

Internal Revenue Service
Appeals Office
701 Market Street, Suite 2200
Philadelphia, PA 19106

Department of the Treasury

Person to Contact:

Employee ID Number:

Tel:

Fax:

Refer Reply to:

Date: **AUG 13 2010**

Number: **201044021**
Release Date: 11/5/2010

In Re:

Tax Period(s) Ended:

Form Number

UIL - 0501 .03-00

Employer Identification Number

CERTIFIED MAIL

**Last Day to File a Petition with the
United States Tax Court: Not Applicable**

Dear :

This is a final adverse determination as to your exempt status under section 501(c)(3) of the Internal Revenue Code. It is determined that you are no longer recognized as exempt from Federal income tax under Section 501(c)(3) of the Internal Revenue Code, effective January 1, 2003. Your application for exemption (Form 1023) and associated materials misstated material fact, and you operated in a manner materially different than originally represented.

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

This organization had conducted no charitable activities, and the manner in which it was structured to operate would further its insiders' interests due to their control. Therefore, it would be operated for a substantial nonexempt purpose. Accordingly, you would not be operated exclusively for exempt purposes described in section 501(c)(3).

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

You are required to file Federal income tax returns on the form indicated above.

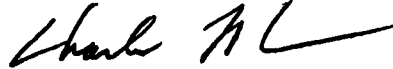
You have waived your right to contest this determination under the declaratory judgment provisions of Section 7428 of the Code by your execution of Form 906, Closing Agreement Concerning Specific Matters, an executed copy of which is being sent to you under separate cover.

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

You also have the right to contact the office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures such as the formal appeals process. The Taxpayer Advocate is not able to reverse legally correct tax determinations, nor extend the time fixed by law that you have to file a petition in the U.S. Tax Court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. If you want Taxpayer Advocate assistance, please contact the Taxpayer Advocate for the IRS office that issued this notice of deficiency. See the enclosed Notice 1214, *Helpful Contacts for Your "Notice of Deficiency"*, for Taxpayer Advocate telephone numbers and addresses.

Thank you for your cooperation.

Sincerely,



CHARLES FISHER
TEAM MANAGER

Enclosures:

Notice 1214 Helpful Contacts for your 'Deficiency Notice'



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Date: May 5, 2009

M

P

Contact Person:

Identification Number:

Contact Number:

FAX Number:

Employer Identification Number:

Dear :

We have considered your application for recognition of exemption from Federal income tax under Internal Revenue Code section 501(a). Based on the information provided, we have concluded that you do not qualify for exemption under Code section 501(c)(3). The basis for our conclusion is set forth below.

ISSUES:

1. Do you, M, who received and hold a % interest in a Limited Liability Company, qualify for exemption under section 501(c)(3) of the Code?
2. If you, M, are exempt, are you a supporting organization as described in IRC section 509(a)(3) of the Code?

Letter 4036(CG)(11-2005)
Catalog Number 47630W

Issue 1 Section 501(c)(3)**Facts:**

Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code, was submitted on z3. M was formed as a trust 2 years and 24 days earlier on z2, by the execution of a Trust Agreement by and between A C and B C, both residents of Y, and both referred to as the "Donors." A C is B C's son, and is referred to as the "Trustee."

Section 1.1 of the Trust Agreement states, in pertinent part, "this Trust is supervised or controlled in connection with, and at all times hereafter will be operated exclusively to support or benefit, as defined by Section 509(a)(3) of the Code, and Treasury Regulation Section 1.509(a)-4, N, a publicly supported organization described in Section 501(c)(3) of the Code."

Section 2.2.1 of the Trust Agreement states in pertinent part, "the Trustee shall distribute at least eighty-five (85%) of the net income of this Trust to N (the "Primary Charity"). In order to ensure that this happens, a majority of this organization's board (as defined in Section 4.1 below) shall also be members of the Primary Charity's board, so the needs of the Primary Charity shall be reflected in the actions of this organization."

Section 2.2.2 of the Trust Agreement states in pertinent part, "the Trustee may make such discretionary distributions of the income in excess of the amount provided in Section 2.2.1 above and of the principal of this Trust to the Primary Charity as is directed by the board in a writing signed by at least two members of the board; provided that each such distribution shall be a distribution which can be made by an organization described in Section 509(a)(3) of the Code."

Section 4 of the Trust Agreement describes the composition of the Board. The board shall consist of at least three board members that will be comprised of one member of the C family and two independent members of the Board. The initial family member of the Board is B C's son, A C. The remaining two (2) members or more of the Board shall be appointed by a majority vote of the remaining members of the board other than the C family. The initial independent board members shall be E & F.

Section 4.1.6 of the Trust states in pertinent part, "the membership of the board shall at all times be such that the original Donor or other Disqualified Persons, as defined in Section 4946 of the Code, do not control the Board."

A C signed the Trust as Trustee and both father and son B C and A C signed the trust as Donors. A C and B C are disqualified persons with respect to M because they are substantial contributors.

The asset of the trust is membership interest in a Limited Liability Company, O. A C and B C are the only two members of O, and each owned % of the interest in O. O is located in the state of Y where A C and B C reside. M submitted three instruments showing assignment

interests. The instruments show that both A C and B C intended to transfer a total of % of their respective interests. The father, B C, transferred % of his LLC interest in the calendar year ending 20 . On the same date A C also assigned % of his interest to M. M shows that for the calendar year ending 20 , A C transferred his second % assignment interest for a total of 5%. The file shows that the total interest transferred so far to M, by A C and B C is % of the LLC's interest. Therefore A C owns %, B C owns % of the LLC. The file shows B C donated \$ cash to M during 20 .

The LLC, O, was formed on z1, and is managed solely by A C and B C. O's operating agreement states its purpose is to acquire and develop real estate and to engage in any lawful activity for which a limited liability company may be organized under the Y Revised Limited Liability Company Act. As of the calendar year-end 2005 the book value of O's assets are \$, which consist of the following:

Cash in the Bank	\$
N/R – in another LLC	
Land (8.89 Acres)	
Land (20.39 Acres)	
Land and Building (.50 Acres)	
Furniture & Fixtures	_____
Total Assets (Book Value)	\$

As of the calendar year-end 2006, the book value of O's assets was \$, which consists of the following:

Cash in Bank	\$
Various Notes Receivables	
Land	
Land (20.89 Acres)	
Condo	
Investment 1	
Investment 2	
Investment – Camaro	_____
Total Assets (Book Value)	\$

We requested an appraisal of the property and received a two page entity valuation, which did not show it was from a certified appraiser, and which did not list the appraiser's credentials and experience in independent business valuations. It included a list of the above assets; the market value of the assets based on multiple "Offers to Purchase" which was \$; and market value net equity in the company which was \$. The debt of the company is \$. We requested a more complete appraisal of O, and M replied that

O never had a property appraisal performed and an appraisal of the assets is not relevant to make a determination of their tax exempt status.

We also requested a detailed description of the _____ acres of land including if the property is a business or residence and if anyone is residing on the property. M replied by stating O owns some undeveloped land in an area of generally rising property values, and this property is not occupied or rented. O also holds some rental property and other assets. No other information was given on the description of the assets.

We inquired why the financial data only included a \$ _____ distribution in 20 ____ . M indicated that the members decided to hold the assets since this will generate the greatest amount of income from the property. We then asked how the assets will generate income that can be distributed to M. M replied that O expects to sell its various assets at a profit, and reinvest those profits over the course of its existence. The board members determined that this is the best method to generate income. At least 1/3 of the income will be distributed to N. M feels that it will obtain the greatest asset value by holding its interest in the O until the Limited Liability Company sells the property, rather than having M sell its interest in O.

M is requesting exemption as a Type 2 supporting organization. Their primary purpose is to provide funds in the form of grants to N, the supported organization. N was also formed by trust agreement. N was formed by father and son, B C and A C, one day later than M's formation on 2/22. The exemption applications for M and N were received at same time. N's tax status is pending at this time, and has not been finalized, but the Service is tentatively proposing to grant N tax exemption as a private foundation. A private foundation would not qualify as a supported organization under IRC 509(a)(3).

M's financial data shows contributions received of \$ _____ and \$ _____ for _____ and 20 ____ , respectively. The expenses are professional fees for \$ _____ in 20 ____ and \$ _____ in _____ contributions paid out in 20 ____ . M's submitted memoranda of action in lieu of meetings for 20 ____ and 20 ____ . For both years, M determined that the assets held by the Trust did not produce any income and M decided not to make any charitable distributions. Therefore, M never distributed the \$ _____ that they projected in 20 ____ and has not made any charitable distributions since it was formed.

Law:

Section 501(a) of the Code provides, in part, that organizations described in section 501(c) are exempt from federal income tax. Section 501(c)(3) of the Code describes, in part, an organization which is organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purpose, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 501(c)(3) of the Code provides, in part, for the exemption from Federal income tax organizations organized and operated exclusively for charitable, religious or educational purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(a)(1) of the Regulations states that in order to qualify under section 501(c)(3) of the Code, an organization must be both organized and operated exclusively for one or more exempt purposes. If an organization fails to meet either the organizational or operational test, it is not exempt.

Section 1.501(c)(3)-1(a)(2) of the Regulations states that the term "exempt purpose or purposes", means any purpose or purposes specified in section 501(c)(3) of the Code.

Section 1.501(c)(3)-1(c)(1) of the Regulations states that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3) of the Code. An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Section 1.501(c)(3)-1(d)(1)(ii) of the Regulations states that an organization is not operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. It must not be operated for the benefit of designated individuals or the persons who created it.

In **Better Business Bureau v. United States, 326 U. S. 279 (1945)**, the Supreme Court stated that the presence of a single nonexempt purpose, if substantial in nature, will preclude exemption under section 501(c)(3) of the Code, regardless of the number or importance of statutorily exempt purposes. Thus the operational standard prohibiting a substantial nonexempt purpose is broad enough to include inurement, private benefit, and operations that further nonprofit goals outside the scope of section 501(c)(3).

In **P.P.L. Scholarship v. Commissioner, 82 T.C. (1984)**, an organization operated bingo at a bar for the avowed purpose of raising money for scholarships. The board included the bar owners, the bar accountant, also the director of the bar, as well as two players. The board was self-perpetuating. The Court reasoned that since the bar owners controlled the organization and appointed the organization's directors, the activities of the organization could be used to the advantage of the bar owners.

Leon A Beeghly v. Commissioner 35 T.C. 490 (1960), provided that where an exempt organization engages in a transaction with a related interest and there is a purpose to benefit the private interest rather than the organization, exemption may be lost even though the transaction ultimately proves profitable for the exempt organization.

In **Salvation Navy v. Commissioner, T.C.M. 2002-275(2002)**, the court found that one of the reasons why the organization did not qualify for exemption from federal income tax was that it could not prove that its net earnings would not inure to the benefit of a private individual, its founder.

In **Bubbling Well Church of Universal Love, Inc. v. Commissioner, 670 F.2d 104 (9th Cir. 1981)**, the court affirmed the tax court's decision that held that the organization supplied no

evidence showing that the payments to its controlling members were reasonable and the court also found that the potential for abuse created by the family's control of the organization required open candid disclosure of facts.

In Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943), in which the Supreme Court stated that so long as a corporation (1) is organized for a legitimate business purpose other than tax avoidance, or (2) actually carries on such a business it will be respected for tax purposes. The Supreme Court continued by stating that "the corporate form may be disregarded where it is a sham or unreal. In such situation the form is a bold and mischievous fiction." Over the years the courts have applied the same principles to partnerships. (See *Bertoli v. Commissioner*, 103T.C. 501, 511-12 (1994)).

Revenue Procedure 2008-9 Internal Revenue Bulletin, 208-2 page 262 read in part, as follows:

"Exempt status will be recognized in advance of operations if proposed operations can be described in efficient detail to permit a conclusion that the organization will clearly meet the particular requirements of the section under which exemption is claimed.

- (1) A mere restatement of purposes or a statement that proposed activities will be in furtherance of such purposes will not satisfy this requirement.
- (2) The organization must fully describe the activities in which it expects to engage, including the standards, criteria, procedures, or other means adopted or planned for carrying out the activities; the anticipated sources of receipts; and the nature of contemplated expenditures.
- (3) Where the organization cannot demonstrate to the satisfaction of the Service that it qualifies for exemption pursuant to the section of the Internal Revenue Code under which exemption is claimed, the service will generally issue a proposed adverse determination letter or ruling."

Rev. Rul. 67-5, 1967-1 C.B. 123, holds that a foundation controlled by the creator's family was operated to enable the creator and his family to engage in financial activities that were beneficial to them, but detrimental to the foundation. This resulted in the foundation's ownership of common stock that paid no dividends of a corporation controlled by the foundation's creator and his family, which prevented it from carrying on a charitable program commensurate in scope with its financial resources. This ruling concluded that the foundation was operated for a substantial non-exempt purpose and served the private interest of the creator and therefore, was not entitled to exemption under section 501(c)(3) of the Code.

Rev. Rul. 68-489, 1968-2 C.B. 210, holds that an organization will not jeopardize its exemption under section 501(c)(3) of the Code, even though it distributes funds to nonexempt organizations, provided it retains control and discretion over use of the funds for 501(c)(3) purposes. The revenue ruling states that the exempt organization ensures uses of the funds for section 501(c)(3) purposes by limiting distribution to specific projects that are in furtherance of

its own exempt purpose. It retains control and discretion as to the use of the funds and maintains records establishing that the funds were used for section 501(c)(3) purposes.

Application of Law:

Because M's articles of incorporation state that its purposes are described in section 501(c)(3) of the Code and also state that upon dissolution all assets will go to organizations that are exempt under section 501(c)(3) of the Code, M passes the organizational test, as described in Section 1.501(c)(3)-1(a) of the Regulations.

The facts submitted show that the activities of M are to hold and manage real estate and other investments; it will sell the assets and invest the funds. Income from the investments will be distributed to N. So far, nothing has been distributed to charity and there is no indication when M will begin to make distributions. M has also not shown that its activities will not inure to the benefit of AC and other members of C family. Therefore, they are not operated exclusively for purposes described in section 501(c)(3) of the Code.

M is not described in **Section 1.501(c)(3)-1(c)(1) of the Regulations** because more than an insubstantial part of its activities is not in furtherance of an exempt purpose. The purpose of M is to make annual distributions to N. M received contributions in 2005 and 2006 of 7.5% of O from AC and BC. The purpose of O is to hold property interests and to acquire and develop real estate. The assets of O consist of cash, notes receivables, land, rental property, and investments. M's objective was to sell the assets of the company, invest the proceeds, and donate the earning to N. Thus far, nothing has been donated to N. In the memoranda in lieu of the 2006 and 2007 board meetings, M determined that the assets held by the trust did not produce any income. For this reason, M decided not to make any charitable grants. M also stated that it would be more beneficial to continue to hold the assets until the market conditions improve. Owning 7.5% of a Limited Liability Company that holds and manages assets is not a 501(c)(3) activity.

Reg. 1.501(c)(3)-1(c)(2) clarifies that an organization is not operated exclusively for exempt purposes if its net earning inure to the benefit of private individuals. A C and B C both took sizeable tax deductions for contributions that they made to M. This allowed them to lower their taxable income, even though no income was used for charitable purposes. In addition, A C and B C together own 92 ½ % of O which means that they control M and the assets that they have an interest. From 2005 to 2006 the assets of O increased 40.7% and at the same time M decided not to make any distributions because the Trust did not produce any income.

Similar to **Bubbling Well Church of Universal Love, Inc v Commissioner, Supra**, M did not supply any evidence to show that the members of the C Family are not benefiting or using the assets of the organization. We requested a detailed description of the property, if the property was occupied and who was living on the property, is it being rented, and is it a residence or a business. M stated that O owns undeveloped land in an area of generally rising property values, some rental property, and holds other assets. No other descriptions of the assets were given.

We requested an appraisal of the property and M submitted a two page valuation report that was taken from the financial statements. When we requested a more detailed appraisal M indicated that an appraisal was never done on O, and that the appraisals are not relevant because ownership interest in O, and not interest in any assets, were contributed to the Taxpayer. M is similar to Salvation Navy v. Commissioner, Supra, in that it has not provided sufficient information for us to determine that the assets of the organization will not inure to A C or B C or members of their family.

Control is an important factor in determining whether an organization operates for the benefit of private interests. Similar to the organizations in P.L.L. Scholarship v. Commissioner, supra, Leon A Beeghly v. Commissioner, supra and Rev. Rul. 67-5, M did not submit information that demonstrates it is not formed for the private interest of the board members and their families. The Board of Directors is comprised of three member directors. AC is the family member and E and F are the two independent members. The independent members are selected by a majority of board members that are not members of C family. There are only three Directors. The only member left after you remove the independent directors is AC. Per section 4.1.3 of the Trust, AC is not permitted to select the independent Directors. This creates some uncertainty as to how the independent directors were selected.

There is no indication that the two independent Directors take an active part in the organization or have a voice in the management of the assets. Their signatures appear only on one memorandum in lieu of one board meeting a year. Article 5 of the operating agreement for O states that it will be managed by A C and B C. Therefore, they manage all of the assets of M. Section 1.501(c)(3)-1(d)(1)(ii) of the Regulations clearly states that an organization must not be operated for the benefit of designated individuals or the persons who created it.

Furthermore, unlike the organization in Rev. Rule 68-489, M did not submit any information that indicates the activities they are conducting serve section 501(c)(3) purposes. Holding a % interest in O that holds and manages assets does not serve a 501(c)(3) purpose. In addition, M does not satisfy the "not more than an insubstantial part of its activities" standard of section 1.501(c)(3)-1(c)(1) of the Regulations. M has a non-charitable purpose that is substantial in nature. See Better Business Bureau v. United States, Supra.

Even though M was formed as a trust, it is similar to the organization described in Moline Properties, Inc. v. Commissioner, Supra. It appears that M was formed for the purpose of tax avoidance while retaining control of the assets by the C family. In 20 and 20 M accepted contributions of % interest in O from A C & B C valued at \$ and nothing has been given to charity. A C & B C took tax deductions for this amount lowering their taxable income. The organization has not conducted any other activity. M states that they are going to wait for the property values to increase before they sell the property.

M appears to be nothing more than a pass-through entity. Their purpose is to receive income from O and distribute it to N. The purpose of N is to give funds to organizations described in 501(c)(3) of the Code. O could have distributed their revenue directly to N instead of creating a

middle entity.

In a letter dated April , 20 M stated that it will hold the property and distribute the income to N. When we asked how the property will generate income M indicated that O will sell the assets and invest the income. The value report dated March , 20 stated that the market value of the total assets owned by O is \$ based on multiple "Offers to Purchase" and other market valuation reports. Based on this information M had chances to sell the property in 2007 to produce income but decided to hold the property. This statement also contradicts what is in the minutes of the board meetings. The minutes state that the reason nothing was given to charity is because the assets did not produce any income.

Per the valuation reports for 20 and the following year, O is buying assets and not selling them. A condo, a Camaro, and note receivable were assets added in the year following 20. No information was submitted about who is using the condo and the vintage car.

Per Revenue Procedure 2008-9 M did not demonstrate to the satisfaction of the Service that it qualifies for exemption pursuant to the section of the Internal Revenue Code under which exemption is claimed. M has not made any distributions to N and does not plan to do so until the assets begin to produce income. The only function of M is to hold % interest in O, which was formed to hold and manage assets.

Applicant's Position:

M asserts that they qualify for exemption under section 501(c)(3) of the Code because it was formed for charitable purposes and its net earnings do not inure to the benefit of private individuals.

The purpose of M is to hold assets and distribute the income from those assets to qualified charities, which is consistent with Reg. 1.509(a)-4. Thus far, M has been holding assets but no income has been produced and this is why nothing has been distributed to qualified charities. Their position is that this lack of income does not disqualify it as a charitable organization. They refer to sections 2.2.1 and 2.2.2 of the Trust Agreement that states that distributions will be made when it receives income. Furthermore, the organization can't sell the limited liability company's assets. The organization has a far less than a controlling interest in the limited liability company. The limited liability company is not controlled by M, and such the sell would require the concurrence of both managers.

M has taken the position that an appraisal of the property and a detailed description of the property are not relevant to the determination. M states that it does not hold any interest in real property. Rather, its assets are a member interest in a limited liability company which holds various assets, including real property.

M also holds the position that its activities do not benefit members of the C family because no distributions have been made to any members of C family. They cited *Easter House v. Commissioner*, 87-1 USTC 9359 (Ct. Cl 1987) 846 F 2d 78 (Fed. Cir. 1988), in which exemption

was denied because a substantial part of the earning for Easter House inured to the President of the organization in the form of loans to related organizations.

The common theme in M's position is that there is no proof that the members of C family benefit from the activities of M. They continuously refer to the trust document that states, "No part of the net earning of this Trust shall inure to the benefit of any individuals". M also refers to the Trust when asserting that they are not controlled by C family, referring to Section 4.1 (all authority and power is held by the Board); Section 4.1.6 (the board cannot be controlled by disqualified persons); Section 4.1.7 (the Board must always include a majority of the members of the Primary Charity's Board).

Service's Position:

The two issues are whether (1) M is operated exclusively for charitable purposes, and (2) has M demonstrated that no part of its net earnings inure to the private individuals. On the first issue the major reason that M is not operated for charitable purposes is that nothing has been donated to other 501(c)(3) organizations because they have not earned any income. Their current plan is to hold the assets until the market improves in hopes that this will increase their earning.

No one can say for certain when M will receive income or if it ever will. M's position is that holding assets and distributing the income at some future date qualify them for exempt status simply because it is in the Trust. Having this language in the Trust agreement is required to pass the organizational test. For an organization to pass the operational test is must fully describe the activities in which it expects to engage, including the standards, criteria, procedures, or other means adopted or planned for carrying out the activities; the anticipated sources or receipts; and the nature of contemplated expenditures. A mere restatement of the purposes or a statement that proposed activities will be in furtherance of such purposes will not satisfy this requirement. See Revenue Procedure 2008-9.

One area of disagreement is whether M should submit an appraisal and a detailed description of the property in question. Since the assets are not producing income it is very important that the Service is aware of exactly of the type of assets it has an interest. Without this information the Service is in the dark if M will ever produce any income. We are concerned that the property may be worthless or overstated; that C family members may be living on the property or otherwise using the property for personal use; or that there are other scenarios that would have an effect on our determination. If M would have provided us with this information a number issues could be resolved.

Holding assets until the market conditions improve is not an exempt purpose. M states that they are being denied exemption because they have not produced any income. However, this is not the case. They are being denied exemption because they are not making distributions to qualified charities and they have no intention to do so until they receive some income.

Regarding the second issue, M has not demonstrated that their activities do not inure to

members of C family. M is under the assumption the since no distributions have been made to any member of the C family then there is no inurement. This is completely erroneous. Inurement can come in many different forms. Any transaction between an organization and a private individual in which the individuals appears to receive a disproportionate share of the benefits of the exchange relative to the charity serve presents an inurement issue. Such transactions may include assignment of income, compensation arrangements, sales or exchange of property, and gifts with retained interest.

M must show to the Service's satisfaction that the activities do not inure to the benefit of private individuals. (See *Salvation Navy v. Commissioner*, *Supra* and *Bubbling Well Church of Universal Love, v. Commissioner*, *Supra*). M's only argument is the language in the Trust and that no distributions have been made to the C family.

M also discounts the fact that AC and BC took a tax deduction in 20 and 20 for \$ and nothing has ever been distributed for 501(c)(3) purposes. Not only did they take a tax deduction, they continue to control the very assets that they contributed.

The income will come from the sale of the assets. Since M only owns 7.5% interest in the limited liability company it has no control over when the assets will be sold. This control resides with the other two members. M states that only one of the members is affiliated with M. What they do not say is that the one that is not affiliated with M is BC, the father of AC and is also a donor to the Trust. Therefore, the income that M will receive will come from the decisions made by AC and BC and not by E & F. By holding the assets until more favorable conditions will benefit AC and BC more than M because they hold a combine interest of 92.5% in O.

Determination:

Based on the information provided in Form 1023 and supporting documentation, we conclude that you are not operated exclusively for purposes described in section 501(c)(3) of the Code. You have not conducted any activities that are described in section 501(c)(3) and you have not shown that your assets do not inure to any private individuals. Therefore, your organization does not qualify for exemption under section 501(c)(3) of the Code.

ISSUE 2 – IRC 509(a)(3)

Introduction:

We have also considered M's application for supporting organization status (non-private foundation status) under section 509(a)(3) of the Code in the event that it would qualify for exemption under section 501(c)(3). Our conclusion regarding private foundation classification under section 509(a)(3) of the Code is based on a number of factors discussed in the following material.

Section 509(a)(3) of the Code provides that the term "private foundation" does not include 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 section 509(a)(1) or (2),

(B) is operated, supervised, or controlled by or in connection with one or more organizations described in section 509(a)(1) or (2), and

(C) is not 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 organizations described in section 509(a)(1) or (2).

Section 509(a)(3)(A), in effect, describes as a public charity, an organization which is organized and at all times thereafter is operated, exclusively for the benefit of, to perform the functions of, or carries out the purposes of one or more specified organizations described in sections 509(a)(1) or 509(a)(2). In our discussion of these issues, we are cognizant of the fact that at all times M asserts its qualification under section 509(a)(3) under the "supervised and controlled in connection with" relationship provided in section 1.509(a)-4(h)(1) of the Income Tax Regulations.

For an organization to qualify as a supporting organization it must pass the organizational and operational test (509(a)(3)(A)), relationship test (509(a)(3)(B)) and a control test (509(a)(3)(C)). Your organization does not pass the operational test, the relationship test, and control test.

Operational Test:

Section 509(a)(3)(A) of the Code provides that, in order to qualify under section 509(a)(3) an organization 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 section 509(a)(1) or (2).

Reg. 1.509(a)-4(b)(1) provides that 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" one or more specified publicly supported organizations. If it fails to meet either the organizational test or operational test, it cannot qualify as a supporting organization.

Reg. 1.509(a)-4(e)(1) provides that a supporting organization will be regarded as "operated exclusively" to support one or more specified public supported organization only if it engages solely in activities which support or benefit the specified publicly supported organizations.

Application of Operational Test:

You are not operated exclusively for the benefit of specified publicly supported organizations as required by section 509(3)(a)(A). A C and B C took charitable deductions of \$ for tax

years ending 20 and 20 but nothing was ever given to the supported organization. In addition, our records show to date that N, the specified supported organization, is not a public charity described in section 509(a)(1) or 509(a)(2) of the Code. M has not demonstrated that it was formed to benefit N, the supported organization.

Relationship test:

Section 509(a)(3)(B) of the Code provides that, in order to qualify under section 509(a)(3), an organization must be "operated, supervised, or controlled by," "supervised or controlled in connection with," or "operated in connection with" one or more publicly supported organizations.

Reg. 1.509(a)-4(f)(3)(i) provides that 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.

Reg. 1.509(a)-4(h)(1) provides that "supervised or controlled in connection with", as used in section 509(a)(3)(B), presupposes a substantial degree of direction over the policies, programs, and activities of the supporting organization by one or more publicly supported organizations. The relationship requires that there must be common supervision or control by the persons supervising or controlling both the supporting organization and the supported organizations to insure that the supporting organization will be responsive to the needs and requirements of the publicly supported organization. Therefore, in order to meet such requirement, the control and management of the supporting organization must be vested in the same persons that control and manage the publicly supported organization.

Application of the Relationship Test:

On schedule D M indicated that it is a Type 2 supporting organization which is "supervised or controlled in connection with" the supported organization. The relationship is comparable to a brother/sister relationship.

Section 1.509(a)-4(f)(3)(i) of the Regulations provides that the supporting organization will be responsive of the needs and demands of the publicly supported organization and will constitute an integral part of, or maintain a significant involvement in, the operations of the publicly supported organization. Also, organizations that are "supervised or controlled in connection with", as used in section 509(a)(3), presupposes a substantial degree of direction over the policies, programs, and activities of the supporting organization by the publicly supported organization.

As described in Section 1.501(a)-4(h)(1) of the Regulations, the control and management of the supporting organization must be vested in the same persons who control and manage the publicly supported organization. M has not demonstrated N's direction over the policies, programs, and activities of M so that the activities are directed for exclusively charitable and public purposes, or that M is responsive to the needs of a publicly supported charity. In its 32

months of existence M has not made any distributions to N. There have been no distributions that have resulted in exclusively charitable activities for the public. N has not shown that they have taken any direction over the activities of M for the exclusive benefit of the public. The only activity that they have taken is to document annual memoranda in lieu of an annual board meeting, in which they decided not to make any charitable distributions since the Trust did not produce any income.

The managers of O, are father and son, A C & B C. As managers they provide direction and control directly and indirectly over the applicant, M. If N had a publicly represented board and operated exclusively as a public charity that had a significant voice in M's operations, that it would have exerted control and required charitable activity and distributions to be made to its organization.

Conclusion:

Based on the facts M has failed to meet the relationship test of Section 509(a)(3)(B) of the Code. M has not demonstrated that N is a publicly supported charity that controls M's policies, programs, or activities for the exclusive benefit of the public. As described in Section 1.501(a)-4(h)(1) of the Regulations, the control and management of the supporting organization must be vested in the same persons that control and manage the publicly supported organization. M failed to demonstrate N has exercised a substantial degree of direction over M's policies, programs, and activities for exclusively charitable purposes.

Control Test:

Section 509(a)(3)(C), in effect, provides that public charity status under section 509(a)(3) is precluded for an organization that is 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 organizations described in paragraph (1) and (2).

Section 4946(a) of the Code defines a disqualified person as a substantial contributor to the foundation. Section 507(d)(2) includes in its definition of a substantial contributor the creator of the trust. Therefore, A is a disqualified person.

Section 1.509(a)-4(j)(1) of the Regulations provides that if a person who is a disqualified person with respect to a supporting organization, such as a substantial contributor to the supporting organization, is appointed or designated as a foundation manager of the supporting organization by a publicly supported beneficiary organization to serve as the representative of such publicly supported organization, then for purposes of this paragraph, such person will be regarded as a disqualified person rather than as a representative of the publicly supported organization.

An organization will be considered "controlled," for purposes of section 509(a)(3), 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 a 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.

Rev. Rul. 80-207, 1980-2 C.B. 193, held that for purposes of classification as a supporting organization under section 509(a)(3) of the Code, an employee of a corporation owned (over 35 percent) by a substantial contributor, a disqualified person, will be considered under the indirect control of a disqualified person for purposes of the control test.

Application of the Control Test

M is controlled directly and indirectly by disqualified person(s). Section 509(a)(3)(C), in effect, provides that public charity status under section 509(a)(3) is precluded for an organization that is 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 organizations described in paragraph (1) and (2).

All pertinent facts and circumstances will be taken into consideration in determining whether a disqualified person does in fact control the supporting organization. A C is a substantial contributor and disqualified person as defined by section 4946 of the Code. Section 4 of the Trust document states that the board will consist of one family member who is A C and two independent members. Section 4.1.6 of the Trust states that the at all times the original Donor or other disqualified persons, as defined by Section 4946 of the Code, shall not control the board. However, based on the facts submitted it appears in addition to the level of direct control A C can exert, and M also remains indirectly controlled by A C and the interests of the C family.

The two independent board members shall be appointed by a majority vote of the remaining members of the Board other than the C Family members. However, if you remove the two independent board members the only other member that is left is A C, and unknown is who selected D and E. The only activity that D & E have demonstrated participation is through the memoranda in lieu of the annual board meetings. A C manages M's assets as outlined in the Section 3.1 of the Trust document. M owns % interest in O. The other % is owned by A C and B C. The assets that they owned consist of land, buildings and furnishings. Article 5 of the operating agreement for O states that it will be managed by A C and B C. Based on the structure of O, M and N lack the power and independence to determine how these assets are managed. Even though A C is only one of M's three board members, he and his father of the C family are in a position of authority by controlling the direction and control of the LLC's assets and therefore M's interests.

Section 4.1.7 of the trust states that the membership of the Board shall at all times include a majority of the Board members of the Primary Charity, shall in all other ways satisfy the "supervised or controlled in connection with" requirements of Treasury Regulations Section 1.509(a)-4. N is the primary charity and submitted their application for exemption at the same time as M. N requested exemption as a public charity described in section 509(a)(2) of the

Code. The Service has tentatively proposed that N would not qualify for exemption as a public charity but would qualify as a private foundation.

Rev.Rul. 80-207 provides the following analysis:

Because one of the organization's directors is a qualified person and neither the disqualified person nor any other director has a veto power over the organization's actions, the organization is not directly controlled by a disqualified person under section 1.509(a)-4(j) of the regulations. However, in determining whether an organization is indirectly controlled by one or more disqualified persons, one circumstance to be considered is whether a disqualified person is in a position to influence the decisions of members of the organization's governing body who are not themselves disqualified persons.

It is apparent that A C is in a position of influence. A C and B C provide all of the funding for the corporation and manage all of the assets. There is no evidence that the supported organization has control of the policies, programs, activities or funds of the organization. N, the supported organization, is also controlled by AC and BC. Based on the facts of the case, the creator of the organization, A C, and his father, B C, directly and indirectly control the supporting organization.

Conclusion:

Based on the facts of the case, the creators of the organization, A C and B C, directly and indirectly control the supporting organization. Although two of the three directors are independent directors, you have not shown that they have taken an active and controlling role in M's programs, policies, and activities. Therefore, M does not meet the control test.

Applicant's Position:

M holds the position that they pass the organizational test, relationship test, and the control test and should qualify as a type 2 supporting organization described in section 509(a)(3) of the Code. They will make distributions when they sell the assets and they are controlled by the two independent board members.

M states that they pass the operational test because they will distribute funds to "qualified charities" when it will earn income and the absence of income will not disqualify it from qualifying for exemption.

M asserts that it passes the relationship test because the board members are the same board members as the supported organization as specified in section 4.1.7 of the Trust. They also deny that O controls the M because only one of the managers of O is on M's Board.

M maintains that they pass the control test because two of the three board members are independent of C family, and Revenue Ruling 80-207 does not apply because the independent

board members control M.

Service's Position:

M did not include any new facts or law and plan to continue to operate in the same manner. M made several statements to substantiate our position that O does controls M. On page 6 in the paragraph highlighted "Application of Law 12th Paragraph" in their letter they state, "the limited liability company is not controlled by the Organization, and such a sale would require the concurrence of both managers, only one is affiliated with the Organization. The letter's conclusion that the Organization could make the limited liability company sell its assets is inconsistent with the Organization's interest in the limited liability company, the limited liability company's operating agreement, and the law applicable to the governance of the limited liability company." At the top of page 7 M states, "the Organization holds a minority of the member interest in the limited liability company, and does not control its management or their business decisions."

M has no voice in when the assets of O will be sold. Therefore, they have no control when they will receive income and be able to conduct tax exempt activities. All of these decisions will be made by AC and BC, who are the controlling managers of O. M only holds a % interest in O and does not have the authority to sell any assets. Furthermore, O has had offers to sell the assets but declined.

M's statement how the independent board members are selected or what happens if the are both remove has nothing to do with the control test is completely erroneous. The selection of the board has everything to do with the control test. They might be independent of C family, but they have no voice when assets are sold which is vital to their exempt purpose. This control is which AC and BC. This leads to a very simply conclusion that M is controlled directly and indirectly by disqualified persons.

Determination – Issue 2

Based on our analysis of your actual and proposed activities and, in light of the applicable law we have determined you do not qualify for exclusion from private foundation status under section 509(a)(3) of the Code. You did not pass the operational test, relationship test, and the control test.

Summary:

Based on our analysis of your activities and, in light of the applicable law, we have determined you do not qualify for tax exemption as an organization described in section 501(c)(3) of the Code. Even if we determine that you were described in section 501(c)(3), you would be a private foundation and not a supporting organization under section 509(a)(3) of the Code. You must file federal tax returns.

Letter 4036(CG)(11-2005)

You have the right to file a protest if you believe this determination is incorrect. To protest, you must submit a statement of your views and fully explain your reasoning. You must submit the statement, signed by one of your officers, within 30 days from the date of this letter. We will consider your statement and decide if the information affects our determination. If your statement does not provide a basis to reconsider our determination, we will forward your case to our Appeals Office. You can find more information about the role of the Appeals Office in Publication 892, *Exempt Organization Appeal Procedures for Unagreed Issues*.

"Under penalties of perjury, I declare that I have examined the statement of facts presented in this appeal and in any accompanying schedules and statements and, to the best of my knowledge and belief, they are true, correct, and complete."

The declaration must be signed by an officer or trustee of the organization who has personal knowledge of the facts.

Your appeal will be considered incomplete without this statement.

If an organization's representative submits the appeal, a substitute declaration must be included stating that the representative prepared the appeal and accompanying documents; and whether the representative knows personally that the statements of facts contained in the appeal and accompanying documents are true and correct.

An attorney, certified public accountant, or an individual enrolled to practice before the Internal Revenue Service may represent you during the appeal process. If you want representation during the appeal process, you must file a proper power of attorney, Form 2848, *Power of Attorney and Declaration of Representative*, if you have not already done so. You can find more information about representation in Publication 947, *Practice Before the IRS and Power of Attorney*. All forms and publications mentioned in this letter can be found at www.irs.gov, Forms and Publications.

If you do not file a protest within 30 days, you will not be able to file a suit for declaratory judgment in court because the Internal Revenue Service (IRS) will consider the failure to appeal as a failure to exhaust available administrative remedies. Code section 7428(b)(2) provides, in part, that a declaratory judgment or decree shall not be issued in any proceeding unless the Tax Court, the United States Court of Federal Claims, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted all of the administrative remedies available to it within the IRS.

If you do not intend to protest this determination, you do not need to take any further action. If we do not hear from you within 30 days, we will issue a final adverse determination letter. That letter will provide information about filing tax returns and other matters.

Please send your protest statement, Form 2848, and any supporting documents to the applicable address:

Mail to:

Deliver to:

You may fax your statement using the fax number shown in the heading of this letter. If you fax your statement, please call the person identified in the heading of this letter to confirm that he or she received your fax.

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

Sincerely,

Robert S Choi
Director, Exempt Organizations
Rulings & Agreements

Enclosures:
Publication 892