

Internal Revenue Service  
Tax Exempt and Government Entities Division  
Exempt Organizations: Examinations

Department of the Treasury

Release Number: 201517014

Release Date: 4/24/2015

UIL Code: 501.03-00

**Date:**

October 2, 2014

**Taxpayer Identification Number:**

**Form:**

**Tax Year(s) Ended:**

October 31, 20XX, December 31,  
20XX, and December 31, 20XX

**Person to Contact/ID Number:**

**Contact Numbers:**

Telephone:

Fax:

**Manager's name/ID number:**

**Manager's contact number:**

**Response due date:**

October 20, 20XX

**Certified Mail – Return Receipt Requested**

Dear

**Why you are receiving this letter**

We propose to revoke your status as an organization described in section 501(c)(3) of the Internal Revenue Code (Code). Enclosed is our report of examination explaining the proposed action.

**What you need to do if you agree**

If you agree with our proposal, please sign the enclosed Form 6018, *Consent to Proposed Action – Section 7428*, and return it to the contact person at the address listed above (unless you have already provided us a signed Form 6018). We'll issue a final revocation letter determining that you aren't an organization described in section 501(c)(3).

After we issue the final revocation letter, we'll announce that your organization is no longer eligible for contributions deductible under section 170 of the Code.

**If we don't hear from you**

If you don't respond to this proposal within 30 calendar days from the date of this letter, we'll issue a final revocation letter. Failing to respond to this proposal will adversely impact your legal

standing to seek a declaratory judgment because you failed to exhaust your administrative remedies.

**Effect of revocation status**

If you receive a final revocation letter, you'll be required to file federal income tax returns for the tax year(s) shown above as well as for subsequent tax years.

**What you need to do if you disagree with the proposed revocation**

If you disagree with our proposed revocation, you may request a meeting or telephone conference with the supervisor of the IRS contact identified in the heading of this letter. You also may file a protest with the IRS Appeals office by submitting a written request to the contact person at the address listed above within 30 calendar days from the date of this letter. The Appeals office is independent of the Exempt Organizations division and resolves most disputes informally.

For your protest to be valid, it must contain certain specific information including a statement of the facts, the applicable law, and arguments in support of your position. For specific information needed for a valid protest, please refer to page one of the enclosed Publication 892, *How to Appeal an IRS Decision on Tax-Exempt Status*, and page six of the enclosed Publication 3498, *The Examination Process*. Publication 3498 also includes information on your rights as a taxpayer and the IRS collection process. Please note that Fast Track Mediation referred to in Publication 3498 generally doesn't apply after we issue this letter.

You also may request that we refer this matter for technical advice as explained in Publication 892. Please contact the individual identified on the first page of this letter if you are considering requesting technical advice. If we issue a determination letter to you based on a technical advice memorandum issued by the Exempt Organizations Rulings and Agreements office, no further IRS administrative appeal will be available to you.

**Contacting the Taxpayer Advocate Office is a taxpayer right**

You have the right to contact the office of the Taxpayer Advocate. Their assistance isn't a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate can't reverse a legally correct tax determination or extend the time you have (fixed by law) to file a petition in a United States court. They can, however, see that a tax matter that hasn't 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:

Internal Revenue Service  
Office of the Taxpayer Advocate

**For additional information**

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,



*B.L.H.* Barbara L. Harris  
Acting Director, EO Examinations

Enclosures:  
Report of Examination  
Form 6018  
Publication 892  
Publication 3498

Form <b>886-A</b> (Rev. January 1994)	<b>EXPLANATIONS OF ITEMS</b>	Schedule number or exhibit
Name of taxpayer  ORG	Tax Identification Number	Year/Period ended 10/31/20XX 12/31/20XX 12/31/20XX

**ISSUES:**

1. Whether ORG is operated exclusively for exempt purposes described within Internal Revenue Code 501(c)(3)?
2. Whether ORG is engaged primarily in activities that accomplish an exempt purpose?
3. Whether ORG is operated for the purpose of serving a private benefit rather than public interests?
4. Whether any part of the net earnings of ORG inured to the benefit of any private shareholder or individual?

**FACTS:**

On November 19, 20XX, ORG, hereinafter, "ORG", filed articles of incorporation with the State Secretary of State. The articles provided its purpose was to provide a mechanism for women after having and mastectomies a funding source for augmentations. Further, to provide financial assistance for breast cancer patients, screenings, individual and family counseling. In a determination letter dated May 13, 20XX, ORG was recognized by the Internal Revenue Service, hereinafter "Service", as exempt from Federal income tax as an organization described in section 501(c)(3) of the Internal Revenue Code.

ORG was founded by Founder, a survivor, because she was dissatisfied with services provided by different organization at that time. The organization is currently run by the Founder's family: Founder, CEO (wife), CFO, CFO (husband) and Secretary, Secretary (daughter). ORG accomplishes its exempt purpose by providing several program services to help preventative and also assist survivors during and after treatment. The organization provides preventative programs by referring clients and/or providing financial assistance for mammograms, ultrasounds, MRIs, and biopsies. Services provided to survivors include: food, utilities, prescription, family support, co-pay, gas, and other assistance for those with financial hardships.

A majority of ORG's revenue is generated through the use of professional fundraisers soliciting contributions on their behalf. During the examination periods the organization contracted with (now known as ) to run a contribution campaign on their behalf and raise funds for the organization. Contributions raised by were deposited into bank account # at . The Service obtained the bank statements for the examination periods and noted that the contributions deposited into The were transferred on almost a daily basis to a commercial checking account # . In response to Form 4564, Information Document Request, #6 issued to determine who the commercial checking account belongs to, ORG responded that the account belongs to CO-1 and Individual-1 has signature authority over the account. The accountant of ORG further explained that the commercial account for CO-1 is their general checking account and it is used for multiple organizations that they service. In 20XX, ORG retained CO-1 to receive, open, and process mail on their behalf. The contract states, in part, "CO-1 will prepare bank deposits and provide financial reports. All proceeds shall be deposited in a bank account under the sole and exclusive control of Organization (ORG)". (See exhibit

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Vehicles:

During the periods under examination, ORG made auto loan payments on several vehicles used solely by Founder, CFO, and Secretary. Founder entered into sales agreements and financed the following vehicles: a 20 Chevy Silverado and later traded for a 20XX Chevy Suburban for herself; a 20XX Chevy Silverado for CFO; and a 20XX Chevy Cruze for Secretary. ORG paid the following for monthly auto loans and insurance:

<u>Officer</u>	<u>20XX</u>	<u>20XX</u>
Founder	\$0	\$0
CFO	\$0	\$0
Secretary	\$0	\$0

ORG did not maintain any documentation to show the business use of the vehicles in 20XX or 20XX. No mileage logs were provided with specific dates, miles driven, and locations of travel, no receipts and no business purpose for the use of the vehicles was provided. ORG allocated 50% personal use of the vehicles and reported on Forms 1099-MISC as follows:

<u>Officer</u>	<u>20XX</u>	<u>20XX</u>
Founder	\$0	\$0
CFO	\$0	\$0
Secretary	\$0	\$0

Credit Card and Loans:

Founder and CFO used ORG's corporate cards for personal purchases in 20XX and 20XX totaling \$0 for Founder and \$0 for CFO. ORG prepared monthly expense reports to categorize monthly credit card usage. The expense reports included columns to report amounts due from officer and unidentified items. The amounts were not repaid by Founder or CFO and were not reported as compensation.

ORG also loaned CO-2 (a for-profit company run by CFO) \$0 from its operating checking account. There was no contemporaneous documentation of the loan, no security or repayment provisions, any interest accrued, and repayment to ORG. The amounts were not reported as compensation to CFO.

LAW:

Section 501(c)(3) of the Code describes corporations organized and operated exclusively for charitable 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 be exempt as an organization described in section 501(c)(3) of the Code, 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.

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Section 1.501(a)-1(c) of the regulations provides that the terms "private shareholder or individual" in Section 501 refer to persons having a personal and private interest in the activities of the organization.

Section 1.501(c)(3)-1(c)(2) of the regulations provides that an organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals as defined in Section 1.501(a)-1(c).

In *Better Business Bureau of Washington D.C., Inc. v United States*, 326 U.S. 279 (1945), the Supreme Court held that the presence of a single non-exempt purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly exempt purposes. The Court found that the trade association had an "underlying commercial motive" that distinguished its educational program from that carried out by a university.

### Benefiting Private Interests

Internal Revenue Code section 501(c)(3) specifies that an exempt organization described therein is one in which "no part of the net of earnings inures to the benefit of any private shareholder or individual." The words "private shareholder or individual" in section 501 to refer to persons having a personal and private interest in the activities of the organization. Treas. Reg. § 1.501(a)-1(c). The inurement prohibition provision "is designed to prevent the siphoning of charitable receipts to insiders of the charity . . ." United Cancer Council v. Commissioner, 165 F.3d 1173 (7<sup>th</sup> Cir. 1999). Reasonable compensation does not constitute inurement. Birmingham Business College v. Commissioner, 276 F.2d 476, 480 (5<sup>th</sup> Cir. 1960).

Treasury Regulation section 1.501(c)(3)-1(d)(1)(ii) provides that an organization is not organized or operated exclusively for one or more of the purposes specified in subdivision (i) of this subparagraph unless it serves a public rather than a private interest. Thus, to meet the requirement of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

Fact patterns suggesting inurement also frequently suggest excess benefit transactions between an exempt organization and a disqualified person under § 4958. The recent regulations issued under § 501(c)(3), at Treas. Reg. § 1.501(c)(3)-1(f)(ii), instruct the Service to consider a variety of factors to determine whether revocation is appropriate when section 4958 excise taxes also apply:

- (A) The size and scope of the organization's regular and ongoing activities that further exempt purposes before and after the excess benefit transaction or transactions occurred;
- (B) The size and scope of the excess benefit transaction or transactions (collectively, if more than one) in relation to the size and scope of the organization's regular and ongoing activities that further exempt purposes;
- (C) Whether the organization has been involved in multiple excess benefit transactions with one or more persons;
- (D) Whether the organization has implemented safeguards that are reasonably calculated to prevent excess benefit transactions; and
- (E) Whether the excess benefit transaction has been corrected (within the meaning of section 4958(f)(6) and § 53.4958-7), or the organization has made good faith efforts to seek correction from the disqualified person(s) who benefited from the excess benefit transaction

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The Commissioner has discretion to weight the factors depending on the particular situation, but the latter two factors are weighted heavier only when the Organization has taken preemptive steps to correct the excess benefit transaction before they were brought to the Commissioner's attention. Treas. Reg. § 1.501(c)(3)-1(f)(iii).

Treas. Reg. § 1.501(c)(3)-1(f)(iv) Example 3 supposes that an organization's founder diverts significant portions of the organization's to pay personal expenses, which reduces the funds available to conduct exempt activity, over the course of multiple years. The board of trustees never authorized the organization to pay the founder's personal expenses and takes no action to seek repayment or terminate the founder's involvement with the organization. The founder claims that the payments represent loans, but no contemporaneous documentation exists and no payments of principal or interest were ever made to the organization. Based on the factors above, the regulations contemplate that not only does the diversion of funds constitute an excess benefit transaction under § 4958, but the prohibition against inurement has been violated and the organization no longer qualified as an organization described in § 501(c)(3).

Excessive compensation for services is a form of inurement. For example, in Mabee Petroleum Corp. v. U.S., 203 F. 2d 872, 875 (5<sup>th</sup> Cir. 1953), the Fifth Circuit held that the organization's payment of a full-time salary for part-time work was inurement.

The use by insiders of the organization's property for which the organization does not receive adequate consideration is a form of inurement. See, e.g., The Founding Church of Scientology v. U.S., 412 F.2d 1197, 1201 (Ct. Cl. 1969) (holding that the insiders' use of organization-owned automobiles and housing constituted inurement); Spokane Motorcycle Club v. U.S., 222 F.Supp. 151 (E.D. Wash. 1963) (holding that the organization's provision of goods, services and refreshments to its members constituted inurement).

Loans that are financially advantageous to insiders from the organization's funds (particularly unexplained, undocumented loans) are a form of inurement. For example, in The Founding Church of Scientology, 412 F.2d at 1200-01, the Claims Court listed unexplained loans to and from insiders among the examples of inurement. In Church of Scientology v. Commissioner, 823 F.2d 1310, 1314-15, 1318 (9<sup>th</sup> Cir. 1987), the Ninth Circuit held that "debt repayments" in the form of 10 percent of the organization's income made to the organization's founder, allegedly to compensate the founder for the organization's past use of his personal income and capital, constituted inurement. In Airlie Foundation v. Commissioner, 283 F. Supp. 2d 58 (D.D.C., 2003), the court held that forgiveness of interest was a form of inurement.

Payment to one person for services performed by another (or for services presumed to be performed, without any proof of performance) is a form of inurement. In Church of Scientology, 823 F.2d at 1314, 1317-18, the court listed royalties received by the organization's founder on the sale of publications written by others among the improper benefits received by the founder from the organization. In The Founding Church of Scientology, 412 F.2d at 1202, the court held that the payment of salary to the founder's daughter without any proof that she actually performed any services for the organization constituted inurement.

A number of courts have held that unaccounted for diversions of a charitable organization's resources by one who has complete and unfettered control can constitute inurement. Parker v. Commissioner, 365 F.2d 792, 799 (8th Cir. 1966); Kenner v. Commissioner, 318 F.2d 632 (7th Cir. 1963); Church of Scientology, 823 F.2d at 1316-17, 1319

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In Greg R. Vinikoor v. Commissioner, T.C. Memo. 1998-152, the Tax Court held that whether a financial transaction constitutes a loan depends on all the facts and circumstances, including whether (1) there was a promissory note or other evidence of indebtedness; (2) interest was charged; (3) there was security or collateral; (4) there was a fixed maturity date; (5) a demand for repayment was made; (6) any actual repayment was made; (7) the transferee had the ability to repay; (8) any records maintained by the transferor and/or the transferee reflected the transaction as a loan; and (9) the manner in which the transaction was reported for Federal tax purposes.

In Rameses School of San Antonio, Texas v. Commissioner, T.C. Memo 2007-85, the Tax Court held that a private school failed to qualify for exemption under section 501(c)(3) because it operated for the private benefit of its founder. The Tax Court stated: Factors highlighted of a prohibited relationship have included control by the founder over the entity's funds, assets, and disbursements; use of entity moneys for personal expenses; payments of salary or rent to the founder without any accompanying evidence or analysis of the reasonableness of the amounts; and purported loans to the founder showing a ready private source of credit. Nearly all of these factors are present here.

### **GOVERNMENT'S POSITION:**

The 501(c)(3) tax exempt status of ORG should be revoked because it is not operated exclusively for tax exempt purposes. An organization described in section 501(c)(3) must establish that no more than an insubstantial part of its activities is not in furtherance of an exempt purpose. Treas. Regs. 1.501(c)(3)-1(c)(1).

ORG allowed all the funds raised by \_\_\_\_\_ to be transferred CO-1's checking account during entire period of examination. You did not have access or control of the funds once they were transferred to CO-1's bank account. This practice goes against your contract with CO-1 that clearly stated that you should have sole and exclusive control of the bank account.

The Family are officers and are "private shareholders or individuals" because they are "persons having a personal and private interest in the activities of the organization", as defined in section 1.501(a)-1(c). The \_\_\_\_\_ have sole control over the income, disbursements, and assets of the organization.

The Family expended ORG's funds for non-exempt purposes, including paying their personal expenses. They used the organization funds to pay monthly auto loans and insurance and there was no documentation of any business use of the vehicles. They also used the organization's corporate \_\_\_\_\_ credit card to purchase clothing, furniture, and other personal items. Lastly, the organization made a loan to CFO's for-profit business without any terms of repayment.

There is no internal control to ensure that funds were used for exempt purposes. The Family had free reign over the following:

- Pay the note of their personal vehicles;
- Use ORG's credit cards for personal expenses;



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- Transfer funds to themselves with no documentation required

There is no record of the other Board members having any involvement with the finances of the organization.

Analysis under the factors laid out in Treas. Regs. section 1.501(c)(3)-1(f) support the conclusion that revocation of ORG's exempt status is appropriate in this case. This situation is very similar to example 3 of the regulation. The funds available for ORG's activities before and after the transactions appear to have been affected. The [redacted] diverted thousands of dollars in payments of personal expenses, yet only had minimal documented charitable activities. The size and scope of the transactions are substantial in relation to ORG exempt activities.

The excess benefit transactions between the Family and ORG multiple and repeated during the years at issue. No loan documentation exists, nor are the Family's known to have made any payments of principal or interest on the amounts loaned. There were no internal controls in place, the board did not question the Family's management of ORG's funds, and no safeguards were put in place to prevent the occurrence of excess benefit transactions. No correction is known to have been sought by or made to ORG.

In summary, The Family operated ORG more like a personal business than an exempt organization. The Family had control over ORG's funds, assets and disbursements and made use of the funds for personal use. The Family essentially appear to have had access to a zero interest line of credit with no promissory notes, terms of repayment, interest charged, or balance approved by an informed board of directors for purported loans between ORG and the Family. The income and assets of ORG inured to the benefit of the Family, founders and officers of ORG, thus ORG was not operating exclusively for exempt purposes as required by section 501(c)(3). Rameses School of San Antonio, Texas v. Commissioner, T.C. Memo 2007-85

**TAXPAYER'S POSITION:**

The taxpayer signed Form 6018, Consent to Proposed Action – Section 7428, agreeing to the proposed revocation of ORG's exemption, effective November 1, 20XX. They do not wish to contest the revocation.

**CONCLUSION:**

ORG is not exclusively for 501(c)(3) exempt purposes. You fail the operational test because you allowed an outsider for-profit entity to have complete control over a majority of your funds. You did not exercise adequate discretion and control over the funds as required by your contract and by 501(c)(3). In addition, more than an insubstantial portion of ORG's operations is for the purpose of serving the private interests of Founder, CFO, and Secretary.

It is recommended that ORG's tax-exempt status be revoked effective November 1, 20XX.