

Internal Revenue Service
Appeals

Department of the Treasury

Date: **JAN 15 2010**

Number: **201014077**
Release Date: 4/9/2010

UIL: 9300.99-04

Address any reply to:

Employer Identification Number:

Form Number:

Person to Contact:

Contact Telephone Number:

Fax Number:

Last Day to File a Petition with the United
States Tax Court:

APR 15 2010

Certified Mail

Dear Taxpayer:

This is our final adverse determination with respect to your exempt status under section 501(a) of the Internal Revenue Code ("Code"). Recognition of your exemption under Code section 501(c)(3) is revoked effective January 1, 20XX.

If you decide to contest this determination under the declaratory judgment provisions of Code section 7428, a petition to the United States Tax Court, the United States Court of Federal Claims, or the District Court of the United States for the District of Columbia must be filed within 90 days from the date this determination was mailed to you. Contact the Clerk of the appropriate court for rules for filing petitions for declaratory judgment. To secure a petition from the United States Tax Court, write to the United States Tax Court, 400 Second Street, N.W., Washington, D.C. 20217.

Our adverse determination was made because **** is not operated exclusively for exempt purposes. Under Treasury Reg. § 1.501(c)(3)-1(d)(1)(ii), an organization is not operated exclusively for exempt purposes unless it serves a public rather than a private interest. **** operated for the benefit of ****.

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

You are required to file Federal income tax returns on Form **** for any years which are still open under the statute of limitations. Based on the information you furnished, it appears that returns should be filed starting with the year beginning January 1, 20XX. You should file any returns due for these years or later years with: Department of the Treasury, Internal Revenue Service Center, Ogden, UT 84201-0148 (as applicable for ****). Processing of income tax returns will not be delayed because you have filed a petition for a declaratory judgment under Code section 7428.

If you have questions about this letter, you may write to or call the contact person whose name, telephone number, and IRS address are shown on the first page of this letter. If you write, please include your telephone number, the best time for us to call you if we need more information, and a copy of this letter to help us identify your account. Keep the original letter for your records. If you prefer to call and the telephone number is outside your local calling area, there will be a long distance charge to you.

The contact person identified on the front of this letter can access your tax information and help you get answers. You also have the right to contact the office of the Taxpayer Advocate. You can call 1-877-777-4778 and ask for Taxpayer Advocate assistance, or you can contact the nearest Taxpayer Advocate office by calling **** or writing to Local Taxpayer Advocate, ****. Taxpayer Advocate assistance is not a substitute for established IRS procedures such as the formal appeals process. The Taxpayer Advocate is not able to reverse legally correct tax determinations. 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 IRC section 6104(c). You should contact your state officials if you have any questions about how this determination may affect your state responsibilities and requirements.

Sincerely yours,

/s/
Appeals Team Manager



DEPARTMENT OF THE TREASURY
Internal Revenue Service
1244 Speer Blvd. Suite 442
Denver, CO 80204

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

ORG = ORG ADDRESS - ADDRESS CITY = CITY STATE = STATE PRESIDENT
= PRESIDENT

ORG
ADDRESS
CITY, STATE

Taxpayer Identification Number:
Form:

Tax Year(s) Ended:
December 31, 20XX and 20XX

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

Letter 3618 (04-2002)
Catalog Number 34809F

Alternate Position

Form 886-A (Rev. January 1994)	EXPLANATION OF ITEMS	Schedule Number or exhibit
Name of taxpayer ORG	Taxpayer Identification Number	Year/Period ended December 31, 20XX & 20XX

LEGEND
 ORG - ORGANIZATION NAME ADDRESS - ADDRESS CITY - CITY STATE - STATE
 COUNTRY - COUNTRY FOUNDER - FOUNDER COMM - COMM CO-1, 2, 3, 4, 5 - 1ST, 2ND, 3RD,
 4TH & 5TH COMPANIES DIR 1-6 - 1ST, 2ND, 3RD, 4TH, 5TH & 6TH DIRECTORS

ISSUE:

Whether the ORG (ORG) operated exclusively for exempt purposes in that was ORG created to benefit primarily the personal interests of Director, principal/director.

FACTS:

ORG is an organization exempt from federal income tax under §501(a) of the Code as an organization described under §509(a)(3). ORG was organized by the filing of a Declaration of Trust with the State of State. The Trustee is Director.

The Trust Document allows for five board members. There are two types of board members: Charity Members and Trust Members. Three (3) Charity members are allowed that are to be appointed by CO-1 or its designated agent; two Trust members shall be from the class consisting of Director and DIR-1 and each of their descendants. Board members include Director, Director, DIR-2, spouse to Director and also known as DIR-1, DIR-3, DIR-4 and DIR-5. The founders and donors of ORG are Director and DIR-2.

In researching the internet there were numerous articles, news reviews and other information about the CO-2 (CO-2) regarding Director, DIR-5 and DIR-4 as follows:

Director, also known as Director, is a member of the CO-3 of CO-2 and is currently serving in the Employed by the CO-2' CO-4 (CO-4) for many years, he has been a teacher and director, a curriculum writer, a director of college curriculum, and a zone administrator.

DIR-4 is recognized for his experiences as an administrator in the CO-4-Religious Education and Secondary and Elementary Education.

DIR-5, also known as DIR-5, is a member of the CO-5 of CO-2. DIR-5 has worked in a number of teaching and senior administrative capacities for the CO-4.

The CO-4 (CO-4) of CO-2 consists of several institutions that provide religious and secular education for CO-1 secondary and post-secondary students and adult learners. Approximately 1.2 million individuals were enrolled in CO-4 programs in approximately 135 countries during the 20XX (03-04) school-year. CO-4 courses of study are separate and distinct from religious instruction provided through an CO-2. The Commissioner of the CO-4 is COMM of the CO-5.

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Director is a client of DIR-3 where he pays DIR-3 for services. DIR-3 in turn offers Director, as he does all his clients, tax planning advice and various financial strategies as well as opportunities and/or products that are intended to minimize Director's federal income tax liability. One strategy DIR-3 offered his clients was the creation of a supporting organization (S.O.), pursuant to §509(a)(3) of the Code. This would allow the donor or Director to put a large sum of money into the S.O., which in turn would be invested. The interest that is generated from the investment is to be used for charitable purposes pursuant to §501(c)(3) of the Code.

On November 1, 20XX, with the assistance of DIR-3, Director created the ORG, a S.O. The Trust Document lists CO-1 () as the supported organization (S.D). Attached to the Trust Document is "Schedule A" which is a list of charitable organizations that ORG may contribute to as a S.O. DIR-3 created in order to facilitate the creation of numerous S.O.s that he would offer his clients. DIR-3 and Director are both included as board members for ORG while DIR-3 is also a principal officer for

Also on November 1, 20XX, Director, with the assistance of DIR-3, executed the Credit Line Promissory Note as well as the Trust Deed. The promissory note allows Director to borrow from ORG up to \$. Director subsequently contributed \$ during the period covering January 20XX through December 20XX. Director then borrowed from the S.O. \$ or nearly 80 percent of the amount he originally contributed. The funds were used to purchase a \$ million cabin located at Address, City State. The cabin and Director's residence were held as collateral for the note. The assessed value of the Director's residence located at Address, City State as of April 22, 19XX was \$.

Several documents were provided by ORG, which included balance sheets for the 20XX, 20XX, 20XX and 20XX Forms 990. Also provided were an executed copy of the "Credit Line Promissory Note" and amendments and an executed copy of the "Trust Deed" which states:

THIS TRUST DEED is made this 1st day of November, 20XX, between Director and DIR-1, as Trustors, at Address, City State, DIR-3, Trustee, and ORG, as Beneficiary.

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Trustor hereby CONVEYS AND WARRANTS TO TRUSTEE IN TRUST, WITH POWER OF SALE, the following described property situated in State County, State of State:

LOT 3, "A", Address, City, STATE.

Other facts and information were also gathered and noted on the Form 886-A, attached as Exhibit A, that was prepared by the SB/SE Division for the Service that was issued to Director and DIR-2 for their personal Form 1040 for tax years ended December 31, 20XX, 20XX, 20XX and 20XX. Excerpts from this document state:

Director explained that he was advised by DIR-3 to create a trust deed and transfer his home at Address, to the ORG. He explained that he then initiated the promissory note to the foundation and made the mortgage payments to the foundation. . He said the stated interest rate on the mortgage was 10%, but was lowered later to 5%. A copy of the promissory note is included in the following workpapers.

The Directors deducted the mortgage interest paid to the foundation on their personal tax returns. In 20XX, the additional mortgage interest the Director's claimed as being to ORG was \$. In 20XX, the deduction was \$, and in 20XX, the taxpayer did not claim paying any mortgage interest to ORG. Director said he paid off his home in March of 20XX. A property search showed that after the mortgage on his home and the loan from ORG was paid off, Director transferred title of the home back to himself and his wife.

The deductions for the charitable contributions to the foundation were reported on Director's personal tax returns, and the family limited partnership returns, with flow through deductions to the Directors' and their children's personal returns. Additional mortgage interest paid to the foundation was also deducted on the Directors' personal tax returns, as explained above.

A review of the public property records showed that August 27, 20XX the Director's refinanced their home and initiated a trust deed on their home, showing the lender as the ORG. On August 19, 20XX, they again refinanced the home and initiated another deed of trust with CO-6s Bank showing themselves, not the ORG as the owners. On July 29, 20XX, the home was again refinanced with CO-6s Bank by Director.

According to the facts in the attached 886-A, Director took federal charitable tax deductions on his personal Form 1040 for what he contributed to the S.O. In addition Director took a mortgage interest tax deduction for the interest he paid on the note to the S.O. for tax years ended December 31, 20XX and 20XX in the amounts of \$ and \$ respectively.

The following is an outline of the facts taken from these documents:

The Trust Deed:

Dated: November 1, 20XX

Trustors: Director N Director and DIR-1

Trustee: DIR-3

Beneficiary: ORG

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Trustor conveys the property described as Plat A, Address, City, State. The address is also known as the residence of the Trustors at Address, City, State. The purpose of the Deed is to secure the payment of the indebtedness evidenced by the promissory note in the amount of \$.

Credit Line Promissory Note:

Dated: November 1, 20XX

The note allows the Director's to borrow up to \$ at 10% per year. The note requires the Director's to make monthly payments, due on the 5th of each month, equal to the interest on the outstanding principal balance. The entire principal and unpaid interest shall be paid on or before December 31, 20XX.

Amendment To Credit Line Promissory Note:

Dated: January 1, 20XX

The interest on the unpaid balance of the loan shall be adjusted to Five per cent (5%) per annum.

The schedules below illustrate the amount disbursed to ORG by Director and the amount borrowed back from ORG by Director.

Also noted in the 20XX bank statements for acct # were \$ deposits in February, March and April and \$ deposits in July, September, October and November. In 20XX for the same acct deposits of \$ in January thru September.

The schedule below illustrates certain information that was reported on the Form 990 for ORG:

The following schedule illustrates the contributions made by ORG according the Forms 990:

Board minutes that may have discussed the line of credit agreement and/or other grant-making considerations were not provided.

The historical prime rates for November 20XX and January 20XX rates were 9.5% and 4.25% respectively.

LAW:

IRC §501(c)(3) Corporations..., organized and operated exclusively for religious, charitable..., or educational purposes..., no part of the net earnings of which inures to the benefit of any private shareholder or individual....

Treas. Reg. §1.501(c)(3)-1(a) *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.

Treas. Reg. §1.501(c)(3)-1(c) *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). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

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Treas. Reg. §1.501(c)(3)-1(a)(2) *Distribution of earnings*. 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. For the definition of the words "private shareholder or individual", see paragraph (c) of §1.501(a)-1.

Treas. Reg. §1.501(a)-1(c) *"Private shareholder or individual" defined*. The words "private shareholder or individual" in section 501 refer to persons having a personal and private interest in the activities of the organization.

Treas. Reg. §1.501(c)(3)-1(d) *Exempt purposes-- (1) In general*. (i) An organization may be exempt as an 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... (f) Educational....

(ii) 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.

Founding Church of Scientology v. U.S., 412 F.2d 1197 (Ct. Cl. 1969) Action by church to recover federal income taxes and assessed interest paid. The Court of Claims, Collins, J., held that where the founder of the church was not only paid, in addition to his salary, commissions and royalties but he and his family received unexplained payments in the nature of loans and reimbursement, the church was not entitled to exemption from federal income taxation under statute, which includes among those organizations exempt from taxation a corporation organized and operated exclusively for religious or educational purposes, no part of net earnings of which inures to benefit of any private shareholder or individual.

Haag vs. Commissioner, 88 T.C. 604, 615 (1987), Whether a withdrawal of funds by a shareholder from a corporation or an advance made by a shareholder to a corporation creates a true debtor-creditor relationship is a factual question to be decided based on all relevant facts and circumstances. For disbursements to constitute true loans there must have been, at the time the funds were transferred, an unconditional obligation on the part of the transferee to repay the money, and an unconditional intention on the part of the transferor to secure repayment... Because direct evidence of a taxpayer's state of mind is not generally available, courts have focused on certain objective factors to distinguish bona fide loans from disguised dividends, compensation, and contributions to capital. Among the factors relevant to this case are: (1) The existence or nonexistence of a debt instrument; (2) provisions for security, interest payments and a fixed repayment date; (3) treatment of the funds on the corporation's books; (4) whether repayments were made; (5) the extent of the shareholder's participation in management; and (6) the effect of the "loan" on the shareholder/employee's salary.

Western Catholic Church v. Commissioner of Internal Revenue, 73 T.C. 196, Slough made large contributions to petitioner for which he took charitable contribution deductions. This money, however, never passed out of Slough's control since he dominated petitioner. Nor was any substantial portion of this money ever expended other than for investment purposes. Thus, in effect, Slough was able to reduce his current taxable income for donations which never left his control...it is clear that money passed back and forth between petitioner and Slough and his businesses whenever one or the other needed the cash. Petitioner was utilized by Slough as an

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"incorporated pocketbook" into which he could transfer excess personal funds, claiming tax deductions, while he still retained complete control of the funds and used them for purposes unrelated to religious activities... Based on the evidence produced, we cannot conclude that as a result of its financial transactions, no part of petitioner's net earnings inured to the benefit of Slough or members of his family or one of his wholly owned corporations. In view of petitioner's burden of proof, this question must be resolved in favor of respondent. Held: Petitioner was not operated exclusively for an exempt purpose and it has not shown that no part of its net earnings inured to the benefit of private individuals. Respondent's retroactive revocation of his ruling that petitioner was exempt under §501(c)(3), I.R.C. 1954, is sustained.

Better Business Bureau v. United States, 326 U.S. 279 (1945), the United States Supreme Court held that regardless of the number of truly exempt purposes, the presence of a single substantial non-exempt purpose will preclude exemption under §501(c)(3) of the Code.

GOVERNMENTS POSITION:

The law is very clear in requiring organizations, described under §501(c)(3) of the Code, to serve a public rather than a private interest. Section 501(c)(3) and its Regulations include only those organizations where no part of the net earnings inure in whole or in part to the benefit of any private shareholder or individual. Section 1.501(c)(3)-1(d) of the Regulations state that an organization is not organized or operated exclusively for one or more exempt purpose 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 demonstrate 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.

The set of facts for this case are similar to those of the Western Catholic Church, (WCC). Like Slough in WCC, Director made large contributions to ORG for which Director took charitable contribution deductions. Director also took tax deductions on the purported mortgage interest he paid. Since Slough dominated WCC, as Director dominates ORG, Slough always maintained total control. Slough, like Director, was able to reduce his taxable income for donations that never left his control. It was stated in the case that Slough utilized WCC as an "incorporated pocketbook" where he would transfer funds, claim a tax deduction, while still having total control and used the funds for non-exempt purposes. Similarly Director borrowed back 80 percent of the money the exact same day he made the contributions. The intent of Director was never primarily charitable but self serving in that Director used the borrowed funds from ORG to purchase a cabin for his personal use.

This scheme directly benefited Director in that it allowed Director to realize a lower federal income tax liability on his personal Form 1040 by contributing large amounts of money to ORG and then immediately borrowing it back for his own personal use. This activity clearly serves the private interests of Director rather than serving the interests of the public. Therefore the assets of ORG have in fact inured, in whole or in part, to the benefit of Director; ORG should consequently lose its tax exempt status.

Bona Fide Loan:

Regarding the loan with Director, as it states in Haag vs. Commissioner the courts have determined that for disbursements to constitute true loans, there must be, at the time the funds are transferred, an unconditional

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intention on the part of the transferor to secure repayment and an unconditional obligation on the part of the transferee to repay the money and whether or not repayments were in fact actually made.

The terms of the loan require Director to make monthly payments equal to the interest on the outstanding balance. On November 10, 20XX Director made a contribution to ORG for a total of \$ and on that same day Director borrowed back \$, which was outstanding for 3 months at 10 percent per year. On February 7, 20XX Director made a contribution to ORG for \$ and on the same day borrowed \$\$ creating a loan balance of \$\$, which was outstanding for 6 months at 10 percent per year. On May 10, 20XX Director made a contribution to ORG for \$\$ and then on August 6, 20XX Director made contributions to ORG totaling \$\$ and then borrowed \$\$ on August 6, creating a loan balance of \$\$, which was the total outstanding on December 31, 20XX at 10 percent per year as was indicated as the receivable balance on the balance sheet. Then on February 3, 20XX Director issued a check for \$ to ORG, however, it is not clear what the intended purpose of this disbursement was for in that: ORG includes \$\$ in interest income in 20XX, which may include the payment by Director. The balance sheet indicates a reduction in principal by \$ while Director took a tax deduction on his personal Form 1040 for the \$. If the payment was intended to reduce the principal balance then Director received a double tax benefit in that he took a tax deduction when he made the original contribution then another deduction when he paid it back after he borrowed it. In correspondence from DIR-3 that was faxed to the Service on September 8, 20XX, it was stated that check # in the amount of \$ was in fact a contribution. There was no other payment received by ORG that would reduce the principal or indicate interest was paid on the note. Therefore if the \$ was a "contribution" then ORG should not have reduced its principle by that amount nor shown the amount as interest income. According to the 20XX 990 a reduction on the principal was made in the amount of \$\$ making the account receivable balance \$ through the end of the 20XX tax year. Also beginning in 20XX the interest rate was reduced to 5%.

In computing the monthly interest only payment on the outstanding balances, based on the receivable balances recorded on the balance sheet, as the agreement required, the payments would approximately have been as follows:

What the schedule illustrates is the approximate amount of the interest payments Director should have been making. Although the bank statements indicate that there were somewhat regular monthly payments of \$ and \$, Director should have made regular monthly payments beginning in December 20XX for approximately \$. The payments would have increased to approximately \$ beginning in March 20XX and increased again in September 20XX to approximately \$ and then reduced to \$ beginning in March 20XX and then reduced in 20XX to \$. Below is a schedule that illustrates the estimated annual interest that should have been paid during 20XX thru 20XX and compares the figures to the actual amount reported on the Forms 990.

What the schedules illustrate is that while the loan balance has remained relatively constant the interest payments have steadily reduced over the years to almost zero. What this indicates is that Director has control over the terms of the loan, e.g. he is able to make the required payments at his sole discretion. ORG has no control over the funds it lent out, e.g. there were no late payment penalties assessed or notices issued to Director, which would be normal for a common commercial loan.

Although the loan document contained language that gave the appearance that ORG would in fact pursue collection if the borrower became delinquent, ORG never enforced collection. Director was nevertheless allowed to make payments as he wished, which would not normally be the case in a commercial loan.

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It is evident that the loan Director entered into with ORG benefited him directly in that it was more advantageous than if he would have entered into a loan with a commercial lender. Director would not have been able to make payments as he did with ORG in a commercial loan. He would have received delinquency penalties and the entire balance could have been demanded of Director. This also further supports the control Director has over ORG and that ORG was primarily serving the private interests of Director rather than serving the interest of the general public.

This also illustrates that the loan does not meet the statutory definition of a loan in that there was not an unconditional obligation of Director to repay the money nor was there an unconditional intent on the part of ORG to secure repayment. In addition Director did not consistently make the required regular monthly payments.

Because direct evidence of a taxpayer's state of mind is not available, courts have identified and considered various objective factors in the context of making a determination as to whether a particular advance is in fact a bona fide loan or a debt which include the following:

- The existence or nonexistence of a debt instrument
- The names given the instruments by the parties
- The relationship of the parties
- Whether the repayment of the loan was predicated on the success of the venture
- The presence or absence of a fixed maturity date and schedule of payments
- The source of the repayments and the ability to repay
- The presence or absence of a fixed interest rate and interest payments
- Whether third parties would have made the loan under the same conditions
- Whether the claimed loan was secured
- Whether payments were made
- Whether a demand for repayment has been made
- Failure to pay on the due date or to seek a postponement
- Whether the parties' records, if any, reflect the transaction as a loan

See Dixie Dairies Corp. v Commissioner, 74 T.C. 476, 493 (1980), acq. 1982-2 C.B. 1, Baldwin v. Commissioner, T.C. Memo, 1993-433; Gilboy v. Commissioner, T.C. Memo 1978-114, Smith v. Commissioner, 370 F.2d 178, 180 (6th Cir.1966), affg. T.C. Memo.1964-278.

The above factors are not exclusive, and no one factor is dispositive. See John Kelley Co. v. Commissioner, 326 U.S. 521, 530 (1946). The factors are simply objective criteria helpful to the Court in analyzing all relevant facts and circumstances. The ultimate question remains whether "there [was] a genuine intention to create a debt, with a reasonable expectation of repayment, and did that intention comport with the economic reality of creating a debtor-creditor relationship". Litton Business Systems Inc. v. Commissioner, 61 T.C. 367, 377. This is a factual issue, to be decided upon all the facts and circumstances in each case. See Geffman v. Commissioner, T.C. Memo. 1996-447.

Based on the facts presented it has not been demonstrated that the loan was in fact a bona fide loan. As such the transaction was entered into simply to benefit Director.

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Section 1.501(a)-1(e) of the Regulations define 'private shareholder or individual' as persons having a personal and private interest in the activities of the organization. As a director of ORG there is no question that Director, as well as DIR-3, would be considered insiders or individuals having a personal and private interests in the activities of ORG. As an insider, Director used ORG to realize a reduced federal income tax liability: by contributing large amounts of money, of which he took a charitable contribution tax deduction, and then borrowing 80 percent back for his own personal use in addition to paying interest on a mortgage that was in essence paid to his self.

It is therefore evident that ORG did not in fact operate exclusively for exempt purposes. The activities of ORG served the private interests of Director. Because the assets of ORG inured in whole or in part to the benefit of Director, ORG should lose its federal tax exemption.

TAXPAYERS POSITION:

ORG provided a response, dated June 7, 20XX, to the initial Form 886-A issued April 16, 20XX. The items ORG argues are highlighted here in italics. The Services rebuttal is noted immediately following:

"We disagree that the foundation should be revoked and that any private inurement occurred for the following reasons:"

"The loan from ORG was less than % of the value of the properties put up as collateral for the loan, certainly in any lenders mind, a safe loan."

"...title was never given to...ORG only a security interest was given and released when the note was paid off."

"The note was paid off in the early part of March 20XX as evidenced by the increase in...monies invested in the market."

"While ORG loaned money the principal did not decrease."

"While monies have been invested in the market there have been fluctuations both up and down with the market and certainly not as safe as the money that was loaned and secured by real assets whose value was 5 times the amount of the loan."

"Director did not take a double deduction for interest paid and then also for charitable contributions:"

"Because the prime rate changed so dramatically between 20XX and 20XX the note was changed to reflect market rates as most credit lines are tied to prime the interest paid was more than the market would have required, thus more evidence that there was not private inurement to Director."

"ORG...always paid more than % of its income to Charities listed in the Trust indenture."

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"The loan was paid off in its entirety and was always intended to be paid in full. Interest was paid at least on an annual basis, so as to keep the accounting and number of checks written and deposited to a minimum. On the 990's for 20XX, 20XX and 20XX it was reported that the amount of interest that was received by ORG...was what was due pursuant to the receivable outstanding. The money was received and deposited by ORG...."

"In looking at the Haag v. Commissioner case the fact that interest was always paid and more than adequate security was provided and in fact the loan was repaid prior to the terms of the loan is good evidence that the loan created a true debtor-creditor relationship. The fact that a security interest was given is evidence that there was an unconditional intention on the part of the transferor to secure repayment and an unconditional obligation on the transferor to repay the money."

"In the Western Catholic Church v. Comm. case the facts are very different in that the income of the ORG was in fact given to charities whether it was given directly or through CO-1 the money went to charities to help the charities purposes. Money was not passed back and forth but 3 loans were made pursuant to the line of credit and all of the principal and interest was repaid and paid."

"The fact that money was loaned back did not dilute the public interest at all. If the money had been invested in the market during that same period there would have been a decrease in the monies. The income earned would have been less, thus reducing the amount that would have been contributed to charities, so in fact the public interest was better served by making the loans, preserving the principal and creating income to give to charities."

"Director received no economic benefit from the loan, he could have easily gotten the same terms, if not better, from a commercial lender, given the loan to value ratio and the income level of Director."

"The Board was very familiar with Director's financial situation was not concerned about the collectability of the note, and further were not concerned with the payments being made monthly or annually, it was discussed at a meeting and all present agreed to allow the payments to be made annually, so as to minimize the accounting functions."

"Board of Trustees meetings were held where the distributions of the income was discussed and agreed upon by the board, there was also a meeting held that discussed the line of credit as an investment alternative and the board approved ORG...entering into the loan agreement. There is nothing in the code or the regulations that require that minutes be kept of the meetings. Because the meetings were once a year and action was taken on the meeting approvals immediately there were no minutes prepared."

Overall the statements that DIR-3 states on behalf of Director and ORG are of no consequence in light of all the facts presented. As discussed above, Director's total control over ORG allowed him to deviate from the executed loan agreement at his sole discretion, a feature not common in commercial loans. As it was also discussed, Director received an economic benefit from the loan in that he received a tax deduction from the contribution to ORG as well as a tax deduction from the mortgage interest paid to ORG. To date the purported payoff of the loan has not been substantiated. DIR-3 makes naked assertions that they have been paid off. Although the Code and Regulations do not require minutes to be kept, it is the burden of board for ORG to

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demonstrate that the activities it engages in are consistent with organizations described in §501(c)(3). Properly recorded minutes would have documented the activities of ORG as well as the interaction by the board particularly the evaluating and approval of the loan. The lack of minutes gives further indication that Director had sole control over ORG and did as he pleased and any statement regarding purported actions by the board are simply naked, undocumented assertions.

Further, as noted above, at the time of advances, Director's state of mind was not available, therefore reliance was made on the objective factors that have been identified by the courts in determining whether the advances were in fact bona fide loans; specifically:

- The relationship of the parties
- The presence or absence of a fixed interest rate and interest payments
- Whether third parties would have made the loan under the same conditions
- Whether payments were made
- Whether a demand for repayment has been made
- Failure to pay on the due date or to seek a postponement
- Whether the parties' records, if any, reflect the transaction as a loan

In applying these particular factors, as this report indicates, the advances were not bona fide loans.

Additionally the primary common factor with ORG and Western Catholic Church v. Commissioner of Internal Revenue is the unbridled control that Director has over ORG. Director has the ability to conduct as many or as few transactions as he desires. The actual number is of no consequence.

Where the same individuals control both the transferor and the transferee, the transaction must be scrutinized according to "an objective test of economic reality" to determine its true economic nature. Fin Hay Realty Co. v. United States, 398 F.2d 694 (3rd Cir. 1968) (where "the same persons occupy both sides of the bargaining table," the form of a transaction "does not necessarily correspond to the intrinsic economic nature of the transaction, for the parties may mold it at their will" in order "to create whatever appearance would be of ... benefit to them despite the economic reality of the transaction."). Accordingly, some courts have refused to characterize transfers as debts where the purported debtor conveyed its funds to another entity over which it retained a degree of control only to "borrow" the same funds back a short time later. See, e.g., Wilken v. Commissioner, T.C. Memo. 1987-272 (transfers from trusts to taxpayers who had funded the trusts were not bona fide loans, despite promissory notes bearing interest and mortgage securing repayment, since taxpayers had retained control over trust assets and thus were 'borrowing' their own assets in order to generate deductible interest payments); Ribisi v. United States, 1983 WL 1581 (N.D.Cal.1983) (transfers from trust to taxpayer were not a valid loan, despite a promissory note, because taxpayer had used the trust as a "conduit" through which it cycled the funds purportedly borrowed), aff'd, 746 F.2d 1487 (9th Cir. 1984).

On August 24, 20XX a formal protest was received requesting that the case be reviewed by Appeals. A review of that document indicated that the content was identical to the document submitted on June 7, 20XX and highlighted above. Therefore no additional comment is necessary at this time.

CONCLUSION:

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ORG was created to serve the needs and interests of its founder, Director. As such assets inured to his personal and private benefit. Therefore ORG fails the operational test and should lose its federal tax exemption effective January 1, 20XX.

Should it be determined during the Appeals Process that ORG should NOT lose its Federal Tax Exemption the following alternate position should be considered.

ISSUE:

1. Whether ORG meets one of the three required relationships specified in §1.509(a)-4(f)(2) of the Regulations and whether the relationship insures ORG responsiveness to the needs and demands of the specified publicly supported organization(s) and whether the activities of ORG are an integral part of the operations of the specified supported organization(s) and if not whether ORG should be reclassified as a Private Foundation.
2. Whether Director, as the foundation manager, jeopardized the investments for ORG subjecting it to the excise taxes proscribed under §§ 4944(a)(1) and (b)(1).

FACTS:

Please refer to the set of facts above.

LAW:

Issue 1:

Foundation Status:

IRC §509(a)(3) an organization which --

- (A) is organized, and at all times thereafter is operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified organizations described in paragraph (1) or (2),
- (B) is operated, supervised, or controlled by or in connection with one or more organizations, described in paragraph (1) or (2), and
- (C) is not controlled directly or indirectly by one or more disqualified persons other than foundation managers and other than one or more organizations described in paragraph (1) or (2);

Treas. Reg. §1.509(a)-4(a) *In general.*

- (1) Section 509(a)(3) excludes from the definition of "private foundation" those organizations which meet the requirements of subparagraphs (A), (B), and (C) thereof.
- (2) Section 509(a)(3)(A) provides that a section 509(a)(3) organization must be organized, and at all times thereafter operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified organizations described in section 509(a)(1) or (2). Section 509(a)(3)(A) describes the nature of the support or benefit which a section 509(a)(3) organization must provide to one or more section 509(a)(1) or (2) organizations. For purposes of section 509(a)(3)(A), paragraph (b) of this section generally describes the organizational and operational tests; paragraph (c) of this section describes permissible purposes under the organizational test; paragraph (d) of this section describes the requirement of supporting

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or benefiting one or more "specified" publicly supported organizations; and paragraph (e) of this section describes permissible beneficiaries and activities under the operational test.

- (3) Section 509(a)(3)(B) provides that a section 509(a)(3) organization must be operated, supervised, or controlled by or in connection with one or more organizations described in section 509(a)(1) or (2). Section 509(a)(3)(B) and paragraph (f) of this section describe the nature of the relationship which must exist between the section 509(a)(3) and section 509(a)(1) or (2) organizations. For purposes of section 509(a)(3)(B), paragraph (g) of this section defines "operated, supervised, or controlled by"; paragraph (h) of this section defines "supervised or controlled in connection with"; and paragraph (i) of this section defines "operated in connection with".
- (4) Section 509(a)(3)(C) provides that a section 509(a)(3) organization must not be controlled directly or indirectly by disqualified persons (other than foundation managers or organizations described in section 509(a)(1) or (2)). Section 509(a)(3)(C) and paragraph (j) of this section prescribe a limitation on the control over the section 509(a)(3) organization.

Treas. Reg. §1.509(a)-4(b) *Organizational and operational tests.*

- (1) Under subparagraph (A) of section 509(a)(3), in order to qualify as a supporting organization, an organization must be both organized and operated exclusively "for the benefit of, to perform the functions of, or to carry out the purposes of" (hereinafter referred to in this section as being organized and operated "to support or benefit") one or more specified publicly supported organizations. If an organization fails to meet either the organizational or the operational test, it cannot qualify as a supporting organization.

Treas. Reg. §1.509(a)-4(c) *Organizational test.*

- (1) *In general.* An organization is organized exclusively for one or more of the purposes specified in section 509(a)(3)(A) only if its articles of organization (as defined in §1.501(c)(3)-1(b)(2)):
- (i) Limit the purposes of such organization to one or more of the purposes set forth in section 509(a)(3)(A);
 - (ii) Do not expressly empower the organization to engage in activities which are not in furtherance of the purposes referred to in subdivision (i) of this subparagraph;
 - (iii) State the specified publicly supported organizations on whose behalf such organization is to be operated (within the meaning of paragraph (d) of this section); and
 - (iv) Do not expressly empower the organization to operate to support or benefit any organization other than the specified publicly supported organizations referred to in subdivision (iii) of this subparagraph.
- (2) *Purposes.* In meeting the organizational test, the organization's purposes, as stated in its articles, may be as broad as, or more specific than, the purposes set forth in section 509(a)(3)(A). Therefore, an organization which, by the terms of its articles, is formed "for the benefit of" one or more specified publicly supported organizations shall, if it otherwise meets the other requirements of this paragraph, be considered to have met the organizational test.
- (3) *Limitations.* An organization is not organized exclusively for the purposes set forth in section 509(a)(3)(A) if its articles expressly permit it to operate to support or benefit any organization other than those specified publicly supported organizations referred to in subparagraph (1)(iii) of this paragraph.

Treas. Reg. §1.509(a)-4(d) *Specified organizations.*

- (1) *In general.* In order to meet the requirements of section 509(a)(3)(A), an organization must be organized and operated exclusively to support or benefit one or more "specified" publicly supported organizations. The manner in which the publicly supported organizations must be "specified" in the articles for purposes of section 509(a)(3)(A) will depend upon whether the supporting organization is "operated, supervised, or

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controlled by" or "supervised or controlled in connection with" (within the meaning of paragraph (g) and (h) of this section) such organizations or whether it is "operated in connection with" (within the meaning of paragraph (i) of this section) such organizations.

Treas. Reg. §1.509(a)-4(e) *Operational test*

- (1) *Permissible beneficiaries.* A supporting organization will be regarded as "operated exclusively" to support one or more specified publicly supported organizations (hereinafter referred to as the "operational test") only if it engages solely in activities which support or benefit the specified publicly supported organizations.
- (2) *Permissible activities.* A supporting organization is not required to pay over its income to the publicly supported organizations in order to meet the operational test. It may satisfy the test by using its income to carry on an independent activity or program which supports or benefits the specified publicly supported organizations. All such support must, however, be limited to permissible beneficiaries in accordance with subparagraph (1) of this paragraph

Treas. Reg. §1.509(a)-4(f) *Nature of relationship required between organizations*

- (1) *In general.* Section 509(a)(3)(B) describes the nature of the relationship required between a section 501(c)(3) organization and one or more publicly supported organizations in order for such section 501(c)(3) organization to qualify under the provisions of section 509(a)(3). To meet the requirements of section 509(a)(3), an organization must be operated, supervised, or controlled by or in connection with one or more publicly supported organizations. If an organization does not stand in one of such relationships (as provided in this paragraph) to one or more publicly supported organizations, it is not an organization described in section 509(a)(3).
- (2) *Types of relationships.* Section 509(a)(3)(B) sets forth three different types of relationships, one of which must be met in order to meet the requirements of subparagraph (1) of this paragraph. Thus, a supporting organization may be:
 - (i) Operated, supervised, or controlled by,
 - (ii) Supervised or controlled in connection with, or
 - (iii) Operated in connection with, one or more publicly supported organizations.
- (3) *Requirements of relationships.* Although more than one type of relationship may exist in any one case, any relationship described in section 509(a)(3)(B) must insure that:
 - (i) The supporting organization will be responsive to the needs or demands of one or more publicly supported organizations; and
 - (ii) The supporting organization will constitute an integral part of, or maintain a significant involvement in, the operations of one or more publicly supported organizations.
- (4) *General description of relationships.* In the case of supporting organizations which are "operated, supervised, or controlled by" one or more publicly supported organizations, the distinguishing feature of this type of relationship is the presence of a substantial degree of direction by the publicly supported organizations over the conduct of the supporting organization, as described in paragraph (g) of this section. In the case of supporting organizations which are "supervised or controlled in connection with" one or more publicly supported organizations, the distinguishing feature is the presence of common supervision or control among the governing bodies of all organizations involved, such as the presence of common directors, as described in paragraph (h) of this section. In the case of a supporting organization which is "operated in connection with" one or more publicly supported organizations, the distinguishing feature is that the supporting organization is responsive to, and significantly involved in the operations of, the publicly supported organization, as described in paragraph (i) of this section.

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Treas. Reg. §1.509(a)-4(g) *Meaning of "operated, supervised, or controlled by"*.

(1)(i) Each of the items "operated by", "supervised by", and "controlled by", as used in section 509(a)(3)(B), presupposes a substantial degree of direction over the policies, programs, and activities of a supporting organization by one or more publicly supported organizations. The relationship required under any one of these terms is comparable to that of a parent and subsidiary, where the subsidiary is under the direction of, and accountable or responsible to, the parent organization. This relationship is established by the fact that a majority of the officers, directors, or trustees of the supporting organization are appointed or elected by the governing body, members of the governing body, officers acting in their official capacity, or the membership of one or more publicly supported organizations.

Treas. Reg. §1.509(a)-4 (h) *Meaning of "supervised or controlled in connection with."*

(1) In order for a supporting organization to be "supervised or controlled in connection with" one or more publicly supported organizations, there must be common supervision or control by the persons supervising or controlling both the supporting organization and the publicly supported organizations to insure that the supporting organization will be responsive to the needs and requirements of the publicly supported organizations. Therefore, in order to meet such requirement, the control or management of the supporting organization must be vested in the same persons that control or manage the publicly supported organizations.

Treas. Reg. §1.509(a)-4(i) *Meaning of "operated in connection with"*

(1) *General rule.* (i) Except as provided in subdivisions (ii) and (iii) of this subparagraph and subparagraph (4) of this paragraph, a supporting organization will be considered as being operated in connection with one or more publicly supported organizations only if it meets the "responsiveness test" which is defined in subparagraph (2) of this paragraph and the "integral part test" which is defined in subparagraph (3) of this paragraph.

(2) *Responsiveness test*

(i) For purposes of this paragraph, a supporting organization will be considered to meet the "responsiveness test" if the organization is responsive to the needs or demands of the publicly supported organizations within the meaning of this subparagraph. In order to meet this test, either subdivision (ii) or subdivision (iii) of this subparagraph must be satisfied.

(ii)(a) One or more officers, directors, or trustees of the supporting organization are elected or appointed by the officers, directors, trustees, or membership of the publicly supported organizations;

(b) One or more members of the governing bodies of the publicly supported organizations are also officers, directors or trustees of, or hold other important offices in, the supporting organizations; or

(c) The officers, directors or trustees of the supporting organization maintain a close and continuous working relationship with the officers, directors or trustees of the publicly supported organizations; and

(d) By reason of (a), (b), or (c) of this subdivision, the officers, directors or trustees of the publicly supported organizations have a significant voice in the investment policies of the supporting organization, the timing of grants, the manner of making them, and the selection of recipients of such supporting organization, and in otherwise directing the use of the income or assets of such supporting organization.

(iii)(a) The supporting organization is a charitable trust under State law;

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- (b) Each specified publicly supported organization is a named beneficiary under such charitable trust's governing instrument; and
- (c) The beneficiary organization has the power to enforce the trust and compel an accounting under State law.

(3) Integral part test; general rule.

- (i) For purposes of this paragraph, a supporting organization will be considered to meet the "integral part test" if it maintains a significant involvement in the operations of one or more publicly supported organizations and such publicly supported organizations are in turn dependent upon the supporting organization for the type of support which it provides. In order to meet this test, either subdivision (ii) or subdivision (iii) of this subparagraph must be satisfied.
- (ii) The activities engaged in for or on behalf of the publicly supported organizations are activities to perform the functions of, or to carry out the purposes of, such organizations, and, but for the involvement of the supporting organization, would normally be engaged in by the publicly supported organizations themselves.
- (iii)(a) The supporting organization makes payments of substantially all of its income to or for the use of one or more publicly supported organizations, and the amount of support received by one or more of such publicly supported organizations is sufficient to insure the attentiveness of such organizations to the operations of the supporting organization. In addition, a substantial amount of the total support of the supporting organization must go to those publicly supported organizations which meet the attentiveness requirement of this subdivision with respect to such supporting organization. Except as provided in (b) of this subdivision, the amount of support received by a publicly supported organization must represent a sufficient part of the organization's total support so as to insure such attentiveness. In applying the preceding sentence, if such supporting organization makes payments to, or for the use of, a particular department or school of a university, hospital or church, the total support of the department or school shall be substituted for the total support of the beneficiary organization.
- (b) Even where the amount of support received by a publicly supported beneficiary organization does not represent a sufficient part of the beneficiary organization's total support, the amount of support received from a supporting organization may be sufficient to meet the requirements of this subdivision if it can be demonstrated that in order to avoid the interruption of the carrying on of a particular function or activity, the beneficiary organization will be sufficiently attentive to the operations of the supporting organization. This may be the case where either the supporting organization or the beneficiary organization earmarks the support received from the supporting organization for a particular program or activity, even if such program or activity is not the beneficiary organization's primary program or activity so long as such program or activity is a substantial one.

Treas. Reg. §1.509(a)-4(j) Control by disqualified persons—

- 1) *In general.* Under the provisions of section 509(a)(3)(C) a supporting organization may not be controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more publicly supported organizations.... An organization will be considered "controlled", for purposes of section 509(a)(3)(C), if the disqualified persons, by aggregating their votes or positions of authority, may require such organization to perform any act which significantly affects its operations or may prevent such organization from performing such act. This includes, but is not limited to, the right of any substantial contributor or his spouse to designate annually the recipients, from

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among the publicly supported organizations of the income attributable to his contribution to the supporting organization. Except as provided in subparagraph (2) of this paragraph, a supporting organization will be considered to be controlled directly or indirectly by one or more disqualified persons if the voting power of such persons is 50 percent or more of the total voting power of the organization's governing body or if one or more of the total voting power of the organization's governing body or if one or more of such persons have the right to exercise veto power over the actions of the organization.

(2) *Proof of independent control.* Notwithstanding subparagraph (1) of this paragraph, an organization shall be permitted to establish to the satisfaction of the Commissioner that disqualified persons do not directly or indirectly control it.

Treas. Reg. §53.4942(b)-1. Operating foundations

(c) *Substantially all.* —For purposes of this section, the term “substantially all” shall mean 85 percent or more. Thus, if a foundation makes qualifying distributions directly for the active conduct of activities constituting its charitable, educational, or other similar exempt purpose in an amount equal to at least 85 percent of its adjusted net income, it will be considered as satisfying the income test described in this section even if it makes grants to organizations or engages in other activities with the remainder of its adjusted net income and with other funds. In determining whether the amount of qualifying distributions made directly for the active conduct of such exempt activities equals at least 85 percent of a foundation's adjusted net income, a foundation is not required to trace the source of such expenditures to determine whether they were derived from income or from contributions.

Rev. Rul. 76-208, 1976-1 CB 161, (Jan. 01, 1976)

Section 1.509(a)-4(i)(3)(iii)(a) of the regulations provides that one requirement of the integral part test will be satisfied if the supporting organization makes payments of substantially all of its income to or for the use of one or more publicly supported organizations.

Although the term “substantially all” is not defined in the regulations under section 509 of the Code, it is defined in the Foundation Excise Tax Regulations issued under sections of the Code which were promulgated under the Tax Reform Act of 1969 as was section 509.

Section 53.4942(b)-1(c) of those regulations provides that for the purposes of section 4942(j)(3)(A) of the Code (relating to qualifying distributions by private operating foundations) the term “substantially all” shall mean 85 percent or more.

For purposes of the integral part test, the term “substantially all” is considered to have the same meaning of 85 percent or more that it has in section 53.4942(b)-1(c) of the regulations. Accordingly, because the trust described above distributes less than 85 percent of its income to or for the use of one or more publicly supported organizations, it does not satisfy the “substantially all” requirement of the integral part test set forth in section 1.509(a)-4(i)(3)(iii)(a) of the regulations and is not a supporting organization within the meaning of section 509(a)(3) of the Code.

Issue 2:

Excise Taxes:

RC §4944(a)(1) INITIAL TAXES ON THE PRIVATE FOUNDATION. —If a private foundation invests any amount in such a manner as to jeopardize the carrying out of any of its exempt purposes, there is hereby imposed on the

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making of such investment a tax equal to 5 percent of the amount so invested for each year (or part thereof) in the taxable period. The tax imposed by this paragraph shall be paid by the private foundation.

IRC §4944 (b)(1) ADDITIONAL TAXES ON THE FOUNDATION. —In any case in which an initial tax is imposed by subsection (a)(1) on the making of an investment and such investment is not removed from jeopardy within the taxable period, there is hereby imposed a tax equal to 25 percent of the amount of the investment. The tax imposed by this paragraph shall be paid by the private foundation.

IRC §4944(e)(1) TAXABLE PERIOD. —The term “taxable period” means, with respect to any investment which jeopardizes the carrying out of exempt purposes, the period beginning with the date on which the amount is so invested and ending on the earliest of (A) the date of mailing of a notice of deficiency with respect to the tax imposed by subsection (a)(1) under section 6212, (B) the date on which the tax imposed by subsection (a)(1) is assessed, or (C) the date on which the amount so invested is removed from jeopardy.

IRC §4944(e)(2) REMOVAL FROM JEOPARDY. —An investment which jeopardizes the carrying out of exempt purposes shall be considered to be removed from jeopardy when such investment is sold or otherwise disposed of, and the proceeds of such sale or other disposition are not investments which jeopardize the carrying out of exempt purposes.

Treas. Reg. §53.4944-1(a)(1). Initial taxes *On the private foundation in general.* —If a private foundation invests any amount in such a manner as to jeopardize the carrying out of any of its exempt purposes, section 4944(a)(1) of the Code imposes an excise tax on the making of such investment. This tax is to be paid by the private foundation and is at the rate of 5 percent of the amount so invested for each taxable year (or part thereof) in the taxable period (as defined in section 4944(e)(1)). The tax imposed by section 4944(a)(1) and this paragraph shall apply to investments of either income or principal.

Treas. Reg. §53.4944-1(a)(2) *Jeopardizing investments*

(i) an investment shall be considered to jeopardize the carrying out of the exempt purposes of a private foundation if it is determined that the foundation managers, in making such investment, have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment, in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes. The determination whether the investment of a particular amount jeopardizes the carrying out of the exempt purposes of a foundation shall be made on an investment by investment basis, in each case taking into account the foundation's portfolio as a whole.

IRC §4946(a)(1) DISQUALIFIED PERSON, IN GENERAL. —For purposes of this subchapter, 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, (C) an owner of more than 20 percent of the total combined voting power of a corporation, the profits interest of a partnership, or the beneficial interest of a trust or unincorporated enterprise, which is a substantial contributor to the foundation, (D) a member of the family of any individual described in subparagraph (A), (B), or (C), (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 which is effectively controlled

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(directly or indirectly) by the same person or persons who control the private foundation in question, or 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, 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.

IRC §4946(b)(1) FOUNDATION MANAGER. —For purposes of this subchapter, the term “foundation manager” means, with respect to any private foundation 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),

IRC §4946(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.

GOVERNMENTS POSITION:

Issue 1: Foundation Status:

ORG is currently classified as a public charity as an organization described under §509(a)(3) of the Code. It is necessary to determine whether ORG satisfies the requirements of a supporting organization under the provisions of §1.509(a)-4 of the Regulations.

Organizational Test:

Section 1.509(a)-4(c) states that an organization is organized exclusively for one or more of the purposes specified in §509(a)(3) only if its articles of organization limit the purposes of such organization to one or more of the purposes set forth in §509(a)(3)(A) of the Code, does not expressly empower the organization to engage in activities which are not in furtherance of the purposes referred to in subdivision (i) of this subparagraph, states the specified publicly supported organizations on whose behalf such organization is to be operated and does not expressly empower the organization to operate to support or benefit any organization other than the specified publicly supported organizations referred to in subdivision (iii) of this subparagraph.

Relationship Test:

Section 1.509(a)-4(f) of the Regulations states that in order for a §501(c)(3) organization to qualify under the provisions of §509(a)(3), the relationship required between the §501(c)(3) and the supported organization must meet one of three types: (1) operated, supervised, or controlled by; (2) supervised or controlled in connection with, or (3) operated in connection with, one or more publicly supported organizations. The Regulations also require that the relationship must insure that, (a) the supporting organization will be responsive to the needs or demands of one or more publicly supported organizations; and (b) the supporting organization will constitute an integral part of, or maintain a significant involvement in, the operations of one or more publicly supported organizations.

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Section 1.509(a)-4(g) of the Regulations describes the type of relationship where the supporting organization is "operated by", "supervised by", and "controlled by" the supported organization, as used in section 509(a)(3)(B). This type of relationship presupposes a substantial degree of direction over the policies, programs, and activities of a supporting organization by one or more publicly supported organizations. The relationship required under any one of these terms is comparable to that of a parent and subsidiary, where the subsidiary is under the direction of, and accountable or responsible to, the parent organization. This relationship is established by the fact that a majority of the officers, directors, or trustees of the supporting organization are appointed or elected by the governing body, members of the governing body, officers acting in their official capacity, or the membership of one or more publicly supported organizations.

Although the Trust Document indicates that _____ will appoint three (3) of the five (5) members to the Board of Directors for ORG it is apparent that two of the Charity members serve the interests of Director rather than _____. Both DIR-4 and DIR-5 are members and/or administrators along with Director in the CO-4 in addition to DIR-4 also being an _____. It is apparent that Director's relationship with these individuals goes beyond that of just being common board members. The fact that DIR-4 and DIR-5 are affiliated with organizations as Director is neither incidental nor coincidental. It was the intent of Director, not _____ to appoint DIR-4 and DIR-5 as board members in order to control the board and his monetary interest in ORG.

Therefore the type of relationship that exists does not satisfy the provisions of §1.509(a)-4(g) of the Regulations and would preclude qualification as a supporting organization under §509(a)(3).

Type II

Section 1.509(a)-4(h) of the Regulations describes the type of relationship where the supporting organization is "supervised or controlled in connection with" the supported organizations. In order for a supporting organization to meet this type of relationship, there must be common supervision or control by the persons supervising or controlling both the supporting organization and the publicly supported organizations. Therefore the control or management of the supporting organization must be vested in the same persons that control or manage the publicly supported organizations.

Similar to the "Type I" discussion above Director has total control over the affairs of ORG. There is no board member that has control over both ORG and _____. Therefore because there is no common supervision of both ORG and _____ or any other charity the relationship that exists does not satisfy the provisions of §1.509(a)-4(h) of the Regulations and would preclude qualification as a supporting organization under §509(a)(3).

Type III

Section 1.509(a)-4(i) of the Regulations describes the type of relationship where the supporting organization is "operated in connection with" the supported organizations. The *general rule* is that a supporting organization will be considered as being operated in connection with one or more publicly supported organizations only if it meets the "responsiveness test" and the "integral part test".

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The responsiveness test requires the supporting organization to be responsive to the needs or demands of the publicly supported organizations. To meet this test either (ii) or (iii) of must be satisfied:

(ii)

- (a) One or more officers, directors, or trustees of the supporting organizations are elected or appointed by the officers, directors, trustees, or membership of the publicly supported organizations;

Although Director has influence in selecting four (4) of the five board members, DIR-3 does represent on the board.

- (b) One or more members of the governing bodies of the publicly supported organizations are also officers, directors or trustees of, or hold other important offices in, the supporting organizations; or

DIR-3 is a board member of both Wishes and ORG.

- (c) The officers, directors or trustees of the supporting organization maintain a close and continuous working relationship with the officers, directors or trustees of the publicly supported organizations; and

This part of the responsiveness test is not challenged at this time.

- (d) By reason of (a), (b), or (c) of this subdivision, the officers, directors or trustees of the publicly supported organizations have a significant voice in the investment policies of the supporting organization, the timing of grants, the manner of making them, and the selection of recipients of such supporting organization, and in otherwise directing the use of the income or assets of such supporting organization.

As stated above Director has total control over the affairs of ORG. Although DIR-3 may, from time to time, offer advice on the investment policies of ORG he does not have the authority to implement any such policy. DIR-3 merely offers advice while Director has total authority for all investments ORG engages in. Also DIR-3 has no voice in the selection of the recipients for ORG nor does he have the authority to direct the use of the income or assets of ORG. Director has the only voice and authority to direct the use of the income or assets of ORG and to who ORG selects as a recipient.

Because Director has total control over ORG which included the investment policies, the selection of recipients as well as the direction for the use of the income or assets for ORG it will preclude ORG in satisfying this section of the responsiveness test.

(iii)

- (a) The supporting organization is a charitable trust under State law;

- (b) Each specified publicly supported organization is a named beneficiary under such charitable trust's governing instrument; and

- (c) The beneficiary organization has the power to enforce the trust and compel an accounting under State law.

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There is no dispute that ORG is in fact a charitable trust under the state of State where it lists in its Trust document the specified publicly supported organizations that it states it will support. It is also presumed that under state law that the stated supported organization, has the power to enforce the trust and compel an accounting. Given these facts it would appear that pursuant to the "letter of the law" ORG could possibly qualify as a supporting organization under this section of law. However the "spirit" of the responsiveness test demands that organizations seeking exemption under this section be responsive to the needs or demands of the organization it intends to support of which ORG does not satisfy. As it has been demonstrated Director has complete and total control over the affairs of ORG which does not ensure that ORG will be responsive to the needs of or any other organization. Therefore ORG will not satisfy this part of the responsiveness test.

Responsiveness Test Conclusion:

Because Director has total control over ORG, it does not ensure that ORG will be responsive to the needs and demands of . Therefore ORG fails to satisfy the provisions of §1.509(a)-4(i) of the Regulations and would preclude qualification as a supporting organization under §509(a)(3).

The integral part test requires the supporting organization to maintain a significant involvement in the operations of one or more publicly supported organizations. The publicly supported organizations are in turn dependent upon the supporting organization for the type of support which it provides. Because ORG primarily makes payments to the publicly supported organization, in order to meet this test the following must be satisfied:

- The supporting organization makes payments of substantially all of its income to or for the use of one or more publicly supported organizations, and
- The amount of support received by one or more of such publicly supported organizations is sufficient to insure the attentiveness of such organizations to the operations of the supporting organization.
- A substantial amount of the total support of the supporting organization must go to those publicly supported organizations which meet the attentiveness requirement of this subdivision with respect to such supporting organization. Except as provided in (b) of this subdivision, the amount of support received by a publicly supported organization must represent a sufficient part of the organization's total support so as to insure such attentiveness.

Integral Part Test Conclusion:

ORG makes distributions to the CO-2 (CO-2) and to . Further distributions to have steadily decreased over the past years with no distributions made in either 20XX or 20XX. ORG has not demonstrated that it provided a substantial amount of the total support to either of these organizations that would insure their attentiveness. See Lapham Foundation, Inc. v. C.I.R., C.A. 620XX, 389 F.3d 606).

Control Test:

Section 1.509(a)-4(j) of the Regulations states that a supporting organization may not be controlled, directly or indirectly, by one or more disqualified persons other than foundation managers and other than one or more

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publicly supported organizations. . . . An organization will be considered "controlled", for purposes of §509(a)(3)(C), if the disqualified persons, by aggregating their votes or positions of authority, may require such organization to perform any act which significantly affects its operations or may prevent such organization from performing such act. This includes, but is not limited to, the right of any substantial contributor or his spouse to designate annually the recipients, from among the publicly supported organizations of the income attributable to his contribution to the supporting organization. Except as provided in subparagraph (2) of this paragraph, a supporting organization will be considered to be controlled directly or indirectly by one or more disqualified persons if the voting power of such persons is 50 percent or more of the total voting power of the organization's governing body or if one or more of the total voting power of the organization's governing body or if one or more of such persons have the right to exercise veto power over the actions of the organization.

As it has been established, Director has total control over the activities and affairs of ORG. Director also has over 50% of the voting power in addition to having veto power. Because of the control ORG fails to satisfy the provision of §1.509(a)-4(j) of the Regulations and would preclude qualification as a supporting organization under §509(a)(3).

Overall ORG has failed to meet the provisions specified in §509(a)(3) of the Code and §1.509(a)-4 of the Regulations. Accordingly ORG should be reclassified as a private foundation.

Issue 2: Excise Taxes:

Section 4944 of the Code imposes a tax on investments each year which jeopardize a private foundation's charitable purpose. Section 4944(a)(1) of the Code imposes a 5% tax on the private foundation when it invests any amount in such a manner as to jeopardize the carrying on of its exempt purposes. In any case in which the §4944(a)(1) tax is imposed, §4944(b)(1) of the Code imposes a 25% tax on the private foundation when the investment upon which the tax is imposed is not removed from jeopardy within the taxable period. Section 53.4944-1(a)(2) of the regulations provides that, in general, an investment is considered to jeopardize the carrying out of the exempt purposes of a private foundation when it is determined that the foundation managers, in making the investment, failed to exercise ordinary business care and prudence in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes. Moreover, the regulation also requires that this determination shall be made on an investment by investment basis, in each case taking into consideration the foundation's portfolio as a whole.

Director created ORG as a tax planning strategy and where he made large contributions to ORG of which are invested in the loan made to Director. The interest that the investments earned were intended to be distributed to charitable organizations that ORG claimed to have supported. The investment that ORG made however was a line-of-credit that was extended to Director. The terms of the agreement allowed Director to borrow up to \$ of which he borrowed \$\$\$. The terms of the agreement required Director to make monthly interest only payments, and as indicated above, he did not make. The agreement stated that ORG would pursue collection should Director become delinquent in his payments. ORG did not issue any notices to Director demanding payment nor did ORG enforce its right to collect the delinquent payments. Further in 20XX & 20XX Director made very minimal payments and ORG still did not pursue collection. Because Director was not making the required payments pursuant to the agreement, ORG was unable to make the disbursements that it could have if the payments were made timely. It is apparent that in allowing Director to deviate, at his discretion, from the

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agreement, ORG was not exercising ordinary business care and prudence in providing for the long- and short-term financial needs of ORG. Therefore ORG should be held liable for the private foundation taxes pursuant to §4944(a)(1). If ORG fails to remove the investment from jeopardy within the taxable period, it should also be held liable for the tax proscribed under §4944(b)(1).

Tax computation:

CONCLUSION:

Director controlled ORG to the point that it failed to meet the provisions of §1.509(a)-4. As such ORG should be reclassified as a private foundation. Director also jeopardized the investments for ORG causing it to be subject to the excise taxes proscribed in §§ 4944(a)(1) and (b)(1).