



DEPARTMENT OF THE TREASURY

INTERNAL REVENUE SERVICE

TE/GE: EO Examination

625 Fulton Street, Room 503

Brooklyn, NY 11201

TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

Date: September 16, 2008

Number: **200851031**  
Release Date: 12/19/2008

EO

LEGEND

ORG = Organization name

UIL:501.03-01

XX = Date      Address = address

ORG  
ADDRESS

Taxpayer Identification Number:  
Person to Contact:  
Identification Number  
Contact Telephone Number:

LAST DATE FOR FILING A PLEADING  
WITH THE TAX COURT, THE CLAIMS  
COURT, OR THE UNITED STATES  
DISTRICT COURT FOR THE DISTRICT  
OF COLUMBIA: December 15, 20XX

Dear :

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

IRC 501(c)(3) exempts from taxation organizations which are organized and operated exclusively for charitable or educational purposes, no part of the net earnings of which inure to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation and which do not participate in, or intervene in, any political campaign on behalf of (or in opposition to) any candidate for public office.

We have determined that you are not operating exclusively for any charitable purpose, educational purpose, or any other exempt purpose. Our examination reveals that you are not conducting charitable activities, educational activities, or any other exempt activities pursuant to IRC section 501(c)(3), and that you failed to meet the "organizational test" and the "operational test" under Treas. Regs. 1.501(c)(3)-1(a)(1).

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

Contributions to your organization are no longer deductible under section 170 of the Internal Revenue Code.

You are required to file Federal income tax returns on Form 1120. These returns should be filed with the appropriate Service Center for all years beginning October 1, 20XX.

Processing of income tax returns and assessment of any taxes due will not be delayed should a petition for declaratory judgment be filed under section 7428 of the Internal Revenue Code.

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

You have the right to contact the office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. You may call toll-free and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate.

We will notify the appropriate State Officials of this action, as required by section 6104(c) of the Internal Revenue Code.

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

Sincerely Yours,

Vicki L. Hansen  
Acting Director, EO Examinations

Enclosure:  
Publication 892



**DEPARTMENT OF THE TREASURY**

Internal Revenue Service  
PHILADELPHIA, PA 19103

**TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION**

LEGEND

ORG = Organization name      XX = Date

Address = address

**Date:**

May 13, 2008

**Taxpayer Identification Number:**

**Form:**

**Tax Year(s) Ended:**

**Person to Contact: / ID Number:**

**Contact Number:**

Telephone:

Fax:

> ORG  
ADDRESS

***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.

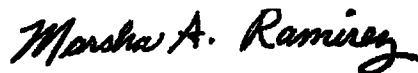
If we do not hear from you within 30 days from the date of this letter, we will process your case based on the recommendations shown in the report of examination. If you do not protest this proposed determination within 30 days from the date of this letter, the IRS will consider it to be a failure to 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 and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate at:

If you have any questions, please call the contact person at the telephone number shown in the heading of this letter. If you write, please provide a telephone number and the most convenient time to call if we need to contact you.

Thank you for your cooperation.

Sincerely,



Marsha A Ramirez,  
Director, EO Examinations

**ENCLOSURES:**

Publication 892  
Publication 3498  
Form 4621, Report of Examination with attachments

**Cc:**

Form <b>886-A</b> (Rev. January 1994)	<b>EXPLANATION OF ITEMS</b>	Schedule or Exhibit No.
<b>Name of Taxpayer:</b> ORG		<b>Tax Year Ended:</b> September 30, 20XX
<b>Tax Identification Number (TIN)</b>		<b>Examiner / Employee Number</b>

LEGEND

ORG = Organization name      XX = Date      XYZ = State      President = president  
 Director = director      CO-1 = 1<sup>st</sup> company

**ISSUES:**

- 1) Whether the ORG (ORG's) is operated exclusively for exempt purposes within the meaning of Section 501(c)(3) of the Internal Revenue Code if:
  - a. It is engaged primarily in activities that accomplish, more than insubstantially, a nonexempt purpose and;
  - b. Its operations confer, more than incidentally, a private benefit to selected individuals rather than for the benefit of the public's interest?

**FACTS:**

An audit of the ORG (hereinafter ORG's) was conducted for the tax year ending September 30, 20XX.

The ORG (hereinafter ORG's) is recognized as being exempt from Federal Income tax under Internal Revenue Code section 501(c)(3) and as not being a private foundation as an organization described by IRC §509(a)(1). Its stated purpose at the time exemption was recognized was to provide vocational skill development and rehabilitation services to individuals with physical and/or mental handicaps.

At a meeting of the Board of Directors held on September 18, 20XX, a legal opinion was submitted by its attorney that ORG's surplus funds and assets could legally be used for other exempt purposes. Based upon this determination, a motion was approved to cease ORG's program of services on April 1, 20XX and to transition into a "public charitable foundation".

Also, with-in 30 days of the vote approving its change in activities, ORG's attorney provided another legal opinion that it was unnecessary to amend ORG's purpose(s) as stated in its Articles of Incorporation, which were originally filed on October 31, 19XX. He reasoned that the phrase "... the corporation shall have the power to engage in any lawful act or activity for which non-profit corporations may be organized under the general corporation of XYZ." was sufficiently broad enough to encompass ORG's new purpose as a foundation that would "Provide grants for projects that promote education for children and families."

On March 31, 20XX, ORG's officially transferred its training contracts and placement programs along with related assets including equipment, office furniture and a vehicle with a cost basis totaling ~\$ to (CO-1) a qualified non-profit agency operating in XYZ. Also it was noted that in connection with ORG's material change in activity, its staffing went from ~12 employees down to two (2) persons.

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One of the two (2) remaining employees was President (hereinafter President) as both President and Executive Director. The other individual was Director, President' daughter, as the Assistant Director and who also a member of the Board of Directors. In recognition of their reduced workload both began working part-time and as a result they also reduced their salaries commensurately by half. President stopped being compensated during the FYE September 30, 20XX.

The Service's records, as of the date of this report, show that ORG's has timely filed a Form 990, *Return of Organization Exempt from Income Tax*, for each of the last six (6) Fiscal years that ends on September 30.

ORG's Form 990 for the tax year beginning on October 1, 20XX and ending September 30, 20XX was filed on April 12, 20XX. ORG's failed to notify the Service of the material change to its program services that occurred half way through this fiscal year. The information reported on the return gave no indications that as of April 1, 20XX, ORG's had ceased to operate its job training center.

ORG's Form 990 for the tax year beginning on October 1, 20XX and ending September 30, 20XX was filed on February 16, 20XX. ORG's again failed to overtly disclose the details regarding the transfer of its program to another agency. It did however include a reworded statement regarding its new primary purpose of making grants to support education of children and families.

In both years ORG's failed to properly answer both Question 76, "Did the organization engaged in any activity not previously reported to the Service?" and Question 79, "Was there a liquidation, dissolution, termination or substantial contraction during the year?" Both of these questions require that a detailed explanation and description of the changes be attached to the return.

The Form 990 for FY ended September 30, 20XX, reports that President was the sole employee. Her salary is detailed in Exhibit #1. It is shown in both as the actual part-time basis and converted to an annualized full-time basis for comparison purposes. Exhibit #1 also includes the unreported taxable fringe benefits adjustments proposed in a separate employment tax report to be included in President' compensation. They are the value for the personal use of ORG's 20XX Toyota and the monthly reimbursement payments issued as an allowance for the purchase of health insurance coverage paid under a non-accountable plan.

A summary of ORG's operating results as reported on its annual Form 990 returns from the time it began making Grant awards as its primary activity is as follows:

<u>Income</u>	<u>20XX</u>	<u>20XX</u>	<u>20XX</u>	<u>20XX</u>
Public Support				
XYZ State Grant-in-Aid				
Interest & Dividends				

**EXPLANATION OF ITEMS**

**Name of Taxpayer:**

ORG

**Tax Year Ended:**

September 30, 20XX

**Tax Identification Number (TIN)**

**Examiner / Employee Number**

Other Income/ (Loss)

Total Income	\$	\$	\$	\$
<u>Expenses</u>	<u>20XX</u>	<u>20XX</u>	<u>20XX</u>	<u>20XX</u>
Grants Awarded				
Salary				
All Other Expenses				
Total Expenses	<u>20XX</u>	<u>20XX</u>	<u>20XX</u>	<u>20XX</u>
Total Income				
Total Expenses				
Net Income				
<u>Net Assets</u>	<u>20XX</u>	<u>20XX</u>	<u>20XX</u>	<u>20XX</u>
Beginning of Year				
End of Year				
Change in Value				
% Change in Assets				

ORG's provided records to establish that the Board of Directors regularly meet on a quarterly basis to actively participate in formulating ORG's grant making policies to ensure that grant recipients are not only qualified organizations but that they also offer programs to educate and support children and families in the community.

**LAW:**

Section 501(c)(3) of the Internal Revenue Code (Code) exempts from Federal income tax organizations that are organized and operated exclusively for religious, charitable, scientific, or educational purposes where no part of the net earnings inures to the benefit of any private shareholder or individual.

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

Section 1.501 (c)(3)-1(c)(1) of the Regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities that accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose. The existence of a substantial nonexempt purpose, regardless of the number or importance of exempt purposes, will cause failure of the operational test. Better Business Bureau of Washington, D.C. v. U.S., 326 U.S. 279 (1945).

In Better Business Bureau of Washington D.C.. Inc. v. United States, supra, The Court found that the organization had an "underlying commercial motive" that distinguished its educational program from that carried out by a university.

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.

An organization must establish that it serves a public rather than a private interest and "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." Treas. Reg. §1.501(c)(3)-1(d)(1)(ii). Prohibited private interests include those of unrelated third parties as well as insiders. Christian Stewardship Assistance, Inc. v. Commissioner, 70 T.C. 1037 (1978); American Campaign. Academy v. Commissioner, 92 T.C. 1053 (1989). Private benefits include an "advantage; profit; fruit; privilege; gain; [or] interest." Retired Teachers Legal Fund v. Commissioner, 78 T.C. 280, 286 (1982).

**Discussion:**

**Taxpayer's Position:**

ORG's believes that the costs it incurred were both necessary and reasonable to accomplish its new exempt purpose.

**Government's Position:**

A determination of an organization's exempt status as an organization described in §501(c)(3), is based on both its stated exempt purposes and its methods of operating to accomplish its purposes. These are both

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factual determinations. The burden of demonstrating its continued entitlement to recognition under §501(c)(3) lies with ORG's.

The first requirement of Treasury Regulation Section 1.501 (c)(3)-1 (a)(1) is the organizational test. The copy of the Articles of Incorporation provided by ORG's were unchanged as to its stated purpose of providing vocational skill development and rehabilitation services to individuals with physical and/or mental handicaps. This activity, if continued as the primary purpose would still be recognized as a qualified exempt purpose. Further, the addition of a secondary activity of making grants to other organizations holding exemption under IRC 501(c)(3) would not adversely affect ORG's exemption status.

However, in this case ORG's has replaced its primary exempt purpose with a minor grant award program that no longer accomplishes its stated purposes for which it was organized and for which exemption had been authorized. Although, ORG's new purpose would most likely qualify as an activity permitted by IRC §501(c)(3), the fact that it lacks a properly adopted amendment to its Articles of Incorporation's stated purposes, it no longer satisfies the "organizational test". In light of the extended period that ORG's failed to amend its governing document, it can only be determined that ORG's has not been properly organized for 501(c)(3) purposes since April 1, 20XX when it ceased operating in furtherance of its stated purpose.

The second requirement of Treasury Regulation Section 1.501 (c)(3)-1 (a)(1) is the operational test. 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 the exempt purposes specified in § 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose. An organization must also establish that it operates for a qualified public purpose rather than for the benefit of private interests.

The first part of the operational test is determining whether ORG's activities are primarily directed toward accomplishing one or more exempt purpose. One method to measure or identify an organizations primary purpose is to evaluate its expenditures for the period being examined. ORG's reported on its Form 990 return for FY 20XX that it issued grants totaling \$. The grants were given to other unrelated organizations to use in conducting their own program of exempt activities. As such, the distributions do qualify as being in furtherance of one or more exempt purposes.

The second part of the operational test considers whether such exempt program expenditures are substantial when compared to the overall expenditures of the organization. In ORG's case, the grants represent merely 26% of its total expenditures during FY 20XX. The remaining 74% of the expenditures consist of the salary paid to President, ORG's President, (44%) and general overhead expenses (30%).