

Internal Revenue Service
Appeals Office
312 Elm Street, Suite 2330
Cincinnati, OH 45202-2763

Release Number: 201035038
Release Date: 9/3/10
Date: June 9, 2010

Department of the Treasury

Person to Contact:

Employee ID Number: *****

Tel: *****

Fax: *****

Refer Reply to:
AP:FE:OH:CIN:*****

In Re:

EO Revocation

Form Required to be Filed:
1120

EIN:

Tax Period(s) Ended:

UIL: 501.33-00

Certified Mail

Dear

This is a final adverse determination regarding your exempt status under Internal Revenue Code (IRC) section 501(c)(3). It is determined that you do not qualify as exempt from Federal income tax under IRC section 501(c)(3) effective October 1, 2003.

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

A substantial amount of your organization's assets inured to the private benefit of your founder and to the private benefit of two for-profit corporations owned and controlled by your founder. Because a substantial amount of your charitable assets were used for private purposes, the organization is not operated exclusively for exempt purposes described in section 501(c)(3) of the Code.

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

You are required to file Forms 1120, U.S. Corporation Income Tax Return, for tax periods beginning on and after October 1, 2003 with the Cincinnati Service Center, Cincinnati, OH, 45999-0012.

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 letter. See the enclosed Notice 1214, *Helpful Contacts for Your "Notice of Deficiency"*, for Taxpayer Advocate telephone numbers and addresses.

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

We have sent a copy of this letter to your authorized representative.

Sincerely,

APPEALS TEAM MANAGER

Enclosure:

Notice 1214 Helpful Contacts for your "Notice of Deficiency"

cc: *****



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY

Internal Revenue Service
N14 W24200 Tower Place, Suite 202
Waukesha, WI 53186

ORG
ADDRESS

Taxpayer Identification Number:

Form:

Tax Year(s) Ended:

Person to Contact/ID Number:

Contact Numbers:

Telephone:

Fax:

Certified Mail - Return Receipt Requested

Dear

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

If you accept our findings, take no further action. We will issue a final revocation letter.

If you do not agree with our proposed revocation, you must submit to us a written request for Appeals Office consideration within 30 days from the date of this letter to protest our decision. Your protest should include a statement of the facts, the applicable law, and arguments in support of your position.

An Appeals officer will review your case. The Appeals office is independent of the Director, EO Examinations. The Appeals Office resolves most disputes informally and promptly. The enclosed Publication 3498, *The Examination Process*, and Publication 892, *Exempt Organizations Appeal Procedures for Unagreed Issues*, explain how to appeal an Internal Revenue Service (IRS) decision. Publication 3498 also includes information on your rights as a taxpayer and the IRS collection process.

You may also request that we refer this matter for technical advice as explained in Publication 892. If we issue a determination letter to you based on technical advice, no further administrative appeal is available to you within the IRS regarding the issue that was the subject of the technical advice.

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,

Renee Wells
Acting Director, EO Examinations

Enclosures:
Publication 892
Publication 3498
Report of Examination

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

LEGEND

ORG = Organization name XX = Date Sate = state President =
 president Vice-President = Vice-President DIR-1 & DIR-2 = 1st & 2nd
 DIRECTORS CO-1, co-2, CO-3, CO04, CO-5, CO-6 & CO-7 = 1st, 2nd, 3rd, 4th,
 5th, 6th, & 7th COMPANIES

Primary Issue:

1. Whether ORG, exempt under IRC Section 501(c)(3), should retain their exempt status?

Facts:

ORG, was granted exemption under IRC Section 501(c)(3) by the Internal Revenue Service in September of 19XX, as a day care provider.

ORG, is governed by President and her family. President is the President of ORG Vice-President, the husband of President, is the Vice-President of the organization; President's daughters, DIR-1 & DIR-2 serve on the board of directors.

President is also the owner of related for-profit day care centers: 2nd Edition and CO-1.

ORG reported \$ in gross receipts and \$\$ in expenses for the year ending September 30, 20XX; \$\$ in gross receipts and \$\$ in expenses for the year ending September 30, 20XX; and \$\$ in gross receipts and \$\$ in expenses for the year ending September 30, 20XX.

During an examination of the organization's records for the years ending September 30, 20XX, 20XX and 20XX the following was noted:

The exempt organization on February 15, 20XX lent President \$. The loan agreement in place stipulated an interest rate of 9%. Throughout the course of this loan there were various advances made to President, increasing the loan balance. It was determined, by the Internal Revenue Service, that for a loan of this type, a 9.9% interest rate represented fair market value. This loan was shown by the exempt organization to have been paid off by President in May of 20XX, at an interest rate of 5%, which was less then the loan agreement stipulated.

In addition there was a second loan of \$ extended to President by the exempt organization in January of 20XX. Throughout the course of this loan there were various advances made to President, increasing the loan balance. This loan was shown by the exempt organization to have been paid off by President in December of 20XX, at a 0% interest rate. It was determined that for a loan of this type, a 9.9% interest rate represented fair market value.

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In cases of both loans, the record shows that the exempt organization provided President with a private source of credit at rates below fair market value.

In addition to these loans there were various expenditures made from the exempt organization by President, or on her behalf, that were for her personal benefit. The majority of these expenditures represent those of the type that were questionable and for the most part unsubstantiated. The amount of expenditures attributed as being made for the personal benefit of President and her related interests (her for-profit organizations) total more than \$ during the years in question.

These expenditures have been documented as follows:

A). There was a total of \$ in Leasehold Improvement expenses. Financial records indicate the expenditures were for a new fence and landscaping. However, during an initial tour of the facility, there was no new fence or landscaping observed. President provided no further explanation that would indicate the expenditures were that of the exempt organization. Based on visual inspections and the lack of substantiation, it was determined that 50% of the amounts expended on leasehold improvements were reasonably made for the exempt organization and 50% of the expenditures were made for the personal benefit of President.

B). There was a total of \$ in Operating Supply expenses. The request to substantiate the expenditures was not provided. Based on the lack of substantiation, it was determined that 50% of the amounts expended were reasonably made for the exempt organization and 50% were made for the personal benefit of President.

C). There was a total of \$ in Utilities expenses. A review of the exempt organization's canceled checks showed a number payments made on various utility accounts. The request for account information to substantiate the owners of the utility accounts was not provided; in fact, President stated that she did not know who owned the utility accounts. Based on the lack of substantiation it was determined that all payments made to the unknown accounts were made for the personal benefit of President.

D). There was a total of \$ in Telephone expenses. A review of the exempt organization's invoices shows that the organization had a number of telephone lines at different locations; in addition the exempt organization shares its cell phones with President related for profit organization (CO-1). Based on the substantiation provided, and the sharing of resources between the exempt organization and related for-profit, it was determined that 50% of the expenditures were reasonably made for the exempt organization and 50% were made for the personal benefit of President.

E). There was a total of \$ in Repairs and Maintenance expenses. Financial records show that the organization was leasing camera systems to provide 24-hour monitoring of the facility.

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Financial records also reveal that payments were being made to two different security companies. The request to provide receipts to substantiate payments to the camera monitoring company and the various security companies was not provided. Therefore, it was determined that 50% of these expenditures were reasonably made for the exempt organization and 50% were made for the personal benefit of President.

F). There was a total of \$ in Advertising & Promotion expenses. Financial records show that the organization had ads in the White Pages, Yellow Pages and the One Book. It also, revealed that organization had a website that was managed and set up by the Yellow Pages phone book company. Review of the advertisements showed listings for three different locations during the 20XX and 20XX years. In the 20XX year, the ads were only for two locations. The exempt organization only had one location. Based on a lack of substantiation it was determined that 33% of the expenditures made were for the benefit of the exempt organization and 67% of the expenditures were made for the personal benefit of President.

G). There was a total of \$ in Property Taxes expenses. Financial records show that the exempt organization paid property taxes for the building it leases from President. A review of the exempt organization's lease does not state that the lessee shall pay property taxes. A review of the exempt organization's cancelled checks also show that the Tax ID number on some of the cancelled checks represents the Tax ID number of President's home address. Because there was no documentation to show that the exempt organization was responsible for paying the property taxes on the building under the lease agreement and as President's personal property taxes was paid with the exempt organization's funds it was determined that all payments made to cover property taxes were made for the personal benefit of President.

H). There were a total of \$ in Vehicles expenses. Financial records show that the exempt organization made a number of payments out of this account for reimbursements and payments on President's personal CO-2 Credit Card. The request to provide receipts to substantiate the reimbursements was not provided. Copies of the CO-2 Credit Card statements were provided and revealed that some of the amounts had already been reimbursed to employees out of petty cash. Documentation requested to provide clarification on the use of the vehicle expense and petty cash accounts was not provided. Based on the details provided, it was determined that 33% of the vehicle expenditures were made for the benefit of the exempt organization and 67% were made for the personal benefit of President.

I). There was a reported \$ in Office expenses. Financial records show that there were a number of reimbursements made with these funds. The request to provide receipts to substantiate the reimbursements was not provided. Based on the lack of substantiation, it was reasonably determined that 50% of the expenses were made for the benefit of the exempt organization and 50% of the expenditures were made for the personal benefit of President.

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J). There was a reported \$ in Vehicle Lease expenses. Financial records show that the exempt organization was leasing six passenger cars and had ownership of four passenger vans. A review of the Day Care Center State Inspection for the year (performed by the State of State) shows that the exempt organization was cited for using the passenger cars to transport children; these vehicles were not authorized by the state to transport children. In addition, a review of the insurance policy showed that the exempt organization's insurance policy provided full coverage on all of the passenger vehicles it leased as well as the passenger vans it owned. Copies of the lease agreements were provided to show the vehicles were all being leased to the exempt organization. Because the vehicles are not and have never been authorized to transport children, they were not leased to further the exempt purpose of the organization. Since there was no documentation showing why the exempt organization needed the vehicles and how they were used to further exempt purposes, it was reasonably determined that 33% of the expenditures were made for the exempt organization and 67% of the expenditures were made for the benefit of President.

K). There was a reported \$ in Insurance expenses. The insurance covered the commercial, auto, property, marine and liability insurance for the exempt, ORG and President' for profit organizations. Included in this coverage were the unauthorized passenger vehicles that the exempt organization was leasing. Based on the information provided, it was reasonably determined that 33% of these expenditures were made for the exempt organization's benefit and 67% of the expenditures were made for the benefit of President.

L). There was reported \$ of Health Insurance expenses with Co-3. A review of the policy indicated that coverage was provided for employees of both President' exempt and non-profit day care centers. Based on the documentation provided, it was determined that 50% of the expenditures were made for the exempt organization and 50% of the expenditures were made for the personal benefit of President.

M). There was a reported \$ in Officer Life Insurance expenses. A review of the financial records shows that payments were made to five different companies: CO-4, CO-5 (2 policies), CO-6 and CO-7. Copies of CO-4 and CO-5 and CO-6 were provided; the CO-7 policy was not provided. The policies that were provided have a face value of more than \$\$\$. It was determined that the total cost of the insurance premiums is not an excludable fringe benefit; only group term life insurance limited to a face amount of \$ would have qualified as an excludable fringe benefit based on the internal revenue code. It was thus determined that the full amount of the expenditures represents payments made for the benefit of President.

Overall between the provision of loans at advantageous terms and the personal expenditures made on President behalf, the record shows that the assets of ORG were improperly used to benefit private interests.

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The assets of an organization exempt under IRC Section 501(c)(3) are not allowed to benefit private interests. Where the assets of an organization exempt under IRC Section 501(c)(3) benefit private interests, the law provides that such organization is not exempt.

Law:

IRC Section 501(c)(3) (in specifying the attributes for exemption) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

Treasury Regulation Section 1.501(a)-(1)(c)

(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.

Treasury Regulation Section 1.501(c)(3)-(1)(c)(2)

(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.

Treasury Regulation Section 1.501(c)(3)-1(d)(1)(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.

Rameses School of San Antonio, Texas v. C.I.R. Tax Court 2007, T.C. Memo 2007-85

In this case the court upheld the revocation of the tax-exempt status of the Rameses School of San Antonio, Texas. The court found that the assets of the exempt organization inured to the

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benefit of the President and CEO of the school. The private benefit and inurement in this case included undocumented expenditures and withdrawals made on the President and CEO's behalf, and questionable payments made for real estate transactions and lease payments. The court also found that there was not proper oversight, as the CEO and President was allowed to direct questionable payments for her benefit, unchecked by the board of directors or any other internal control mechanism.

In making its determination the court noted the following:

"Nonetheless, the presence of a single nonexempt purpose, if substantial in nature, precludes exempt status, regardless of the number or importance of truly exempt purposes. Better Bus. Bureau v. United States, 326 U.S. 279, 283, 66 S.Ct. 112, 90 L.Ed. 67 (1945); Redlands Surgical Servs. v. Commissioner, 113 T.C. 47, 71-72, 1999 WL 513862 (1999), affd. 242 F.3d 904 (9th Cir.2001); Nationalist Movement v. Commissioner, *supra* at 576; Am. Campaign Acad. v. Commissioner, 92 T.C. 1053, 1065, 1989 WL 49678 (1989)..."

"If an organization can be shown to benefit private interests, a limitation substantially overlapping but encompassing more than simply the inurement of earnings to insiders, it will be deemed to further a nonexempt purpose. Am. Campaign Acad. v. Commissioner, *supra* at 1066, 1068-1069; Church of the Transfiguring Spirit, Inc. v. Commissioner, 76 T.C. 1, 5 & n. 5, 1981 WL 11377 (1981). Private benefits within the scope of the prohibition may include an advantage, profit, fruit, privilege, gain, or interest. Am. Campaign Acad. v. Commissioner, *supra* at 1065-1066..."

"Factors emerging repeatedly as indicative of prohibited inurement and private benefit include control by the founder over the entity's funds, assets, and disbursements; use of entity moneys for personal expenses; payment 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. See, e.g., Founding Church of Scientology v. United States, *supra* at 1200-1202; Church of Eternal Life & Liberty, Inc. v. Commissioner, *supra* at 927-928; Church of the Transfiguring Spirit, Inc. v. Commissioner, *supra* at 5-6; Basic Bible Church v. Commissioner, *supra* at 857-858; Bubbling Well Church of Universal Love, Inc. v. Commissioner, *supra* at 534-538; Unitary Mission Church v. Commissioner, *supra* at 513-515..."

"As this Court has noted, such circumstances provide "an obvious opportunity for abuse of the claimed tax-exempt status" and make incumbent "open and candid disclosure of all facts"; otherwise, "the logical inference is that the facts, if disclosed, would show that petitioner fails to meet the requirements of section 501(c)(3)." Bubbling Well Church of Universal Love, Inc. v. Commissioner, *supra* at 535; see also, e.g., Founding Church of Scientology v. United States, *supra* at 1201; Basic Bible Church v. Commissioner, *supra* at 858." "

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Revenue Procedure 84-46, 1984-1 CB 541

Where there is a material change, inconsistent with exemption, in the character, the purpose, or the method of operation of an organization, revocation or modification will ordinarily take effect as of the date of such material change.

Government's Position:

The assets of ORG inured to the private benefit of President and her related interests. The Internal Revenue Code and Regulations provide that an organization exempt under IRC Section 501(c)(3) can not allow its assets to benefit private interests; an organization that allows their assets to benefit private interests is not exempt.

The fact pattern in this case is similar to the fact patterns noted in the case, *Rameses School of San Antonio, Texas v. Commissioner of Internal Revenue Service*. This case involved the provision of loans as a source of credit to the President and CEO of the organization as well as a record of undocumented expenses, and noted personal expenditures made on the President and CEO's behalf. The court established that these transactions constitute prohibited private inurement and therefore upheld the Internal Revenue Service's determination.

Therefore based on the results of the examination of ORG, and the provisions of the Internal Revenue Code, Regulations and case law, it has been determined that the exempt status of ORG should be revoked.

Taxpayer's Position:

Taxpayer stated that she was unaware of the issues involving inurement and would not have applied for exempt status had she known.

Conclusion:

It has been determined that the exempt status of ORG should be revoked effective October 1, 20XX, the date the material change in exempt status was first noted through examination.

As the organization's exempt status is being revoked, the organization is required to file Forms 1120 for all tax years beginning October 1, 20XX; the organization is also no longer exempt from FUTA Tax and is responsible for filing Forms 940.