



DEPARTMENT OF THE TREASURY

INTERNAL REVENUE SERVICE

TE/GE: EO Examination

625 Fulton Street, Room 503

Brooklyn, NY 11201

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Date: August 19, 2008

Release Number: 200846031

Release Date: 11/14/08

LEGEND

ORG = Organization name XX = Date Address = address

ORG
ADDRESS

UIL:501.03-01

Taxpayer Identification Number:

Person to Contact:

Identification Number

Contact Telephone Number:

LAST DATE FOR FILING A PLEADING
WITH THE TAX COURT, THE CLAIMS
COURT, OR THE UNITED STATES
DISTRICT COURT FOR THE DISTRICT
OF COLUMBIA: November 17, 20XX

Dear :

This is a final determination regarding your exempt status under section 501(c)(3) of the Internal Revenue Code (IRC). Recognition of your exemption from Federal income tax as an organization described in Internal Revenue Code section 501(c)(3) is retroactively revoked to September 1, 20 XX because it is determined that you are not operated exclusively for an exempt purpose.

IRC 501(c)(3) exempts from taxation organizations which are organized and operated exclusively for charitable or educational purposes, no part of the net earnings of which inure 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 do not participate in, or intervene in, any political campaign on behalf of (or in opposition to) any candidate for public office.

We have determined that you are not operating exclusively for any charitable purpose, educational purpose, or any other exempt purpose. Our examination reveals that you did not operate exclusively for exempt purposes because your assets inured to, and it served the private interests of your founder, officer and board member. You have not demonstrated that you are not operated for the benefit of your founder, officer and board member as required by Treas. Reg. 1.501(c)(3)-1(d)(1)(ii).

We are revoking your exemption from Federal income tax as an organization described in section 501(c)(3) of the Internal Revenue Code effective September 1, 20XX.

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 1120. These returns should be filed with the appropriate Service Center for all years beginning September 1, 20XX.

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 file a pleading seeking a declaratory judgment in the United States Tax Court, the United States Court of Federal Claims, or the United States District Court for the District of Columbia before the 91st day after the date this final determination was mailed to you. Please contact the clerk of the appropriate court for rules regarding filing pleadings for declaratory judgments and refer to the enclosed Publication 892. You may write to these courts at the following addresses:

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 too-free and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate.

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,

Vicki L. Hansen
Acting Director, EO Examinations

Enclosure:
Publication 892

Form 886A	Department of the Treasury - Internal Revenue Service Explanation of Items	Schedule No. or Exhibit
Name of Taxpayer ORG		Year/Period Ended June 30, 20XX June 30, 20XX June 30, 20XX

LEGEND

ORG = Organization name XX = Date City = city XYZ = State
County = county Bank = bank Co-1 & CO-2 = 1st & 2nd companies
CPA = CPA BM-1, BM-2, BM-3 & BM-4 = 1st, 2nd, 3rd & 4th Board Members

Issue:

Whether ORG's exempt status, under IRC §501(c)(3), should be revoked for the following reasons:

1. ORG's net earnings inured to BM-1 and BM-2.
2. ORG underreported its gross receipts.
3. ORG failed to substantiate the expenses it claimed on Forms 990 for the years shown above.
4. ORG failed to maintain books and records.
5. ORG failed to file Forms W-2 and to correct filed Forms W-2.
6. ORG failed to file Forms 1099.

Facts:

ORG (ORG) was incorporated in the State of XYZ on September 17, 19XX. It was granted exempt status under Internal Revenue Code section 501(c)(3) on March 05, 19XX. The organization's foundation status is 509(a)(2). BM-1 is the founder, President, and CEO of ORG.

According to the organization's Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code, ORG's principal purpose is to provide residential care and treatment to developmentally disabled adults.

The following are listed as Board members on the organization's Forms 990 for the period ending June 30, 20XX, June 30, 20XX, and June 30, 20XX:

1. BM-3
2. BM-4
3. BM-2

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During the determination process, ORG was directed to modify its Board of Directors to place control in the hands of unrelated individuals, selected from the community it served. The initial return filed by ORG for the period September 1, 19XX through August 31, 19XX, shows BM-2, BM-3, and BM-4 as Board members. BM-1 is listed as CEO. BM-3 and BM-1 have the same address. BM-3 is also listed as a cook, for ORG, in documents received from CO-1. BM-2 is BM-1's son. These same Board members appear on subsequent Forms 990. In 20XX ORG filed a tax return for a short year and changed its fiscal year month to June. (See Exhibit A)

ORG's clients are referred by a regional center which contracts with XYZ's Department of Services. The Department of Services is the agency through which the state provides services and supports to individuals with developmental disabilities. The regional centers serve as a local resource to help find and access the services and supports available to individuals with developmental disabilities and their families. The State of XYZ sets the rates paid for consumers living in residential facilities based on the consumer's level of care and the facility's service level. ORG has two facilities. Both are located, in homes, in residential neighborhoods. One of the homes is owned by BM-1. The other, ORG #2, is owned by BM-2.

Prior to incorporating, ORG was operated as a sole proprietorship by BM-1. The business was called ORG. The house for this facility was leased. There was only one facility at that time. According to the Small Business/Self-Employed Division (SB/SE) Revenue Agent this was a profitable business.

This case was opened after receiving a referral and request for a collateral examination from a SB/SE Revenue Agent. The examiner called BM-1 on May 1, 20XX to schedule the initial examination appointment. She did not answer her phone that day, so a message was left on the answering machine. On May 1, 20XX Letter 3611, an appointment letter, was mailed, with an Information Document Request Form and Publication 1, *Your Rights as a Taxpayer*, to ORG. The initial appointment was scheduled for April 26, 20XX. The examiner finally spoke with BM-1 on April 20, 20XX. She stated her Certified Public Accountant, CPA, would be handling the examination. CPA contacted the examiner, by telephone, on April 20, 20XX. He faxed the examiner a copy of the signed Form 2848 appointing him ORG's Power of Attorney. On April 25, 20XX, CPA called and stated that BM-1 could not keep the appointment scheduled for April 26, 20XX. The appointment was rescheduled for June 1, 20XX. On the date of the rescheduled appointment, the examiner traveled to City, XYZ to meet with BM-1 at one of the ORG facilities. She did not have the records requested in the Information Document Request dated, May 2, 20XX. She stated she had given them _____, whose office is in City, XYZ. The examiner called CPA to confirm that the records were in his office. He stated he returned the records to ORG by mail. He said the records were mailed to BM-1's residence at the City, _____ address on May 18, 20XX and delivered, by UPS, on May 19, 20XX. The package was left on BM-1's front porch. BM-1 insisted she hadn't seen any package on her porch.

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The examiner held the initial interview with BM-1 on June 1, 20XX. (See Exhibit B) During this interview BM-1 stated she didn't maintain invoices or receipts for ORG, aside from the information she was required to retain for CO-1. She said all the records she had were in the box she'd given to CPA.

On June 15, 20XX, the examiner received a call from CPA. BM-1 found the box with ORG's records. On June 29, 20XX, CPA delivered the records to the City Post of Duty. The following records were submitted:

1. Copy of ORG's Articles of Incorporation
2. Copy of ORG's By-laws
3. Copies of the State of XYZ Licenses for the two ORG
4. Copy of a customer's *Admission Agreement*
5. Copy of a letter and supporting documents from CO-1, dated January 21, 20XX regarding audits conducted by _____ of ORG
6. Payroll records, from CO-2, for ORG, for the period 1/14/20XX through 7/15/20XX.

On December 07, 20XX the examiner received a large envelope from ORG, mailed to this office by CPA. The envelope contained bank statements and cancelled checks for the year 20XX. Also enclosed were loose receipts, some barely readable, also for the year 20XX.

ORG's initial determination letter states that "this determination is based on evidence that your funds are dedicated to the purposes listed in section 501(c)(3) of the Internal Revenue Code. To assure your continued exemption you should keep records to show that funds are spent only for those purposes. If you distribute funds to other organizations, your records should show whether they are exempt under section 501(c)(3). In cases where the recipient organization is not exempt under section 501(c)(3), you must have evidence that the funds will remain dedicated to the required purposes and that the recipient will use the funds for those purposes."

On July 11, 20XX the examiner prepared Forms 2039, Summons, for the following institutions:

1. Bank
2. Bank
3. CO-1

The examining agent reviewed the records received from these institutions and summonsed additional information from them in December 20XX.

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From the summonsed information the examiner found that BM-1's personal expenses were paid directly from ORG's business bank account. **(See Exhibit C)** Other funds were diverted to personal accounts held by BM-1 alone and in a few instances by her and another related or unrelated individual. There are CD accounts and Christmas club accounts. **(See Exhibit D)** Large amounts of cash were withdrawn from ORG's checking account on a monthly basis. The only person authorized to withdraw these funds from ORG's financial account was BM-1.

BM-1's Schedule E, *Supplemental Income and Loss*, attached to her individual tax returns, show rental income; however, there are no checks with BM-1 as the payee, written on ORG's account. Even though BM-1 used the hours she worked at the facilities to justify claims for payments made by CO-1, she failed to report the amounts claimed, as income on her Forms 1040. There is no compensation shown for BM-1 on the Forms 990. **(See Exhibit E)**

The Department of Housing and Urban Development (HUD) publishes a fair market rent (FMR) level to determine the maximum appropriate payment for housing in a particular area. The examiner compared the data published for County, the location of ORG's homes, to the rents reported by BM-1 and BM-2 for the years under examination. In the year ending June 30, 20XX BM-1 exceeded HUD's FMR by \$. In the year ending June 30, 20XX she exceeded HUD's FMR by \$. In the year ending June 30, 20XX she exceeded HUD's FMR by \$. The rental payments reported by BM-2 exceeded HUD's FMR by a de minimus amount for the years ending June 30, 20XX and June 30, 20XX. For the year ending June 30, 20XX the rents reported by BM-2 were less than HUD's FMR. **(See Exhibit F)**

BM-2 is the payee on numerous checks written on ORG's checking account. Some of the checks were generated by CO-2 as wages for services performed. Some of the other checks, written and signed by BM-1, may be rental payments. However, total payments to BM-2 exceed the amount reported on Forms W-2 and the amount of his reported rental income for the years under examination. ORG's failure to correctly report the income paid to BM-2 and several other ORG employees is addressed in several audits. **(See Exhibit C & G)**

The summonsed bank deposit detail revealed additional income received from ORG clients for the period ending June 30, 20XX, June 30, 20XX, and June 30, 20XX. This additional revenue was not paid by CO-1. It is income received from individuals for certain clients living in a ORG home. This income does not appear on Forms 990 for the years under examination. **(See Exhibit H - 15, H - 16, & H - 17)**

ORG has a fiscal year ending on June 30. The income reported on the Forms 990 is taken from Forms 1099 issued by CO-1. Forms 1099 reflect the income paid in a calendar year. The payments from CO-1 were not properly allocated to ORG's accounting period. The amounts shown on the Forms 1099 were placed on the Forms 990. The failure to apportion the gross

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receipts to the correct reporting period, along with the underreported income, resulted in total underreported income of \$ for the years under examination. (See Exhibit H) This is not a “timing issue”. Timing issues are generally items of income or deductions that are reported in the wrong year. The total underreported income is not reported in any year.

Forms W-2 was not filed for BM-1. Forms W-2C was never filed to correct the underreported payments made to BM-2 and several other ORG employees.

Forms 1099 were not filed. ORG failed to issue Forms 1099 to BM-1 and BM-2 for rents paid to them.

Law:

Section 501(c)(3) provides, in part, that an organization will not qualify for exemption unless no part of the net earnings of the organization inures to the benefit of any private shareholder or individual. The Federal Tax Regulations amplify the statutory language by stating 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, and by clarifying that the words “private shareholder or individual refer to persons having a personal and private interest in the activities of the organization. (Federal Tax Regulations § 501(a)-1(c))

Section 61 Gross Income Defined

61(a) General Definition — Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

- 61(a)(1)** Compensation for services, including fees, commissions, fringe benefits, and similar items;
- 61(a)(2)** Gross income derived from business;
- 61(a)(3)** Gains derived from dealings in property;
- 61(a)(4)** Interest;

Section 162 Trade or Business Expenses.

162(a) In General — There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including

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162(a)(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

162(a)(2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and

162(a)(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

Section 6001 of the Internal Revenue Code requires that any person subject to tax, or any person required to file a return of information with respect to income, shall keep such permanent books of account or records, as are sufficient to establish the amount of gross income, deductions, credits, or other matter required to be shown by such person in any return of such tax or information. Deductions are strictly a matter of legislative grace and the taxpayer bears the burden of proving entitlement to the claimed deduction. *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84 (1992); *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934).

Section 1.6001-1(c)

(c) *Exempt organizations.* —In addition to such permanent books and records as are required by paragraph (a) of this section with respect to the tax imposed by section 511 on unrelated business income of certain exempt organizations, every organization exempt from tax under section 501(a) shall keep such permanent books of account or records, including inventories, as are sufficient to show specifically the items of gross income, receipts and disbursements. Such organizations shall also keep such books and records as are required to substantiate the information required by section 6033.

Section 6033 - Returns by Exempt Organizations.

6033(a) Organizations Required to File

6033(a)(1) In General — Except as provided in paragraph (3), every organization exempt from taxation under section 501(a) shall file an annual return, stating specifically the items of gross income, receipts, and disbursements, and such other information for the purpose of carrying out the internal revenue laws as the Secretary may by forms or regulations prescribe, **and shall keep such records**, render under oath such statements, make such other returns, and comply with such rules and regulations as the Secretary may from time to time prescribe.

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Section 262(a) General Rule — Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses.

Section 3121(a) Wages — For purposes of this chapter, the term “wages” means all remuneration for employment, including the cash value of all payments (including benefits) paid in any medium other than cash.

Federal Tax Regulation § 31.3121(d)-1 states that an officer of a corporation is an employee unless such officer **does not perform any services or performs only minor services and who neither receives nor is entitled to receive, directly or indirectly, any remuneration from the organization.** Corporate officers are specifically included within the definition of employee under Security and Medicare Tax, FUTA, and for Federal Income Tax withholding purposes per Internal Revenue Code sections 3121(d), 3306(i), and 3401(c). The corporation is required to issue Forms W-2 for the corporate officer who was paid compensation for his or her services and/or for **whom the corporation paid personal living expenses.**

Internal Revenue Code § 6051(a) (Receipts for Employees) and § 31.6051-1(a) and (b) of the Federal Tax Regulations provide that employers must furnish the tax return copy and the employee’s copy of Form W-2, Wage and Tax Statement, to employees for remuneration paid during the calendar year.

- a. The Form W-2 must show, among other information, the total amount of wages paid subject to withholding of income tax, the total amount of wages paid subject to FICA tax, and the total amounts of income tax and FICA tax deducted and withheld.
- b. The time for furnishing the Form W-2 to each employee is on or before January 31 of the succeeding year, or if employment is terminated before the close of such calendar year. If an employee asks for Form W-2, the employer must issue the W-2 within 30 days of the request or within 30 days of the final wage payment, whichever is later.
- c. **Section 31.6051-1(c) of the Federal Tax Regulations** further provides that corrected statements (Forms W-2c) must be furnished to employees whenever the originally issued Form W-2 was incorrect.

Internal Revenue Code Section 6041(a) requires taxpayers, who are engaged in a trade or business, and making payment in the course of such trade or business to another person, in the form of rents, salaries, wages, premiums, annuities, compensations, remunerations, or other fixed or determinable gains, profits, and income to file information returns. The requirement is to file the information returns, if, **in a calendar year**, a payment of \$600 or more is made to an

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independent contractor. Form 1099-MISC is used by the payor to report these payments. The time for furnishing the statement to the payee is set forth in Section 6041(d). The statement must be furnished to the payee on or before January 31st of the year following the calendar year for which the return was made.

Taxpayer's Position:

This is the initial notification, to the taxpayer, proposing revocation for the period beginning September 1, 20XX.

A letter, dated March 26, 20XX, was submitted by CPA on March 26, 20XX. It is addressed to the Office of Regional Director of Appeals. The letter states "in summary, ORG acknowledges deficiencies in its past accounting practices, but it not (verbatim) agree these deficiencies are sufficient cause to revoke its tax exempt status". (See attached letter)

Government's Position:

The statute requires that "no part" of the net earnings of an exempt organization inure to the benefit of a private shareholder or individual. Consequently, the Service and the courts generally hold that the occurrence of inurement will result in denial or loss of exemption, and that the amount or extent of inurement is not a decisive factor.

BM-1 used ORG's financial account to pay her personal living expenses. She made large cash withdrawals from ORG's financial account. She transferred funds from ORG's financial account to her personal accounts. These personal expenses, cash withdrawals, and transfers were deducted on Forms 990. No compensation was reported as having been paid to BM-1 in the Forms 990. The law provides that only ordinary and necessary trade or business expenses may be claimed as deductions under § 162 of the Internal Revenue Code.

ORG underreported its gross receipts for the years under examination. Bank deposits are prima facie evidence of income, *Tokarski v. Commissioner*, 87 T.C. 74, 77 (1986), and the taxpayer has the burden of showing that the determination is incorrect, *Estate of Mason v. Commissioner*, 64 T.C. 651, 657 (1975), affd. 566 F.2d 2 (6th Cir. 1977). In such cases the Commissioner is not required to show a likely source of income, although here we have done so. The bank deposits method assumes that all money deposited in a taxpayer's bank account during a given period constitutes taxable income, but the Government must take into account any nontaxable source or deductible expense **of which it has knowledge**. *DiLeo v. Commissioner*, 96 T.C. at 868.

ORG failed to provide records, including books, receipts, and documents, from which its financial condition or business transactions could be determined. Failure to correctly report the

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organization's revenue and expenses distorts the financial status of the organization. Revenue Ruling 77-162, 1977-1 C.B. 400, provides that an organization that omits material information from its Form 990, and neither supplies the information when requested nor establishes reasonable cause for the omission, has failed to file a return for purposes both of the penalties imposed by Internal Revenue Code 6652(d)(1) and the statute of limitations under Internal Revenue Code 6501(c)(3).

Tax-exempt organizations are subject to the general recordkeeping requirements applicable to all taxpayers. Specifically, every tax-exempt organization is obligated to keep permanent books and records, including inventories, that establish the amount of gross income, deductions, credits, and other matters required to be shown by the organization in any tax or information return. An exempt organization must make its records available for inspection at all times by authorized Internal Revenue Service officers or employees. (Federal Tax Regulations § 31.6001-1(e)(1))

Conclusion:

ORG was not operated exclusively for exempt purposes as required under Internal Revenue Code Section 501(c)(3). Instead, the organization furthered the private interests of its founder, who served as the President/CEO, a Board member and an employee. The facts indicate that the organization's financial accounts were being used for personal purposes by BM-1 and BM-2, her son.

ORG failed to substantiate expenses claimed on Forms 990 for the years shown above.

ORG failed to maintain books and records.

ORG failed to file required information returns and to correct filed information returns..

ORG's exempt status should be revoked effective September 1, 20XX

Forms 1120, U. S. Corporate Tax Return, should be filed for the tax period ending on June 30, 20XX and for the tax periods that follow.



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY

Internal Revenue Service
EO Examinations MC 4900
1100 Commerce Street
Dallas, TX 75242

February 26, 2008

ORG
ADDRESS

Taxpayer Identification Number:

Form:

Tax Year(s) Ended:

Person to Contact/ID Number:

Contact Numbers:

Telephone:

Fax:

Certified Mail - Return Receipt Requested

Dear

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

Letter 3618 (04-2002)
Catalog Number 34809F

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
Report of Examination