

Internal Revenue Service
TEGE Appeals Programs
300 N. Los Angeles Street
Los Angeles, CA 90012

Department of the Treasury
CERTIFIED

Number: **201548024**
Release Date: 11/27/2015

Date: August 28, 2015

Redaction Legend:

A=

B=

C=

A

B

Taxpayer Identification Number:

Person to Contact:

Employee ID Number:

Tel: Fax:

Refer Reply to:

In Re:

Tax Years:

UIL Index:

501.03-00

Dear :

This is a final adverse determination to your exempt status under section 501(a) as an organization described under section 501(c)(3) of the Internal Revenue Code. Our adverse determination was made for the following reason(s):

Treas. Reg. section 1.501(c)(3)-1(d)(1)(ii) provides that an organization is not operated exclusively for exempt purposes unless it serves a public rather than a private interest. You operated for the benefit of private interests.

As such, you failed to meet the requirements of I.R.C. section 501(c)(3) and Treasury Regulation section 1.501(c)(3)-1(d)(1)(ii) in that you have not demonstrated that you are operated exclusively for exempt purposes within the meaning of Internal Revenue Code section 501(c)(3).

Contributions to your organization are not deductible under Code § 170. You are required to file federal Form 1120 for the year(s) shown above.

If you decide to contest this determination under the declaratory judgment provisions of Code section 7428, a petition to the United States Tax Court, the United States Court of Claims, or the district court of the United States for the District of Columbia must be filed before the 91st (ninety-first) day after the date this determination was mailed to you. Contact the clerk of the appropriate court for rules for filing petitions for declaratory judgment. To secure a petition form from the United States Tax Court, write to the United States Tax Court, 400 Second Street, N.W., Washington, D.C. 20217.

You also have the right to contact the Office of the Taxpayer Advocate. However, you should first contact the person whose name and telephone number are shown above since this person can access your tax information and can help you get answers. You can call 1-877-777-4778, and ask for Taxpayer Advocate assistance.

Taxpayer Advocate assistance cannot be used as a substitute for established IRS procedures, formal appeals procedures, etc. The Taxpayer Advocate is not able to reverse legal or technically correct tax determinations, or extend the time fixed by law that you have to file a petition in the United States 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.

We will notify the appropriate State officials of this final adverse determination of your exempt status, as required by Code section 6104(c).

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

Sincerely,

Nan Shimizu
Appeals Team Manager

cc:



DEPARTMENT OF THE TREASURY

INTERNAL REVENUE SERVICE
1100 Commerce St, MS 4900 DAL
Dallas, Texas 75242

**TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION**

Date January 23, 2014

Taxpayer identification Number:

Form:

Tax Year(s) Ended:

Person to Contact/ID Number

Contact Numbers:

Telephone:

Fax:

Manager Name:

Manager Number:

Telephone:

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.

Our understanding is that you do not agree with our proposed change in your exempt status. We are in receipt of your protest, and will forward your case to Appeals. The Appeals office is independent of the Exempt Organizations division and resolves most disputes informally. As such, a formal response is not required

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.

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.

In lieu of Letter 3618

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.

Respectively,

Nanette M. Downing
Director, EO Examinations

Enclosures:
Report of Examination
Form 6018
Publication 892
Publication 3498

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

Issues:

Did the Foundation fail to file complete and accurate returns with the Internal Revenue service? Is the Foundation liable for failure to file penalties for its fiscal year ending 30 April 20XX?

Is the Foundation liable for excise taxes under Internal Revenue Code §4942 for failure to distribute income?

Did the Trustee of the Foundation engage in acts of self dealing as defined under Internal Revenue Code §4941?

Did the Trustee of the Foundation allow the assets to inure for the personal benefit of a disqualified individual?

Should the exempt status of the Foundation be revoked for not operating in a manner consistent with IRC §501(c)(3) and allowing the assets and income to insure for the benefit of disqualified individuals?

Facts:

Foundation (Foundation) is a private non-operating foundation and a tax exempt organization under Internal Revenue Code (IRC) § 501(c)(3). It was granted this status on 26 December 19XX. The Foundation is a trust. The trustee is Corporation (Trustee). President is the president of the law corporation.

The trust was formed on 17 May 19XX in the state of State. The trust was created as irrevocable, but it may be terminated at anytime by action of the trustee. The trust's initial source of financial support was from the residue of the estate of Indv-1. The Articles of Trust of the Foundation were signed by President as executor of the Estate of Indv-1; and as president of Corporation.

The Foundation's primary purpose, as stated in its Trust Agreement is: "To devote and apply the property by this instrument vested in the trustee, and the income to be derived there from exclusively for charitable, religious, scientific, literary, and educational purposes. Either directly or by contributions to organizations duly authorized to carry on charitable, religious, scientific, literary, or educational activities."

The Trust Agreement also set out that the trustees will "distribute the income of the trust fund for each taxable year in such time and in such manner as not to become subject to tax on the undistributed income imposed by §4942 of the Internal Revenue Code." Further, the "trustees will not engage in any acts of self dealing as defined in §4941(d), nor retain any excess business holdings as defined in §4943; from making any investments in such manner as to incur tax under §4944; nor make any taxable expenditures as defined in §4945(d)".

On its Form 990 – Return of Private Foundation, the organization indicated on Part VII-A, question 6 that it was in compliance with §508(e) relating to sections 4941 through 4945. The Foundation answered in the affirmative on each filed return between 20XX and 20XX. On Part VII-B, the Foundation indicated "Yes" to "paying compensation to, pay or reimburse the expenses of an disqualified person. In addition, the Foundation indicated that it did not "Furnish goods, services, or facilities to (or accept them from) a disqualified person; "Engage in the sale, exchange, or leasing of property with a disqualified person; nor "Borrow Money from, lend money to, or otherwise extend credit to (or accept credit from) a disqualified person." The Foundation indicated that none of the acts that it participated in failed to meet the exceptions as set out in Treasury Regulation §53.4941(d)-3. For each period, the returns were signed by President as trustee of the Foundation.

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The Foundation owns a four story building. The building is located at Address, in City, State. The building has retail, office, and some residential rental spaces. An appraiser, engaged by the Trustee, described the property as an "older, Class C office building in a secondary location, away from downtown City".

The Foundation did not have a board of directors until 20XX.

During the period 19XX to 19XX, the Trustee administered the Foundation's rental property from an office building owned by President at Address, City, State. During this time President's law firm was located in the same building. This location is located approximately 0 miles from the Foundation's building on Address.

In 19XX at the annual trustee meeting, President acting as Trustee of the Foundation moved to have the law firm occupy office space within the Foundation's property at Address, City, State Zip. President as Trustee occupied Suite which contained 0 square feet of the building's rentable space. Those minutes note that the move will be in compliance with IRC §4941. In addition, the minutes stipulate that the law firm would pay prevailing rates. The Trustee notes that fair rent at the time is about 0 a square foot.

Most of the tenants located at Address have month to month lease terms; however, many of the tenants have been long-term tenants. A majority of the tenants originally had one to five-year lease terms with annual rent increases linked to Consumer Price Index (CPI). As such, many of the month to month tenants are expected to have annual increases in rent linked to CPI if they remain in the building for longer than one (1) year.

Per the general lease form, the Foundation as the landlord, pays all water, gas, heat, light, power, refuse, and other utilities and services supplied to the premises for the office spaces it rents. Retail spaces pay their own utility expenses.

The Trustee did not pay rent or certain utility expenses related to its occupation of the Foundation's property. The expenses for this commercial property have exceeded the rental income eight of the last thirteen years.

| Year | 19XX | 19XX | 19XX | 20XX | 20XX | 20XX |
|-----------------|------|------|------|------|------|------|
| Rental Income | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Rental Expenses | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Net Income/Loss | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |

| Year | 20XX | 20XX | 20XX | 20XX | 20XX | 20XX |
|-----------------|------|------|------|------|------|------|
| Rental Income | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Rental Expenses | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Net Income/Loss | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |

| Year | 20XX |
|-----------------|------|
| Rental Income | 0.00 |
| Rental Expenses | 0.00 |
| Net Income/Loss | |

In 19XX the Foundation loaned \$0 to Synagogue in City, State. The agreement states that the synagogue will repay the loan at an interest rate of 0 percent in accordance with the schedule attached to the note. The agreement was signed on 18 December 19XX. The first payment was due on 1 July 19XX.

| | | |
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As part of the Agreement, the Foundation agreed to make a charitable contribution to Synagogue in an amount equal to the yearly interest which it received from the synagogue; but, only in those years in which it received interest. The contributions were based on the following conditions:

1. Contributions will be made in those years that both the interest and principle payment checks are received by the Foundation exactly on time and in the exact amounts owed in accordance with the note,
2. Contributions will only be made upon Synagogue's providing satisfactory proof of its continued IRC §501(c)(3) tax exempt status for the year in question,
3. Contributions will only be made subject to Synagogue's providing satisfactory proof that its operation of the cemetery is within its §501(c)(3) tax exempt purposes,
4. Contributions will only be made if all above proofs are established prior to 30 April of the year in question and
5. No contributions will be made unless the synagogue meets all the conditional requirements set forth herein.

On 18 March 20XX the Foundation's CPA, CPA, sent Synagogue a letter detailing late payments and their agreement on how the delinquent payments would be treated. The letter included a revised amortization schedule of the remaining balance. At the time of the letter the synagogue was delinquent on three payments; 1 January 20XX, 1 July 20XX, and 1 January 20XX. In an agreement between the Foundation and the synagogue, the Foundation agreed to reduce the loan balance by the amount of the missed payments. In return Synagogue agreed to acknowledge a portion of the delinquent payments as charitable contributions made to it by the Foundation. The Foundation also agreed to make an additional charitable contribution to Synagogue. The letter also stated that Synagogue acknowledges it was past due with respect to two additional payments due on 1 July 20XX and 1 January 20XX. These payments were to be paid by 30 April 20XX.

In 20XX President, in his capacity as president of the law firm, borrowed \$0. The settlement statement, dated 26 September 20XX, identifies this as the "New 2nd loan from Indv-2, Indv-3, and Indv-4". The property securing the loan is the Foundation's rental property at Address.

A loan for \$0, due to Indv-5, is recorded on the Foundation's Form 990-PF balance sheet for the period ending April 30, 20XX. This loan is identified as a 2nd mortgage to the building located at Address.

The Foundation refinanced the mortgage on Address three times in the last three years. The first refinance happened in July 20XX through Sterling Bank and Trust. The settlement statement, dated 29 July 20XX, shows the payoff of two pre-existing loans. The first payoff is to Bank-2 and Trust for \$0 for the previous mortgage. The second payoff of \$0 is made to Indv-2, Indv-3, and Indv-4. This loan is not recorded on the Form 990-PF balance sheet for the period ending April 30, 20XX. The second time the mortgage was refinanced through Bank-1 in February 20XX for \$0. The Mortgage was refinanced again in April 20XX, through Bank-3 for \$0. President's personal loan obligation is included in these refinances. Total interest payments, on President's portion, of the refinanced mortgage, were \$0 for the period beginning September 20XX through December 20XX.

The return preparer's worksheet for the secondary loan, prepared from a copy of the borrower's settlement statement dated 29 July 20XX, shows a computation labeled as "B". The return preparer's computation reduced the \$0 figure appearing on the settlement statement by \$0. The Foundation's Form 990-PF for the year ending December 31, 20XX, lists a transaction of \$0. This transaction is labeled as a payoff of non-recorded loans. For the period ending April 30, 20XX The Form 990-PF Part II, line 6, shows a receivable of \$0 due from officers, directors, trustee and other disqualified persons.

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At the stated interest rate in each of the refinanced loans, the Foundation paid the following amounts in interest to satisfy the portion that were securing personal loans of President.

| Interest Paid by Foundation on Personal Loans | |
|-----------------------------------------------|--------|
| 20XX | \$0.00 |
| 20XX | 0.00 |
| 20XX | 0.00 |
| 20XX | 0.00 |
| 20XX | 0.00 |
| 20XX | 0.00 |
| 20XX | 0.00 |
| 20XX | 0.00 |
| 20XX | 0.00 |
| | \$0.00 |

On 29 January 20XX, in response to an inquiry posed by the Revenue Agent regarding the \$0 receivable, the Power of Attorney, POA, called President and asked him about the \$0 receivable recorded on the Form 990-PF balance sheet. POA stated that President used the Foundation's property to secure a personal loan.

President states that this loan was made in order to pay accumulated Trustee fees due to him for his services as the property and investment manager. (Form 8275, Disclosure Statement, attached to Form 990-T for the period ending 30 April 20XX) President is not the Trustee of the Foundation; his law corporation is the Trustee.

A tax client who pays fees to a law firm in excess of \$600.00 in the course of the client's trade or business is required to issue a Form 1099. No Forms 1099 – *Miscellaneous Income*, nor Forms W-2 – *Wage & Tax Statement*, have been filed by the Foundation; for any of the years being examined; reporting compensation paid to President or to Corporation.

Form 990-PF, Part II, line 7 balance sheets show reductions in the FMV of the \$0 loan balance for each fiscal year between 20XX and 20XX.

| Fiscal year | Beginning of Year | End of Year | FMV | Difference |
|-------------|----------------------|-------------|--------|------------|
| | Book Value | | | |
| 20XX | \$0.00 | \$0.00 | \$0.00 | \$0.00 |
| 20XX | 0.00 | 0.00 | 0.00 | 0.00 |
| 20XX | 0.00 | 0.00 | 0.00 | 0.00 |
| 20XX | 0.00 | 0.00 | 0.00 | 0.00 |
| 20XX | 0.00 | 0.00 | 0.00 | 0.00 |
| Total | | | | \$0.00 |

The Foundation did not receive any payments from President during these periods.

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A "Borrower's Estimated Closing Costs" document dated 3 October 20XX has the Foundation's building, at Address, listed as collateral for a loan of \$0. The proceeds of the loan, \$0 were not deposited in the Foundation's bank account for the period ending 30 April 20XX. The loan was paid off with a personal check from President and wife's bank account. The check is dated 14 June 20XX.

No rent was collected on three office suites as they were affiliated with building management; the Foundation Trustee:

| Suite # | Tenant | Sq. Ft. | Relationship |
|---------|------------------------|---------|------------------------------------------|
| | Indv-6 | 0 | Property manager property |
| | Corporation | 0 | President's law firm |
| | | | Worked as law clerk at President and co- |
| | Indv-7 | 0 | author of a book with President |
| | Total Non-Rented Space | 0 | |
| | | 0 | |

Total Building SQ

% of Sq Ft. Not Paid 0.00%

In a letter Dated 27 June 20XX, President, gave the following reason for his law firm's occupancy in the Foundation's building as:

"My individual and personal commitment to Indv-8 and Indv-9, for whom this Foundation was set up to honor, and my obligation to 'make the trust property productive' and to 'use reasonable judgment in the exercise of my trustee discretion' has dictated that I personally be at the building so that I can benefit the generation of funds for the Foundation to assist the numerous 501c3 type charities that the Foundation does assist. The words 'functionally related' in 26 CFR 53.4941(d) -3 apply to what was needed to build the Foundation's asset."

The Forms 990-PF for the periods 30 April 20XX through 30 April 20XX report a total of \$0 being paid for services and related fees. The fees were reported as paid for accounting and legal services; management and trustee services; and other miscellaneous professional services. Forms 1099 - *Miscellaneous income*, filed by the Foundation with the IRS from 20XX to 20XX only report \$0 as compensation for services and fees. The Foundation reported compensation expenses totaling \$0 for the same period. These payments were not reported on Forms 1096 or Forms W-3 information returns with the Internal Revenue Service (IRS). The Foundation did not issue Forms 1099 nor W-2 to President or to Corporation for this same period.

The Foundation has consistently failed to file its Forms 990-PF - *Return of Private Foundation* and Forms 990-T - *Exempt Organization Business Tax Return*, in a timely manner. As noted below the organization consistently missed its required filing date of 15 September, and paid substantial penalties.

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| Fiscal Year | Due Date | Date Filed | Extension Filed | Days Past Due Date | Daily Delinquency Penalty |
|-------------|-----------|------------|-----------------|--------------------|---------------------------|
| 4/30/20XX | 9/15/20XX | 1/15/20XX | No | 0 | |
| 4/30/20XX | 9/15/20XX | 4/15/20XX | Yes | 0 | |
| 4/30/20XX | 9/15/20XX | 12/1/20XX | Yes | 0 | |
| 4/30/20XX | 9/15/20XX | 5/6/20XX | No | 0 | |
| 4/30/20XX | 9/15/20XX | 11/20/20XX | No | 0 | |
| 4/30/20XX | 9/15/20XX | 2/28/20XX | No | 0 | |
| Total | | | | | 30.00 |

It is noted that the for the period ending 30 April 20XX daily delinquency penalties were assessed by the service center for failure to file, but were later abated.

Law:

IRC § 501(c)(3) allows for the exemption from Federal income tax an organization that is:

“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”

Treasury Regulation § 1.501(c)(3)-1 (a) provides, in general:

“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.”

Treasury Regulation § 1.501(c)(3)-1 (c)(1) provides,

An organization will be regarded as “operated exclusively” for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Treasury Regulation § 1.501(c)(3)-1 (c)(2) provides,

That the operational test is not satisfied where any parts of the organization’s earnings inure to the benefit of private shareholders or individuals, and where the organization serves a private rather than public interest.

Treasury Regulation § 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 IRC § 501(c)(3) unless it serves a public rather than a private interest.

Treasury Regulation § 1.501(c)(3)-1 (e) provides, in general:

“An organization may meet the requirements of section 501(c)(3) although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization’s exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business, as defined in section 513.”

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IRC § 509(b) holds:

If an organization is a private foundation (within the meaning of § 509(a)) on October 9, 1969, or becomes a private foundation on any subsequent date, such organization shall be treated as a private foundation for all periods after October 9, 1969, or after such subsequent date, unless its status as such is terminated under IRC § 507

IRC § 513(a) defines unrelated business income:

Any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under 501

IRC § 6033(a) States:

Except as provided in paragraph (3), every organization exempt from taxation under section 501(a) [IRC Sec. 501(a)] shall file an annual return, stating specifically the items of gross income, receipts, and disbursements, and such other information for the purpose of carrying out the internal revenue laws as the Secretary may by forms or regulations prescribe, and shall keep such records, render under oath such statements, make such other returns, and comply with such rules and regulations as the Secretary may from time to time prescribe.

IRC § 6652(c) imposes a Tax for failure to file an information return as follows:

There shall be paid by the exempt organization \$ 20 for each day during which such failure continues. The maximum penalty under this subparagraph on failures with respect to any 1 return shall not exceed the lesser of \$ 10,000 or 5 percent of the gross receipts of the organization for the year. In the case of an organization having gross receipts exceeding \$ 1,000,000 for any year, with respect to the return required under section 6033(a)(1) for such year, the first sentence of this subparagraph shall be applied by substituting "\$ 100" for "\$ 20" and, in lieu of applying the second sentence of this subparagraph, the maximum penalty under this subparagraph shall not exceed \$ 50,000.

IRC § 6041(a) States:

All persons engaged in a trade or business and making payment in the course of such trade or business to another person, of rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income of \$ 600 or more in any taxable year, or, in the case of such payments made by the United States, the officers or employees of the United States having information as to such payments and required to make returns in regard thereto by the regulations hereinafter provided for, shall render a true and accurate return to the Secretary, under such regulations and in such form and manner and to such extent as may be prescribed by the Secretary, setting forth the amount of such gains, profits, and income, and the name and address of the recipient of such payment

Chapter 42 Taxes

IRC § 4940(a) imposes an excise tax on investment income as follows:

There is hereby imposed on each private foundation which is exempt from taxation under section 501(a) for the taxable year, with respect to the carrying on of its activities, a tax equal to 2 percent of the net investment income of such foundation for the taxable year.

IRC § 4940(c) Defines Net investment income as:

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Net investment income is the amount by which (A) the sum of the gross investment income and the capital gain net income exceeds (B) the deductions allowed by paragraph (3).

The term "gross investment income" means the gross amount of income from interest, dividends, rents, payments with respect to securities loans (as defined in section 512(a)(5)), and royalties.

There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred for the production or collection of gross investment income or for the management, conservation, or maintenance of property held for the production of such income.

IRC § 4941(d)(1) Defines Self Dealing as:

Any direct or indirect sale or exchange, or leasing, of property between a private foundation and a disqualified person; lending of money or other extension of credit between a private foundation and a disqualified person; furnishing of goods, services, or facilities between a private foundation and a disqualified person; payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person; transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation.

IRC § 4941(d)(2)(B) Sets out the following special rule:

the lending of money by a disqualified person to a private foundation shall not be an act of self-dealing if the loan is without interest or other charge (determined without regard to IRC §7872) and if the proceeds of the loan are used exclusively for purposes specified in IRC § 501(c)(3).

IRC § 4941(a)(1) Defines the initial tax on the Self Dealer as:

There is hereby imposed a tax on each act of self-dealing between a disqualified person and a private foundation. The rate of tax shall be equal to 10 percent of the amount involved with respect to the act of self-dealing for each year (or part thereof) in the taxable period. The tax imposed by this paragraph shall be paid by any disqualified person (other than a foundation manager acting only as such) who participates in the act of self-dealing. In the case of a government official (as defined in section 4946(c)), a tax shall be imposed by this paragraph only if such disqualified person participates in the act of self-dealing knowing that it is such an act.

IRC § 4941(a)(2) Defines the initial tax on the Foundation manager as:

In any case in which a tax is imposed by paragraph (1), there is hereby imposed on the participation of any foundation manager in an act of self-dealing between a disqualified person and a private foundation, knowing that it is such an act, a tax equal to 5 percent of the amount involved with respect to the act of self-dealing for each year (or part thereof) in the taxable period, unless such participation is not willful and is due to reasonable cause. The tax imposed by this paragraph shall be paid by any foundation manager who participated in the act of self-dealing.

IRC § 4941(b)(1) Imposes an additional tax on Self Dealer:

In any case in which an initial tax is imposed by subsection (a)(1) on an act of self-dealing by a disqualified person with a private foundation and the act is not corrected within the taxable period, there is hereby imposed a tax equal to 200 percent of the amount involved.

IRC § 4941(b)(2) Imposes an additional tax on Foundation Manager:

In any case in which an additional tax is imposed by paragraph (1), if a foundation manager refused to agree to part or all of the correction, there is hereby imposed a tax equal to 50 percent of the amount involved.

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The tax imposed by this paragraph shall be paid by any foundation manager who refused to agree to part or all of the correction.

IRC § 4941(c)(2) Limits the amount of tax on Foundation manager:

With respect to any one act of self-dealing, the maximum amount of the tax imposed by subsection (a)(2) shall not exceed \$20,000, and the maximum amount of the tax imposed by subsection (b)(2) shall not exceed \$20,000

IRC § 4941(c)(2) defines correction as:

With respect to any act of self-dealing, undoing the transaction to the extent possible, but in any case placing the private foundation in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards.

Treas. Reg. § 53.4941(a)-1(b)(2) Defines Participation of a foundation manager:

Shall include silence or inaction on the part of a foundation manager where he is under a duty to speak or act, as well as any affirmative action by such manager. However, a foundation manager will not be considered to have participated in an act of self-dealing where he has opposed such act in a manner consistent with the fulfillment of his responsibilities to the private foundation.

Treas. Reg. § 53.4941(a)-1(b)(3) Defines Knowing:

For purposes of § 4941, a person shall be considered to have participated in a transaction "knowing" that it is an act of self-dealing only if—

- (i) He has actual knowledge of sufficient facts so that, based solely upon such facts, such transaction would be an act of self-dealing,
- (ii) He is aware that such an act under these circumstances may violate the provisions of federal tax law governing self-dealing, and
- (iii) He negligently fails to make reasonable attempts to ascertain whether the transaction is an act of self-dealing, or he is in fact aware that it is such an act.

Treas. Reg. § 53.4941(a)-1(b)(4) Defines Willful as:

Participation by a foundation manager shall be deemed willful if it is voluntary, conscious, and intentional. No motive to avoid the restrictions of the law or the incurrence of any tax is necessary to make the participation willful. However, participation by a foundation manager is not willful if he does not know that the transaction in which he is participating is an act of self-dealing.

IRC § 4942(c)(2) Defines undistributed Income as:

With respect to any private foundation for any taxable year as of any time, the amount by which--
 (1) the distributable amount for such taxable year, exceeds
 (2) the qualifying distributions made before such time out of such distributable amount.

IRC § 4942(a) Defines the initial tax on the Self Dealer as

There is hereby imposed on the undistributed income of a private foundation for any taxable year, which has not been distributed before the first day of the second (or any succeeding) taxable year following such taxable year (if such first day falls within the taxable period), a tax equal to 30 percent of the amount of such income remaining undistributed at the beginning of such second (or succeeding) taxable year

The tax imposed by this subsection shall not apply to the undistributed income of a private foundation--
 (1) for any taxable year for which it is an operating foundation (as defined in subsection (j)(3)), or

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(2) to the extent that the foundation failed to distribute any amount solely because of an incorrect valuation of assets under subsection (e), if--

(A) the failure to value the assets properly was not willful and was due to reasonable cause,

(B) such amount is distributed as qualifying distributions (within the meaning of subsection (g)) by the foundation during the allowable distribution period (as defined in subsection (j)(2)),

(C) the foundation notifies the Secretary that such amount has been distributed (within the meaning of subparagraph (B)) to correct such failure, and

(D) such distribution is treated under subsection (h)(2) as made out of the undistributed income for the taxable year for which a tax would (except for this paragraph) have been imposed under this subsection

IRC § 4942(b) Imposes an additional tax on the Foundation:

In any case in which an initial tax is imposed under subsection (a) on the undistributed income of a private foundation for any taxable year, if any portion of such income remains undistributed at the close of the taxable period, there is hereby imposed a tax equal to 100 percent of the amount remaining undistributed at such time.

Treas. Reg. § 53.4942(a)-3(1)(a) Defines a Qualifying distribution as:

the amount of a qualifying distribution of property (as defined in subparagraph (2) of this paragraph) is the fair market value of such property as of the date such qualifying distribution is made. The amount of an organization's qualifying distributions will be determined solely on the cash receipts and disbursements method of accounting

Rev. Rul 78-76, 1978-1 C.B. 377,

Address the circumstances where a disqualified person is liable for the tax imposed on an act of self-dealing by IRC §4941(a)(1); as well as the tax imposed on the participating foundation manager by IRC

§4942(a)(2). In the instance of Rev. Rul. 78-76, the disqualified person is also a trustee of a trust that is a private foundation. As such, with respect to the trust, he is a "foundation manager" as that term is defined in section 4946(b). The disqualified person, acting on his own behalf and as trustee on behalf of the trust, sold property he owned to the trust knowing that the transaction was an act of self-dealing under §4941(d)(1)(A). His participation in the transaction was willful and was not due to reasonable cause.

IRC § 4941(j)(4) defines Functionally related business as:

A trade or business which is not an unrelated trade or business (as defined in §513) or, an activity which is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which is related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the exempt purposes of the organization.

IRC § 4946(a)(1) Defines a Disqualified individual as:

a person who is a substantial contributor to the foundation; a foundation manager (within the meaning of subsection (b)(1)), an owner of more than 20 percent of the total combined voting power of a corporation the profits interest of a partnership, or the beneficial interest of a trust or unincorporated enterprise, which is a substantial contributor to the foundation.

IRC § 4946(b)(1) Defines Foundation manager as:

An officer, director, or trustee of a foundation (or an individual having powers or responsibilities similar to those of officers, directors, or trustees of the foundation)

IRC § 7701(a)(1) Defines a person as:

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The term "person" shall be construed to mean and include an individual, a trust, estate, partnership, association, company or corporation

Governments Position:

Issue 1: Did the Foundation fail to file complete and accurate returns with the Internal Revenue service? Is the Foundation Liable for Failure to file penalties for its fiscal year ending 30 April 20XX?

The Foundation did not collect rent under its lease agreement from the Trustee for a period of nearly 0 years. During this time the Forms 990-T – *Exempt Organization Business tax Return*, of the Foundation included amounts attributable to expenses related to the lease of space to Corporation. Since the Foundation did not receive income from the rental of this space that corresponding expenses are not includable as deductible expenses on the 990-T. In addition, amounts originally claimed on the Form 990-T include amounts attributable to the personal expenses of President. These amounts are also not deductible as business expense.

The rental income reported on Form 990-T was incorrect for the period ending 30 April 20XX. The Foundation reported rental income of \$0 on its 990-T. Financial records provided by the Foundation show total rent due for the period ending 30 April 20XX as \$0. The examination determined total rental income received for the period was \$0.

| | 30-Apr-XX | Per Return | Per Exam | Adjustments |
|---------|-----------|------------|----------|-------------|
| Revenue | | \$0 | \$0 | \$0 |

In addition, gross rents received by the organization were underreported by approximately 0%.

| Gross Rents - FYE 30 April 20XX | |
|---------------------------------|--------|
| Per Exam | \$0.00 |
| Reported 20XX | 0 |
| Adjustment | \$0.00 |
| Difference % | 0.0% |

The Foundation was not able to provide any documentation that would support the difference between what was found during examination and what was reported on the 990-T for the year ending 30 April 20XX. It was determined that the subsequent years tax returns were also not accurate, as such the 20XX-20XX returns were adjusted. Expenditures were reduced by amounts directly related to the operation of CORP. Interest was reduced by the amount of interest paid on loans not related to the exempt activities of the Foundation. Miscellaneous Income that could not be substantiated with documentation was removed. And, non-personal expenses were reduced as they were not connected with the exempt function of the Foundation.

Additionally, the Foundation failed to file Forms 1099 for the calendar years ending 31 December 20XX – 20XX for professionals and contractors paid more than \$0. The Foundation filed five (5) Forms 1099 for Calendar year ending 31 December 20XX. Since the fees deducted as legal, professional and management fees were not reported on Forms 1099 they were disallowed as part of expense offset on the form 990-T. Also, large and questionable expenses that could not be substantiated were disallowed.

As such, we have adjusted amounts of income and expense reported on the 990-T of the Foundation

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Issue 2: Is the Foundation liable for Excise taxes under Internal Revenue Code §4942 for failure to distribute income?

In 19XX, the Foundation entered into a loan agreement with Synagogue in City, State. The Foundation loaned the synagogue \$0. On March 18, 20XX, the Foundation agreed to modify the terms of the loan. The synagogue was late on payments of principal and interest due on January 1, 20XX, July 1, 20XX, and January 1, 20XX. In the agreement, the Foundation reduced the loan balance by the amount of the missing payments in exchange for acknowledgment of a portion of the missing payments (\$0) as charitable contributions. The law requires the actual donation of cash or property within the taxable year for a charitable contribution to be recognized. (I.R.C. 170(a)(1))

The law imposes an excise tax on private foundations for failure to distribute income for any tax year, which has not been distributed before the first day of the second tax year following the tax year, or the first day of any succeeding tax year that falls within the taxable period. (I.R.C. 4942(a)) The tax rate is 30% of the foundation's undistributed income. (For tax years beginning prior to August 17, 2006, the tax rate was 15%. (Pension Protection Act of 2006)) The taxable period begins with the first day of the tax year and ending on the earlier of the date of mailing of a notice of deficiency with respect to the initial tax or the date on which the tax is assessed. (I.R.C. 4942(j)(1))

A foundation's undistributed income equals the excess of the foundation's distributable amount over its qualifying distributions. (I.R.C. 4942(c)) The distributable amount is equal to the sum of the minimum investment return increased by 1) certain recouped qualifying distributions and reduced by 2) the sum of the taxes on income and net investment income. (I.R.C. 4942(d)) The minimum investment return is five percent of the excess of the aggregate fair market value of all non-charitable use assets over the foundation's acquisition indebtedness. (I.R.C. 4942(e)(1))

Qualifying distributions include any amounts paid to accomplish one or more charitable (I.R.C. 170(c)(2)(B)) purposes, other than to organizations controlled, directly or indirectly, by the foundation or its disqualified persons. (I.R.C. 4942(g)(1)(A)) Qualifying distributions also include any amounts paid to acquire assets used or held for use in carrying out charitable (I.R.C. 170(c)(2)(B)) purposes. (I.R.C. 4942(g)(1)(B)) The Form 990-PF, Parts I, V, VI, IX, X, XI, XII, and XIII provide the computations necessary in determining whether your foundation fails to distribute income in a given year.

On your Form 990-PF for the tax year ended April 30, 20XX, you reported \$0 in contributions paid to Synagogue. This amount includes the \$0 in forgiven debt. Your total charitable disbursements for the year totaled \$0. This amount also constitutes your total qualifying distributions for the year. You fully subtracted these distributions from your undistributed income, leaving a remaining undistributed income amount of \$0 that carried over to the next year's Form 990-PF.

As such the Foundation is liable for excise taxes under IRC §4942(a) and §4942(b) for failure to distribute income in a manner consistent with IRC §501(c)(3). The Foundation has not made corrections at this time.

Issue 3: Did the Trustee of the Foundation engage in acts of Self dealing as defined under IRC §4941?

President, in his duty as president of the Trustee signed the Articles of Trust which specifically note that the Foundation will not participate in activities that will give rise to Chapter 42 taxes. President as a representative of the Trustee signed the 990-PF return; which under Part-VII A & B points out specific acts of self-dealing, and other acts subject to excise tax under Chapter 42 of the Internal Revenue Code. As such, the Trustee; and President have

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sufficient knowledge of Chapter 42 Excise taxes to know what constitutes an act of self dealing as defined under §4941

The Trustee of the Foundation is considered a foundation manager under IRC §4946(b)(1). It is in charge of the day to day operations of the Foundation. In addition, it is responsible for oversight of all the Foundation's financial functions and contracts. The Trustee is also a disqualified individual as defined in IRC 4946(a)(1) as he has made substantial contributions to the Foundation, acts as a foundation manager, and controls over (0%) of the total voting power of the Foundation.

The Foundation owns a four story building located at Address, City, State. The building has retail, office, and some residential rental spaces.

In 19XX, President, acting as President of the law firm, Corporation (CORP), moved to have CORP occupy office space within the Foundation's property at Address, City, State Zip code. CORP occupied Suite , which contained 0 square feet of rentable space. At the time of the move, the Foundation's minutes reflected that CORP would pay rent to the Foundation and that CORP's occupancy of the Foundation's building would be in compliance with I.R.C. § 4941. Despite the representations made in the Foundation's minutes, CORP did not pay rent or certain utility expenses related to its occupancy in the Foundation's building.

On September 26, 20XX, CORP borrowed \$0 from Indv-2 and Indv-4. Proceeds from this loan were used to pay off a previous loan made by Indv-2 and Indv-4 to CORP, which had an outstanding balance of \$0. After payment of loan fees in the amount of \$0, and prepaid interest in the amount of \$0, the remaining \$0 was remitted to CORP. This loan was secured using the Foundation's property at Address.

On July 29, 20XX, the Foundation refinanced its mortgage on Address. Under your direction and control, \$0 of the proceeds from the refinancing of the Foundation's mortgage were used to pay off the outstanding liability owed by CORP to Indv-2, Indv-4. At the time of the 20XX refinancing, CORP did not make any restitution to the Foundation for this relief of debt.

The Foundation subsequently refinanced its mortgage twice more, on January 8, 20XX, and March 10, 20XX, and each time CORP failed to pay any restitution or assume the \$0 relief in debt it had received in 20XX. All mortgage payments were made by the Foundation.

We have concluded that these activities are "acts of self-dealing" within the meaning of I.R.C. § 4941. A private foundation's assumption of a disqualified person's liability is a self-dealing transaction. I.R.C. § 4941(d)(1)(B). In addition, the Foundation's furnishing of facilities to a disqualified person is a self-dealing transaction. I.R.C. § 4941(d)(1)(C).

Issue 4: Did the Trustee of the Foundation allow the assets to inure for the personal benefit of a disqualified individual?

President, acting through the Trustee of the Foundation used the assets of the Foundation to secure a series of personal loans payable to him. These personal loans were later assumed by the Foundation when they were included in the refinance of the Foundation's mortgages in 20XX.

As stated in IRC §4941(d)(1) acts of self dealing include acts of lending of money between a private foundation and a disqualified person; or payment of compensation or payment of reimbursement of expenses by a private foundation to a disqualified person. In addition, Treasury Regulation 53.4941(d)-2(c)(1) notes that: "an act of self-dealing

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occurs where a note, the obligor of which is a disqualified person, is transferred by a third party to a private foundation which becomes the creditor under the note." As in this case the loan was a personal loan to President, and transferred to the Foundation when it refinanced its mortgages.

In addition, loan fees, principal, and interest were paid fully by the Foundation. At no time did President attempt to make restitution to the Foundation for these payments. At no time did the Trustee of the Foundation demand payment for assumed debts of President. These transactions allowed a portion of the holdings of the Foundation to flow to a disqualified individual making these funds unavailable for use in the charitable mission of the Foundation.

The Trustee for the Foundation had sufficient knowledge of the terms to know that entering into the agreement would cause the funds of the Foundation to be used for personal not charitable endeavors, and would constitute an act of self-dealing as defined in IRC §4941(d)(1). President had sufficient knowledge of the facts to know that he was transferring his debt obligations to the Foundation, and that he would personally benefit from no being removed as obligor of his personal loans.

As trustee, CORP failed to exercise its due diligence to ensure that the loan was in the best short and long term interest of the Foundation. In addition, it violated the trust agreement by allowing the Foundation to be subject to sanctions under Section 42 of the IRC. The Trustee could have easily corrected such deficiencies by not assuming the personal loans of President, and requiring that he take personal responsibility for his loans. President could have taken personal responsibility for his loans, and not allowed them to be bundled into the larger mortgage refinance of the Foundation.

The Trustee's participation in assuming the personal loans of President, falls fully on it as it voluntarily assumed the loans when refinancing the Foundation's mortgage. It was conscious and intentional, as the Trustee had to review the loan documents, confirm all included amounts, pay closing costs and fees, and fully accept the terms of the new mortgage.

Based on these facts, the Trustee of the foundation participated in acts of self-dealing as defined by IRC §4941. In addition, the Trustee of the Foundation allowed the Foundation's assets to be used in a manner not in furtherance of an exempt purpose and jeopardized the exempt status of the Foundation.

Issue 5: Should the Exempt Status of the Foundation be revoked for not operating in a manner consistent with IRC §501(c)(3) and allowing the assets and income to insure for the benefit of disqualified individuals?

The Internal Revenue Code states: for an organization to be exempt under §501(c)(3) the organization needs to meet both the organization and operational tests as defined in Treasury Regulation §1.501(c)(3)-1(a). In addition, IRC §501(c)(3) and Treasury Regulation §1.501(c)(3)-1(c)(2) holds that: an organization shall not be exempt if any of its earnings inure to the private benefit of any of its shareholders or individuals. Treasury Regulation §1.501(c)(3)-1(c)(1) provides: 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.

The Foundation was unable to provide substantiate that its primary activities were charitable activities, or events that further an exempt purpose. During the periods under review, the primary activity of the Foundation was the management and collection of income from its Assets, primarily real-estate. Any charitable contributions the Foundation distributed were incidental in comparison to the private benefits the disqualified individual and the Trustee received.

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In Orange County Agricultural Society V. Commissioner, the organization had substantial nonexempt activities and acted in a manner consistent with a for-profit business than a non-profit organization. The courts held that an organization with substantial nonexempt activities can't avoid revocation of its tax exempt status simply by paying taxes or penalties. In the case of the Foundation, the primary activities of the organization have given rise to substantial excise taxes; and the income generated was used for the private benefit of disqualified individuals.

As such, the Foundation does not meet the operational test, as it is not operated exclusively for IRC §501(c)(3) purposes as defined in Treasury Regulation §1.510(c)(3)-1(d)(1)(i).

In addition to not showing any charitable activities, the foundation engaged in acts of self-dealing that allowed the fund balances of the Foundation to inure to benefit of disqualified individuals.

As noted above, the Foundation's self-dealing transactions with President and Corporation were for the private benefit of a disqualified individual and a disqualified corporation owned by that individual.

The Law Firm occupied space in the Foundation's building for a period of thirteen years. During this time, the Trustee failed to pay rent, and the Foundation failed to demand that rent be paid on the space occupied. During the course of the audit, the Foundation, as well as the Trustee was advised that the Trustee would need to vacate the building. However, the Trustee continued to maintain its offices in the building until 20XX.

In addition to the Lease, the Foundation allowed its assets to be used to secure personal loans to a disqualified person. When this individual was no longer able to satisfy the debt, the Foundation assumed the debt wholly as part of its mortgage refinancing. At no time did the Foundation demand restitution for assuming the loan. This allowed a substantial amount of the Foundation's fund balances to be used for the personal use of a single individual.

As in Orange County, *supra*, an organization will not qualify for tax exempt status if even a small part of its income inures to a disqualified individual.

As such, the Foundation has failed to meet the requirements of Treasury Regulation §1.501(c)(3)-1(c)(2); and Treasury Regulation §1.501(c)(3)-1(d)(1)(ii) by engaging in acts of self dealing as defined in IRC §4941(d)(1). These acts allowed for the income of the Foundation to inure for the personal benefits of disqualified individuals, and not be available for use for charitable activities.

Taxpayer's Position:

In the protest received 13 November 20XX the Foundation holds that :

Issue 1:

The Foundation did not fail to collect rent from the Trustee for nearly 0 years. It is also the Foundation's position that it correctly reported its income and expenses for the years at issue.

Issue 2:

The Foundation denies that it purposefully forgave loan payments to President's synagogue. The Foundation also denies also denies that it is liable for liabilities under Internal Revenue Code §4942 or any associated excise tax.

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Issue 3:

The Foundation denies that President in his duty as Trustee of the Foundation engaged in acts of self-dealing. In the present case, CORP held an office in the building owned by the Foundation. President believes that he did not engage in acts of self-dealing by locating the Law Corporation in a building owned by the Foundation. The Foundation's building is located in a relatively high crime zone in the City of City. By having the Law Corporation located in the building owned by the foundation, President was able to provide proper supervision of the premises and on numerous occasions actually assist law enforcement in protecting the Foundation's building from criminal activity.

It is the position of President that the Foundation is not liable for any taxes or penalties related to failure to distribute income in matters inconsistent with Internal Revenue Code Section 501(c)(3). Furthermore, it is President's position that his Law Corporation paid all applicable rent to the foundation at the current market rate and that the Foundation recognized taxable income on the rents received.

Issue 4:

It is the position of President that the Foundation did not provide assets of the Foundation to a disqualified person. As the Foundation manager of the Foundation, President entered into refinance transactions of the Foundation's building in order to provide reasonable compensation for the services that were rendered. It is President's position that he was never compensated for the services that he provided to the Foundation. A part of the refinance transactions was to provide reasonable compensation for the services that were rendered over the years. On August 20, 20XX, President provided to the examiner a log of some of the services rendered by President. Based on these facts, it is the position of President that the acts of refinancing the foundation's property to pay his reasonable trustee fees was reasonable in light of the circumstances and not acts of self-dealing as defined under Internal Revenue Code § 4941.

Issue 5:

The Foundation denies that it failed to provide substantiation that its primary activities were for charitable activities, or events that further an exempt purpose for lack of complete information and opportunity to compile taxpayer arguments and defenses.

The Foundation also denies that Corporation is a disqualified person described in Internal Revenue Code Section 4946(a)(1)(B).

The Foundation denies that President is a disqualified person as described in Internal Revenue Code § 4946(a)(1)(B).

The Foundation denies that the Foundation participated in acts of self-dealing under Internal Revenue Code § 4941 (d)(1)(B); the lending of money or other extension of credit between the Foundation and a disqualified person for lack of complete information and opportunity to compile taxpayers arguments and defenses. It is the Foundation's position that it did not participate in acts of self-dealing under Internal Revenue Code § 4941 (d)(1)(B). Any monies paid to President represented reasonable compensation to a disqualified person as permitted under the Internal Revenue Code.

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Conclusion:

Therefore, it is the Governments position that the Foundation no longer meets the guidelines under Internal Revenue Code §501(c)(3) and Treasury Regulation §1.501(c)(3)-1(c), as the income of the organization has inured to the personal benefit of the Trustee.

The Foundation subsequently does not meet the operational test because it is not operated exclusively for IRC §501(c)(3) purposes as required and defied by Treasury regulation §1.510(c)(3)-1(d)(1)(i), and has been used as a vehicle to serve the private interests of its trustees rather than public interest as prescribed under Treasury Regulation §1.510(c)(3)-1(d)(1)(ii).

It is recommended that that exempt status of this organization be Revoked as of 30 April 20XX

As such, the organization will be Treated as a taxable private foundation as of this date until such time that the Foundation terminates its Private Foundation status under IRC §507

The Foundation is still subject to Excise taxes under Chapter 42 of the Internal Revenue Code, as such is still required to file form 990-PF; in addition the Foundation is required to file form 1120 as it will also be treated as a for-profit corporation.