any individual; and
- that upon dissolution remaining assets will be distributed to other organizations that are tax-exempt.

President¹ was noted as the incorporator of the 'Foundation' and signed as such on January , 20XX. These articles were filed by him on January , 20XX.

* * * *

¹ President does not appear in any other operation or activity of the organization.

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2. Bylaws- governing body:

According to the organization's bylaws, the governing body was stated to be comprised of three Board of Director (BOD) members and three Officers. The Officers' positions consist of the President, Secretary and Chief Financial Officer. At the discretion of the BOD, other officers may be appointed as may be required. *"Each officer shall hold such office for such period, have such authority and perform such duties as are provided in the Bylaws. . . Any two or more offices may be held by the same person"*. The duties of the officers are:

- **President** – shall be the general manager and chief executive officer and is subject to the BOD; will have general supervision, direction and control over the corporation's business and officers; shall have general powers and duties of management customarily vested in a corporation's president
- **Secretary** – shall keep books of minutes of all meetings and actions taken by the written consent of the BOD or any committees appointed by the BOD; will give notice of all meetings . . .
- **Chief Financial Officer** – shall keep and maintain adequate and correct books and records of corporation's properties, businesses transactions, accounts of assets, liabilities, receipts, disbursements, gains, losses and shares; shall be responsible for all funds, securities, and other valuables; receive and give receipts for monies due and payable to corporation; deposit all monies and other duties prescribed by the BOD.

Both the BOD & Officers are supposed to be elected at each annual meeting. Annual meetings are supposed to be conducted on the 1st Monday of May of each year or the next Monday if that day is a holiday.

In an attachment to the bylaws was a document titled "**Certificate of Secretary**". The purpose was to *certify* that the bylaws adopted by the 'Foundation' were official. This certificate was signed on January , 20XX, by Secretary, as Secretary. (See Exhibit A)

In a second attachment to the bylaws titled "**Written Consent by Directors in Lieu of First Meeting**", President, acting as the incorporator of the 'Foundation' adopted the Bylaws of the Corporation and appointed Secretary as President, CFO and Secretary. Secretary was also designated as the agent of the 'Foundation' for the *"purpose of service of process"*. Subsequent to all of the resolutions made in this document, Secretary signed the document as the *newly appointed* President on 1/ /20XX. (See Exhibit B)

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3. Form 1023 Application:

In February 20XX, the 'Foundation' submitted an application to the Service to request tax-exempt status for its activities. Per the application, the 'Foundation' identified four general categories under which its activities would be conducted; mission, research, education and grants.

1. Mission aspect of the taxpayer was the:

- "Eradication of world hungry [er] through such means as improved health of and brea[e]ding techniques of livestock";
- "Taxpayer will engage in research, sponsor research, will disseminate the results of research, develop educations programs all relating to addressing world hunger."

2. Research aspect is to:

- Initially engage in research designed to improve the health of livestock;
- Look to the application of alternative health care techniques that are being applied to humans to determine the effectiveness of same when applied to livestock; and
- Investigate innovative breeding techniques that enhance the output of quality protein from livestock.

3. Education aspect is to:

- Integrate results of all research conducted into curriculum that is intended for veterinarians, animal geneticists, universities, colleges, agricultural clubs, governmental agencies (i.e. FDA, WHO, & UN) and others. To be shared with the agricultural community;
- "Teaching at existing accredited educations institutions . . . " Or through special conferences and seminars or through classes orchestrated by the Taxpayer;
- Publish, initially without charge, the results of its research to veterinarians, animal geneticists . . . ; and
- Eventually develop programs and research designed to achieve its goals of elimination of world hunger.

4. Grants aspect is to:

- Select candidates for grants with principal requirements with expertise and prior research experience.

Because the Determination Specialist believed that this organization was like an organization described in Regulations section 1.501(c)(3)-1(d)(iii) (scientific

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organization), based *solely* upon the documentation submitted, exemption from federal income taxes was granted on June , 20XX under section 501(c)(3) as a public charity described in IRC Section 170(b)(1)(A)(vi). (See Exhibit C)

Secretary signed and submitted the Form 1023 Application for Recognition of Exemption, under penalties of perjury.

B. Activities:

In 20XX, an examination was opened to examine the organization's operations for tax years ending 12/ /20XX and 12/ /20XX. During that examination, a number of material concerns were identified that would preclude the organization from

1. having received exemption initially, if all items were accurately disclosed; and/or
2. that would disqualify the organization from retaining exemption.

These areas of concern were reviewed circumspectly to determine if exemption should be retained.

1. False Statements in 1023 Application:

The Form 1023 application was submitted in February 20XX. In an attachment to the application, it was stated that there were no assets of the organization [Per Part II, Item 8 (assets)] and that since the organization was dormant, there was no current financial information with regard to source of income, or use of proceeds [Part IV-Item A – (revenue and expenses)]. (See Exhibit D)

Nevertheless, in a meeting of the CO-1 (CO-1)² on April , 20XX, Secretary and RA-1³ met to discuss the formation of a new corporation in State. During that meeting, the two agreed to provide financial assistance to this new corporation (which is the ORG) and to transfer the improvements and any assets to the new corporation once it was formed. (See Exhibit E)

* * * *

² CO-1, formerly the ORG Non-profit housing Corporation, is a State State nonprofit, tax-exempt organization created by Secretary in 19XX for the purpose of housing and providing services to children with autism. It receives its primary funding from Secretary.

³ RA-1 is the mother of Secretary and presently resides in State.

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In 20XX, CO-1 reported expending \$\$ as a "grant" (**See Exhibit F**) to another 501(c)(3) organization. An expense analysis of the "grant" amount showed that \$\$⁴ was actual expenses ***paid out of the personal funds*** of Secretary for the improvement of her personal real property. \$\$ were management and general expenses of the 'Foundation' paid out of the personal funds of Secretary \$\$ was actual expenses paid in 20XX. The remaining \$\$ was direct expenses drawn from the bank account of CO-1. (**See Exhibit G**) The 'Foundation'

1. **did not record** any receipt of this "grant" in its budgets submitted with the application;
2. did not recognize any "transfer of assets"⁵ post formation; and
3. it did not file any type of tax/information return to record the receipt of the income

Secretary controls the *activities* of the CO-1. Secretary also controlled the formation and creation of the ORG. Statements made on the Form 1023 application, with respect to "no current financial information" did not coincide with other known and readily available evidence in Secretary's possession and knowledge. It was Secretary's her money that was used to make the alleged "grant". The Form 1023 application was signed under penalties of perjury.

2. Nonfiler (Noncompliance with Federal Reporting Requirements):

Evidence from an examination of Secretary's Form 1040 returns divulged that charitable contributions were made by Secretary, or one or more of her for-profit and nonprofit extensions, to the 'Foundation' during 20XX and 20XX in excess of \$\$. This minimum threshold would require the 'Foundation' to file Form 990 returns for both years. However, upon reviewing the Service database none had been filed. (**See Exhibit H**) When returns were requested in an initial Information Document Request (IDR), unsigned copies were provided to the Agent. This indicates that Forms 990 returns had been prepared. These copies were then signed by Secretary on April 21, 20XX and sent to the Service for processing by the Revenue Agent.

The organization vehemently claims that it had timely filed the returns, but the Service had lost or misplaced those returns. (**See Exhibit I**) But prior to 20XX, there was no indication that **any** Form 990 return had ever been filed. And in spite of numerous requests for any corroborating evidence that would contradict the information on the Service database, the organization was not able to produce such.

* * * *

⁴ Secretary's Form 1040 is presently under examination in tandem with the examination of this organizaion. The \$\$ is being disallowed on the Form 1040 for 20XX.

⁵ If an actual grant was made, the matter of transferring the "assets" would be immaterial.

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This 'Foundation' is not the only nonprofit organization created by Secretary that has a poor or nonexistent history of filing required information returns.

3. Governing Body - Tenuous (No Independent Board):

Per the organization's bylaws, the officers consist of the President, Secretary and Chief Financial Officer. Per the organization's Form 990, Part V, officers, directors, trustees and key employees are listed as:

Figure 1

Title	20XX	20XX	20XX
President	Secretary	Secretary	Secretary
Secretary	RA-1 ⁶	RA-1	RA-1

The organization held a meeting on May , 20XX. The purpose of the meeting was to appoint MGR as Manager of Animal Projects and to re-elect herself as President. MGR is an employee of Secretary's and is paid by CO-2. The position of Manager of Animal Projects is not listed in the bylaws as a position entitled to vote on the activities of the organization. The *only* person with the official right to vote on the organization's operations, was Secretary. And she voted herself as President to serve another term.

Attending a meeting held on January , 20XX, was Secretary, RA-2 and MGR. The purpose of this meeting was to commence communications with experts in the animal husbandry world for the purpose of appointing a BOD. Three names were selected BM-1 (veterinarian and former sheep breeder), BM-2 (director of sheep program at CO-3) and, BM-3 (head of sheep program at CO-4).

Even though the date of the minutes is outside the parameters of the examination period, neither RA-2 nor MGR was listed on the Form 990 as individuals with the right to govern the operations of the organization. Additionally, neither was appointed and approved in writing, by the sole BOD member (Secretary), to a position that would accommodate a vote.

4. Sources of Income/Revenue (Not a Public Charity):

Per the delinquently filed Form 990 returns, the organization reported gross receipts of \$\$ and \$\$ for 20XX and 20XX, respectively. Of the gross amounts received, the following sources were derived from Secretary or one or more of her for-profit or nonprofit controlled corporations listed below.

Figure 2

* * * *

⁶ ibid

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Donor	20XX	20XX	Total
Secretary	\$\$	\$\$	\$\$
CO-2	\$\$	\$\$	\$\$
CO-5	\$\$	\$\$	\$\$
CO-1	\$\$	\$	\$\$
CO-2	\$	\$\$	\$\$
Totals	\$\$	\$\$	

CO-2 and CO-5 are two wholly-owned for-profit subchapter S corporations of Secretary. CO-1 is a nonprofit tax-exempt corporation that was organized and is controlled by Secretary. It also received more than 90% of its funding from Secretary. CO-2 was incorporated as a for-profit entity in the State of State in 20XX and automatically dissolved in July 20XX. RA-3, the listed resident agent is also an employee of CO-2 and was so during the years of examination.

Secretary claimed a charitable contribution deduction for the amounts paid directly to or on behalf of the 'Foundation' from her personal return, CO-2, and CO-5. While the amount paid from the CO-1 to or on behalf of the 'Foundation' would *generally* be treated as a "grant", Secretary only claimed a charitable contribution deduction with respect to the **original** amount paid to the CO-1. With respect to the amounts paid by CO-2 this entity is a regular for-profit corporation and would generally be limited to a contribution deduction of %.

For 20XX, of the \$\$ recorded as gross receipts, \$\$ or % was derived from Secretary. For 20XX, of the \$\$ recorded as gross receipts, \$\$ or % was derived from her. For the years of operation, Secretary, President, has been the primary funding for the 'Foundation'.

5. Uses of Income/Revenue-Meeting Minutes (Inurement):

Subsequent to the 'Foundation's' incorporation and prior to the date exemption was granted, the organization had a meeting on 3/ /20XX. (See Exhibit J) There were two people present at the meeting, Secretary, who is listed as the president and RA-2, who is purported to be the *acting secretary*. RA-2 was not listed as a Board of Director member on the delinquent Form 990's secured from the organization.

The purpose of the meeting was for the attendees to vote on a document called the "**Affidavit of Irrevocable Restriction and Indemnification**" (See Exhibit K) proposed by Secretary.

Per this *affidavit* Secretary is to purchase 560 acres of land in City, State. 75 acres are for the unlimited use of the 'Foundation'. The remainder is to be used by Secretary for development. The 'Foundation' is to incur costs of land development, including roads,

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clearing, wells, and waterlines, etc. for the entire property. 'Foundation' will be reimbursed for all costs if property is sold and indemnified against any loss; conditions are legally binding on herself, heirs etc and that the document will be recorded in the local county. This agreement was signed by Secretary, as property owner on 3/ /20XX. The document was alleged to have been notarized, but did not have the notary seal and date. Additionally, the document was not recorded in the County prior to June 20XX.

When details of expenses were reviewed, it was noted that the majority of the funds were indeed used to enhance the 560 acres of land owned by Secretary. Our review noted the following uses:

1. to purchase farming assets (i.e. livestock),
2. to purchase supplies and other items (feed) to support livestock and operate a farm;
3. to purchase farming equipment (Truck);
4. to make major improvements of the land owned by the President;
5. to maintain the upkeep of land and buildings owned by the President;
6. to pay for utilities and phone service in the name of the President; and
7. to pay for legal service related to easements of property owned by the President.

Only a minimal amount of monies were expended for items that might be considered related to the administrative operations of an exempt organization. None of the funds were used for any educational purposes or scientific research. The specific categories are noted as follows:

Figure 3

Category	20XX	20XX	Total
Unidentified expenses	\$\$	\$	\$\$
Equipment (farming or other)	\$\$	\$\$	\$\$
Farm Assets	\$\$	\$\$	\$\$
Farming expenses	\$\$	\$\$	\$\$
Legal	\$\$	\$	\$\$
Land, equipment & general maintenance	\$\$	\$\$	\$\$
Leasehold Improvements	\$\$	\$\$	\$\$
Miscellaneous	\$	\$\$	\$\$
Telephone - Personal	\$\$	\$\$	\$\$
Start-up	\$\$	\$	\$\$
Operational	\$\$	\$\$	\$\$

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Annual Totals	\$	\$	
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Details of categorized terms are briefly described below and can be reviewed per attached (**See Exhibit L**)

- Unidentified expenses were paid out of Secretary's personal funds and deducted as a 170(c)(2) contribution as an expense paid on behalf of a qualified charitable organization, no other evidence regarding these amounts were verified;
- Equipment expenses included the purchase of a 20XX Polaris Truck & other farming machinery;
- Farm assets were determined to be the purchase of sheep, donkeys and a goat. The goat was sold during the year. Also, other sheep had been sold during the year;
- Farming expenses included items like oats, hay, grain, sheep shearing expenses, farming supplies, etc;
- Legal services were paid for discussion relating to property easements;
- Land, equipment, maintenance and other includes costs associated with mowing, barn repairs, truck repairs and fuel, utilities, trash removal etc;
- Leasehold improvements included permanent additions or renovations to the land such as fencing, well drilling, dirt road construction, barn construction and capitalized architect expenses;
- Personal expenses included telephone service for two numbers # and #. The former number address data was unpublished and the latter number was listed under the name of Secretary;
- Start-up costs included the payment of fees for incorporation in the State of State, 1023 application user fee and general consulting on corporation structure; and
- Operational expenses included bank charges, office supplies and faxing information. These were believed to be administrative costs of operating an organization;

All expenditures were made and approved by Secretary.

There was no official lease agreement between the organization and Secretary, property owner for the alleged use of the 75 acres of land prior to June 20XX.

6. False Statements in Form 990 Regarding Program Activities

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On the Form 990, Part III, the organization said it paid out \$\$ and \$\$ for 20XX and 20XX, respectively for "*research for improved health & breeding techniques of livestock and matters related thereto, for the purpose of eradication of world hunger through such means*" (See Exhibit M)

From the factual analysis of the expenses, the significant majority of expenditures made during 20XX and 20XX (and even prior to actual incorporation) were for the improvement, maintenance and upkeep on the 560 acres of land that is owned by Secretary. The return was signed, under penalties of perjury, by Secretary as President on April , 20XX.

LAW

Internal Revenue Code section 501(c)(3) provides for the exemption from Federal income tax of corporations **organized and operated** exclusively for religious, charitable, literary, scientific, and educational purposes; no part of the net earnings of which inures to any private shareholder or individual.

Section 1.501(c)(3)-1(a)(1) of the income Tax Regulations provides that in order to qualify for exemption under section 501(c)(3), an organization must be both organized and operated exclusively for one or more exempt purposes. Failure to meet either the organizational or operational test will disqualify an organization from exemption under 501(c)(3).

Treasury Regulations section 1.501(c)(3)-1(c)(1) states that, an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose. Thus, in construing the meaning of the phrase "exclusively for educational purposes" in ***Better Business Bureau v. United States, 326 U.S. 279 (1945)***, the Supreme Court of the United States stated, "This plainly means that the presence of a single non-educational purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly educational purposes."

Treasury Regulations section 1.501(c)(3)-1(c)(2) states 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.

Treasury Regulations section 1.501(a)-1(c) defines a private shareholder or individual in section 501 as those persons having a personal and private interest in the activities of the organization.

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Treasury Regulations section 1.501(c)(3)-1(d)(ii) provides that an organization is not organized or operated exclusively for one or more of the purposes specified in subdivision (i) of this subparagraph unless it serves a public rather than a private interest. Thus, to meet the requirement of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests. Moreover, even though an organization may have exempt purposes, it will not be considered as operating exclusively for such purposes, if more than an insubstantial part of its activities serve private interests.

In **Est. of Hawaii v Commissioner, 71 TC 1067**, the non profit organization engaged in activities relating to "est" programs involving training, seminars, lectures, etc., in areas of intrapersonal awareness and communication. Such activities were conducted under licensing arrangements with for-profit corporations. The courts held that although the activities were educational in nature, the non-profit served the commercial purposes of the for-profit. Thus the non-profit was not operated exclusively for exempt purposes within the meaning of section 501(c)(3) of the Code.

In **Hancock Academy of Savannah, Inc. v Commissioner, 69 TC 488**, the founder of a for-profit entity formed a non profit corporation to take over the educational functions of the for-profit. The non-profit assumed an excessive liability of the for-profit. The court found the academy failed to meet the requirements of section 501(c)(3).

In **John Marshall Law School and John Marshall University v US, 81-2 USTC**, an organization that operated a law school and university did not qualify as an exempt organization because a portion of the organization's net earnings inured to the benefit of the private individuals who operated the organization and their families. The corporation contended that the benefits inuring to the individuals were reasonable compensation for the services they performed, but the court concluded that the payment of personal expenses purchases and interest-free loans involved here far exceeded an ordinary and necessary level of compensation.

In **Texas Trade School v Commissioner, 30 TC 642, 646-647**, Exemption was denied when leasehold improvements were made to property owned by the principal of the corporation.

Revenue Ruling 76-441, Cumulative Bulletin, 1976-2, page 147 held that a nonprofit organization takes over a school's assets and its liabilities, which exceed the value of the assets and include notes owed to the former owners and current directors of the school, is serving the director's private interest and is not operated exclusively for

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educational and charitable purposes.

ARGUMENT

Form 1023:

Evidence submitted in the Form 1023 and related documentation revealed that Secretary made material false statements to the Internal Revenue Service in support of budgets and other sources of revenue/expenses. She indicated that no monies had been received by the 'Foundation' when, in fact, she was fully aware that monies had been paid to the 'Foundation' during 20XX as a grant from the CO-1.

Nonfiler:

There is *prima facie* evidence that this organization did not file Forms 990 for any of the years that it was required to file until it was examined by the Service. The mere preparation of a Form 990 is **not** evidence of filing. While one may say that the 'Foundation' *intended* to file a Form 990, they did not follow through with that *intention*. While an intention to file might absolve the organization of the *willful and intentional disregard* rules for the imposition of certain delinquency penalties, it does not serve as evidence of filing.

This organization also has a non-existent history of filing other required information returns (i.e. Forms 1099). It is not that this organization is not required to file the returns, but that it *has* not filed any such returns.

The inference here is that this organization has difficulty in complying with federal reporting requirements with respect to its business operations. Noncompliance in this area can be deemed as not operating for exempt purposes and could disqualify this organization from retaining exemption.

Governing Body

Secretary has made a number of concerted efforts to lend some legitimacy to the creation, purpose and operation of this organization. In its creation, another person (President as "Incorporator") assigns the overall management and oversight of the organization to Secretary as President, Secretary and Chief Financial Officer.

Bylaws are created to lend some evidence of being governed properly. However, created, they are not engaged in the actual operations of the organization. And if they are, it is with minimal consideration (such as the conduct of an annual meeting).

Meetings are held and recorded to support actions taken or proposed. But in fact, the Board of Directors or "ad hoc Officers" are either a family member (i.e. RA-1), an employee (i.e. MGR) of one of the for-profit entities, or an added body (i.e. RA-2) for the

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purpose of approving actions decided upon by Secretary who has the controlling interest in all of the decisions made.

Certificates, Written Consents, and Affidavits are prepared to give some sense of credibility that this organization will be operated in the best interest of the general public. The Certificates, Written Consents and Affidavits have questionable authenticity (i.e. Written Consent and Certificates with no notarized seal or scratched off dates), or are not enforceable (i.e. Affidavit of Irrevocable Restriction and Indemnification). Even if Secretary did indeed enforce the conditions of the "Affidavit", she has nonetheless conferred upon herself a benefit far greater than the cost to repay. If the property were sold, it would be sold at its appreciated value, which includes the cost of the leasehold improvements. The organization would only be receiving dollar for dollar value, while the value of the property will far exceed the cost of the original improvements. This is part and parcel of the inurement proscription. Furthermore, none of the aforementioned "documents" were arms-length.

Not a Public Charity

Secretary reporting of revenue gives the public the illusion that this organization is supported by the general public in spreading out her contributions amongst a number of different controlled entities. The facts show otherwise. More than % of the funds contributed to this organization come from Secretary or one or more of her wholly-owned for-profit entities or her controlled nonprofit entities. This organization is not a public charity described in IRC section 501(c)(3).

Inurement:

There is general agreement that inurement is a subset of private benefit and involves unjust payment of money. The **inurement** proscription contained in Regulations 1.501(c)(3)-1(c)(1) states 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. **Inurement** is likely to arise where the financial benefit represents a transfer of the organization's financial resources to an individual solely by virtue of the individual relationship with the organization without regard to the accomplishment of exempt purposes.

Inurement of income is strictly forbidden under section 501(c)(3) without regard to the amount involved. This proscription applies to persons who because of their particular relationship with an organization have an opportunity to control or influence its activities. Such persons are considered "insiders" for purposes of determining whether there is inurement of income. Generally, an organization's officers, directors, founders, and their families are considered "insiders".

A federal court of appeals held that the term "inurement": "may include more than the term net profits as shown by the books of the organization or than the difference

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between the gross receipts and disbursements in dollars" and that "[p]rofits may inure to the benefit of shareholders in other ways than dividends. See Northwestern Municipal Ass'n v Commissioner.

Secretary has enjoyed a tremendous tax benefit from financially supporting the activities of the 'Foundation'. Secretary created the ORG. Secretary supports the ORG with her own personal funds, funds from one or more of her wholly-owned for-profit entities or from a second nonprofit entity (CO-1) created and controlled by her. These funds invariably revert back to Secretary in the form of "leasehold improvements", property maintenance, livestock purchase or in the form of payment of personal expenses. Secretary, for all intents and purposes, is an insider.

The payment of leasehold improvements to a property not owned by the organization was sufficient to preclude exemption under 501(c)(3) in the *Texas Trade School* case. In the *John Marshall Law School and John Marshall University*, the payment of personal expenses was deemed inurement and caused the organization to not qualify as an exempt organization. In *Est of Hawaii*, the operation of the organization was not exclusively for exempt purposes within the meaning of section 501(c)(3) of the Code.

Per Regulations section 1.501(c)(3)-1(d)(ii), even though an organization may have exempt purposes, it will not be considered as operating exclusively for such purposes, if more than an insubstantial part of its activities serve private interests. See Better Business Bureau. In this instance more than a substantial amount of the funds of the 'Foundation' are used for private interests.

False Statement in 990:

Evidence submitted in the Forms 990 return further indicated that Secretary made a material false statement to the Service when it was stated that monies of the 'Foundation' were paid for "*research for improved health & breeding techniques of livestock and matters related thereto, for the purpose of eradication of world hunger through such means*" in the amount of out \$\$ and \$\$ for 20XX and 20XX, respectively. The expenses of the organization did not evidence any of the purported amounts for the purpose stated.

TAXPAYER'S POSITION

Taxpayer has not officially advocated a position, but ascertains that it is a valid organization operating for the benefit of the public and not for private purposes.

GOVERNMENT'S CONCLUSION

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Based upon cited court cases, the regulations and Code, we hold that your organization is not operated exclusively for any charitable, educational, or scientific purpose and that you have excessive private benefit and **inurement**, thereby, defeating the retention of exemption.

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

Revocation of your exempt status will be effective as of January , 20XX. Your organization is not entitled to Internal Revenue Section 7805(b) relief because your organization made material false statements in its Form 1023 application. Had the organization disclosed the fact that income sources were derived from a related organization and expended for leasehold improvements to the property owned by the creator, this information would have precluded this organization from receiving exemption. Consequently, the organization's tax-exempt status should be revoked retroactively to the date it received recognition of its exemption.

In accordance with this determination, you are required to file Federal income tax returns on Form 1120. Contributions to your organization are not deductible by donors under section 170(c)(2) of the Code.

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

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

ALTERNATIVE ISSUE

Should it be determined that this organization is operated for one or more exempt purposes and its income does not inure to be the benefit of private individuals, then based upon the income sources, this organization should not be a public charity as described in IRC 509(a)(2), but a private foundation.

If the organization is reclassified to a private foundation, then is it subject to the excise tax provisions of IRC 4941?

FACTS

The ORG ('Foundation') was incorporated under the Non-Profit Public Benefit Corporation laws of the State of State on January , 20XX. On September , 19 it

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was granted exemption under section 501(c)(3), as *other than* a private foundation under section 509(a)(1) and IRC 170(b)(1)(A)(vi).

Sources of Income/Revenue (Not a Public Charity):

Per the delinquent filed Form 990 returns, the organization reported gross receipts of \$\$ and \$\$ for 20XX and 20XX, respectively. Of the gross amounts received, the following sources were derived from Secretary or one or more of her for-profit or nonprofit controlled corporations listed below.

Figure 2

Donor	20XX	20XX	Total
Secretary	\$\$	\$\$	\$\$
CO-2	\$\$	\$\$	\$\$
CO-5	\$\$	\$\$	\$\$
CO-1	\$\$	\$	\$\$
CO-2	\$	\$\$	\$\$
Totals	\$\$	\$\$	

- CO-2 and CO-5 are two wholly-owned for-profit subchapter S corporations of Secretary;
- CO-1 is a nonprofit tax-exempt corporation that was organized and is controlled by Secretary. It also received more than % of its funding from Secretary;
- CO-2 was incorporated as a for-profit entity in the State of State in 20XX and automatically dissolved in July 20XX. RA-3, the listed resident agent is also an employee of CO-2 and was so during the years of examination.

Secretary claimed a charitable contribution deduction for the amounts paid directly to or on behalf of the 'Foundation' from her personal return, CO-2, and CO-5. With respect to the amount paid from the CO-1 to or on behalf of the 'Foundation' would generally be treated as a "grant", Secretary only claimed a charitable contribution deduction with respect to the **original** amount paid to the CO-1. With respect to the amounts paid by CO-2 this entity is a regular for-profit corporation and would generally be limited to a contribution deduction of 10%.

For 20XX, of the \$\$ recorded as gross receipts, \$\$ or % was derived from Secretary. For 20XX, of the \$\$ recorded as gross receipts, \$\$ or % was derived from her. For the years of operation, Secretary, President, has been the primary funding for the 'Foundation'.

LAW

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Internal Revenue Code Section 509(a)(2)(A) the term "private foundation" means a domestic or foreign organization described in section 501(c)(3) other than an organization which normally receives more than one-third of its support in each taxable year from any combination of--

(i) gifts, grants, contributions, or membership fees, and

(ii) gross receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities, in an activity which is not an unrelated trade or business (within the meaning of section 513, not including such receipts from any person, or from any bureau or similar agency of a governmental unit (as described in section 170(c)(1)), in any taxable year to the extent such receipts exceed the greater of \$ or percent of the organization's support in such taxable year,

from persons other than disqualified persons (as defined in section 4946) with respect to the organization, from governmental units described in section 170(c)(1), or from organizations described in section 170(b)(1)(A) (other than in clauses (vii) and (viii)), and

(B) normally receives not more than one-third of its support in each taxable year from the sum of--

(i) gross investment income (as defined in subsection (e)) and

(ii) the excess (if any) of the amount of the unrelated business taxable income (as defined in section 512) over the amount of the tax imposed by section 511

Internal Revenue Code section 4946(a)(1) states that the term "disqualified person" means, with respect to a private foundation, a person who is--

(A) a substantial contributor to the foundation,

(B) a foundation manager (within the meaning of subsection (b)(1)),

(C) an owner of more than 20 percent of--

(i) the total combined voting power of a corporation,

(ii) the profits interest of a partnership, or

(iii) the beneficial interest of a trust or unincorporated enterprise,

which is a substantial contributor to the foundation,

(D) a member of the family (as defined in subsection (d)) of any individual described in subparagraph (A), (B), or (C),

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- (E) a corporation of which persons described in subparagraph (A), (B), (C), or (D) own more than 35 percent of the total combined voting power,
- (F) a partnership in which persons described in subparagraph (A), (B), (C), or (D) own more than 35 percent of the profits interest,
- (G) a trust or estate in which persons described in subparagraph (A), (B), (C), or (D) hold more than 35 percent of the beneficial interest,
- (H) only for purposes of section 4943, a private foundation—
- (i) which is effectively controlled (directly or indirectly) by the same person or persons who control the private foundation in question, or
 - (ii) substantially all of the contributions to which were made (directly or indirectly) by the same person or persons described in subparagraph (A), (B), or (C), or members of their families (within the meaning of subsection (d)), who made (directly or indirectly) substantially all of the contributions to the private foundation in question, and
- (I) only for purposes of section 4941, a government official (as defined in subsection (c)).

(2) Substantial contributors.--For purposes of paragraph (1), the term "substantial contributor" means a person who is described in section 507(d)(2).

(b) Foundation manager.--For purposes of this subchapter, the term "foundation manager" means, with respect to any private foundation—

- (1) an officer, director, or trustee of a foundation (or an individual having powers or responsibilities similar to those of officers, directors, or trustees of the foundation), and
- (2) with respect to any act (or failure to act), the employees of the foundation having authority or responsibility with respect to such act (or failure to act).

(d) Members of family.--For purposes of subsection (a)(1), the family of any individual shall include only his spouse, ancestors, children, grandchildren, great grandchildren, and the spouses of children, grandchildren, and great grandchildren.

Internal Revenue Code Section 507(d)(2)(A) -For purposes of paragraph (1), the term "substantial contributor" means any person who contributed or bequeathed an aggregate amount of more than \$ to the private foundation, if such amount is more than 2 percent of the total contributions and bequests received by the foundation before the close of the taxable year of the foundation in which the contribution or bequest is received by the foundation from such person. In the case of a trust, the term "substantial contributor" also means the creator of the trust.

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Internal Revenue Code Section 4941(a)(1) states that there is hereby imposed a tax on each act of self-dealing between a disqualified person and a private foundation. The rate of tax shall be equal to 10 percent of the amount involved with respect to the act of self-dealing for each year (or part thereof) in the taxable period. The tax imposed by this paragraph shall be paid by any disqualified person (other than a foundation manager acting only as such) who participates in the act of self-dealing. In the case of a government official (as defined in section 4946(c)), a tax shall be imposed by this paragraph only if such disqualified person participates in the act of self-dealing knowing that it is such an act.

Internal Revenue Code Section 4941(a)(2) In any case in which a tax is imposed by paragraph (1), there is hereby imposed on the participation of any foundation manager in an act of self-dealing between a disqualified person and a private foundation, knowing that it is such an act, a tax equal to 5 percent of the amount involved with respect to the act of self-dealing for each year (or part thereof) in the taxable period, unless such participation is not willful and is due to reasonable cause. The tax imposed by this paragraph shall be paid by any foundation manager who participated in the act of self-dealing.

Internal Revenue Code Section 4941(b) Additional taxes.--

(1) On self-dealer.--In any case in which an initial tax is imposed by subsection (a)(1) on an act of self-dealing by a disqualified person with a private foundation and the act is not corrected within the taxable period, there is hereby imposed a tax equal to 200 percent of the amount involved. The tax imposed by this paragraph shall be paid by any disqualified person (other than a foundation manager acting only as such) who participated in the act of self-dealing.

(2) On foundation manager.--In any case in which an additional tax is imposed by paragraph (1), if a foundation manager refused to agree to part or all of the correction, there is hereby imposed a tax equal to 50 percent of the amount involved. The tax imposed by this paragraph shall be paid by any foundation manager who refused to agree to part or all of the correction.

Internal Revenue Code Section 4941(c) Special rules.--For purposes of subsections (a) and (b)--

(1) Joint and several liability.--If more than one person is liable under any paragraph of subsection (a) or (b) with respect to any one act of self-dealing, all such persons shall be jointly and severally liable under such paragraph with respect to such act.

(2) \$20,000 limit for management.--With respect to any one act of self-dealing, the maximum amount of the tax imposed by subsection (a)(2) shall not exceed \$20,000,

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and the maximum amount of the tax imposed by subsection (b)(2) shall not exceed \$20,000.

Internal Revenue Code Section 4941(d)(1) In general.--For purposes of this section, the term "self-dealing" means any direct or indirect--

- (A) sale or exchange, or leasing, of property between a private foundation and a disqualified person;
- (B) lending of money or other extension of credit between a private foundation and a disqualified person;
- (C) furnishing of goods, services, or facilities between a private foundation and a disqualified person;
- (D) payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person;
- (E) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation; and
- (F) agreement by a private foundation to make any payment of money or other property to a government official (as defined in section 4946(c)), other than an agreement to employ such individual for any period after the termination of his government service if such individual is terminating his government service within a 90-day period.

Internal Revenue Code Section 4941(d)(2) For purposes of paragraph (1)--

- (A) the transfer of real or personal property by a disqualified person to a private foundation shall be treated as a sale or exchange if the property is subject to a mortgage or similar lien which the foundation assumes or if it is subject to a mortgage or similar lien which a disqualified person placed on the property within the 10-year period ending on the date of the transfer;
- (B) the lending of money by a disqualified person to a private foundation shall not be an act of self-dealing if the loan is without interest or other charge (determined without regard to section 7872) and if the proceeds of the loan are used exclusively for purposes specified in section 501(c)(3);
- (C) the furnishing of goods, services, or facilities by a disqualified person to a private foundation shall not be an act of self-dealing if the furnishing is without charge and if the goods, services, or facilities so furnished are used exclusively for purposes specified in section 501(c)(3);

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(D) the furnishing of goods, services, or facilities by a private foundation to a disqualified person shall not be an act of self-dealing if such furnishing is made on a basis no more favorable than that on which such goods, services, or facilities are made available to the general public;

(E) except in the case of a government official (as defined in section 4946(c)), the payment of compensation (and the payment or reimbursement of expenses) by a private foundation to a disqualified person for personal services which are reasonable and necessary to carrying out the exempt purpose of the private foundation shall not be an act of self-dealing if the compensation (or payment or reimbursement) is not excessive;

(F) any transaction between a private foundation and a corporation which is a disqualified person (as defined in section 4946(a)), pursuant to any liquidation, merger, redemption, recapitalization, or other corporate adjustment, organization, or reorganization, shall not be an act of self-dealing if all of the securities of the same class as that held by the foundation are subject to the same terms and such terms provide for receipt by the foundation of no less than fair market value;

(G)(1) in the case of a government official (as defined in section 4946(c)), paragraph shall in addition not apply to--

(i) prizes and awards which are subject to the provisions of section 74(b) (without regard to paragraph (3) thereof), if the recipients of such prizes and awards are selected from the general public,

(ii) scholarships and fellowship grants which would be subject to the provisions of section 117(a) (as in effect on the day before the date of the enactment of the Tax Reform Act of 1986) and are to be used for study at an educational organization described in section 170(b)(1)(A)(ii),

(iii) any annuity or other payment (forming part of a stock-bonus, pension, or profit-sharing plan) by a trust which is a qualified trust under section 401,

(iv) any annuity or other payment under a plan which meets the requirements of section 404(a)(2),

(v) any contribution or gift (other than a contribution or gift of money) to, or services or facilities made available to, any such individual, if the aggregate value of such contributions, gifts, services, and facilities to, or made available to, such individual during any calendar year does not exceed \$25,

(vi) any payment made under chapter 41 of title 5, United States Code, or

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(vii) any payment or reimbursement of traveling expenses for travel solely from one point in the United States to another point in the United States, but only if such payment or reimbursement does not exceed the actual cost of the transportation involved plus an amount for all other traveling expenses not in excess of 125 percent of the maximum amount payable under section 5702 of title 5, United States Code, for like travel by employees of the United States; and

(H) the leasing by a disqualified person to a private foundation of office space for use by the foundation in a building with other

ARGUMENT

In 20XX, the 'Corporation' received % of its gross income (see figure 1) from Secretary. Secretary is not only a disqualified person as described in IRC 4946(a)(1)(A), but also a foundation manager as noted in IRC 4946(a)(1)(B). In 20XX and 20XX, more than one-third of the income sources were derived from gross investment income and unrelated business income (billboard advertising). With respect to code section 509(a)(2), this organization does not meet the public support test and thus is a private foundation.

More that % (figure 4) of the funds received from the disqualified person/foundation manager were used to improve land owned by the disqualified person, purchase farm equipment or purchase other farming related supplies. Additionally, other sources were used to pay attorneys and accountants and other service providers on behalf or for the private use of Secretary. In accordance with IRC 4941(d)(1)(E), the *transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation* constitutes an act of self-dealing. The excise tax is imposed on the amount involved. With respect to the years in question, the amount involved is:

Verified Total Annual Payouts	\$	\$	\$
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The excise tax is computed as noted below:

IRC Section	20XX - DP	20XX-FM	20XX-DP	20XX-FM
4941(a)(1) 10%	\$		\$	
4941(a)(2) 5%		\$		\$
4941(b)(1) 200%	\$		\$	
4941(b)(2) 50%		\$		\$
Totals	\$	\$	\$	\$

TAXPAYER'S POSITION

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The 'Corporation' agreed with the Service regarding this classification. Albeit, it jumped the gun in filing a Form 990-PF for 20XX when the examination had not reached its final audit conclusions. The organization does not agree with the imposition of the excise tax on the acts of self-dealing.

GOVERNMENT'S CONCLUSION

The organization is a private foundation. Consequently, it is required to file delinquent Form 990-PF's effective January 1, 20XX. The transaction between the organization and disqualified person/foundation manager constitutes an act of self-dealing. Secretary, as disqualified person and foundation manager is liable for the excise imposed under Chapter 42, with respect to 4941.