Bond Case Briefs

Municipal Finance Law Since 1971

IRS LTR: University's Tax-Exempt Status Is Revoked.

Citations: LTR 201329020

The IRS revoked the tax-exempt status of an online university, concluding that the university's net earnings routinely and continuously inured to its president, vice president, and secretary.

Person to Contact: * * *

Employee Identification Number: * * *

Employee Telephone Number:

(Phone): * * *

(Fax): * * *

501-03.00

Release Date: 7/19/2013

Date: January 7, 2013

Taxpayer Identification Number: * * *

LEGEND:

ORG = organization name

xx = Date

Address = address

Officer — 1-3 = 1st, 2nd & 3rd Officer

Dear * * *:

This is a final adverse determination regarding your exempt status under section 501(c)(3) of the Internal Revenue Code. Our favorable determination letter to you dated February 3, 20XX is hereby revoked and you are no longer exempt under section 501(a) of the Code effective January 1, 20XX.

The revocation of your exempt status was made for the following reason(s):

Organizations described in IRC 501(c)(3) and exempt under section 501(a) must be both organized and operated exclusively for exempt purposes. You must establish that you are operated exclusively for exempt purposes and that no part of your net earnings inures to the benefit of private shareholders or individuals.

Your earnings have inured to the benefit of three of your officers, Officer-1, Officer-2, and Officer-3. This inurement totaled $* * * during the years 20XX, 20XX, and 20XX. This is a substantial amount of inurement, and violates section 1.501(c)(3)-1(c)(2) of the Treasury Regs. Given the routine and continuous nature of the inurement, this warrants revocation of your 501(c)(3) status effective January 1, 20XX.

Contributions to your organization are no longer deductible under IRC § 170 after January 1, 20XX.

You are required to file income tax returns on Form 1120. These returns should be filed with the appropriate Service Center for the tax year ending December 31, 20XX, and for all tax years thereafter in accordance with the instructions of the return.

Processing of income tax returns and assessments 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 under the declaratory judgment provisions of section 7428 of the Code, a petition to the United States Tax Court, the United States Claims Court, or the district court of the United States for the District of Columbia must be filed before the 91st Day after the date this determination was mailed to you. Please contact the clerk of the appropriate court for rules regarding filing petitions for declaratory judgments by referring to the enclosed Publication 892. You may write to the United States Tax Court at the following address:

* * *

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 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 contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Nanette M. Downing

Director, EO Examinations

* * * * *

Person to contact/ID number: * * *

Contact numbers: * * *

Manager’s name/ID number: * * *

Manager’s contact number: * * *

Response due date: * * *

Date: July 24, 2012

Taxpayer Identification Number: * * *

Form: * * *

Tax year(s) ended: * * *

LEGEND:

ORG = * * *

ADDRESS = * * *

Dear * * *:

WHY YOU ARE RECEIVING THIS LETTER

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

WHAT YOU NEED TO DO IF YOU AGREE

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

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

IF WE DON'T HEAR FROM YOU

If you don't respond to this proposal within 30 calendar days from the date of this letter, we'll issue a final revocation letter. Failing to respond to this proposal will adversely impact your legal standing to seek a declaratory judgment because you failed to exhaust your administrative remedies.

EFFECT OF REVOCATION STATUS

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

WHAT YOU NEED TO DO IF YOU DISAGREE WITH THE PROPOSED REVOCATION

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

For your protest to be valid, it must contain certain specific information including a statement of the facts, the applicable law, and arguments in support of your position. For specific information needed for a valid protest, please refer to page one of the enclosed Publication 892, How to Appeal an IRS Decision on Tax-Exempt Status, and page six of the enclosed Publication 3498, The Examination

Process. Publication 3498 also includes information on your rights as a taxpayer and the IRS collection process. Please note that Fast Track Mediation referred to in Publication 3498 generally doesn't apply after we issue this letter.

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

CONTACTING THE TAXPAYER ADVOCATE OFFICE IS A TAXPAYER RIGHT

You have the right to contact the office of the Taxpayer Advocate. Their assistance isn't a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate can't reverse a legally correct tax determination or extend the time you have (fixed by law) to file a petition in a United States court. They can, however, see that a tax matter that hasn't been resolved through normal channels gets prompt and proper handling. You may call toll-free 1-877-777-4778 and ask for Taxpayer Advocate assistance. If you prefer, you may contact your local Taxpayer Advocate at:

Internal Revenue Service

Office of the Taxpayer Advocate

* * *

FOR ADDITIONAL INFORMATION

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

Thank you for your cooperation.

Sincerely,

Nanette M. Downing

Director, EO Examinations

Enclosures:

Report of Examination

Form 6018

Publication 892

Publication 3498

* * * * *

LEGEND:

ORG = Organization name

XX = Date

Address = address

City = city

State = state

President = president

Vice-President = vice president

Secretary = secretary

CPA = CPA

Founder = founder

RA-1 = 1st RA

CO-1 through CO-11 = 1st through 11th COMPANIES

ISSUE

Should ORG'S 501(c)(3) status be revoked on the grounds that its net earnings inured to the benefit of its president, vice-president, and secretary?

FACTS

ORG, formerly known as CO-1 ("ORG"), is an online university. Its corporate office is located at Address, City, State. It offers degrees in * * * and * * *. Its enrollment was approximately 200 students during the years under examination. ORG also conducts live training seminars approximately 30 times throughout each school year. These seminars are held in locations throughout the United States and Canada.

During the years under examination, ORG's president and vice-president were President and Vice-President (husband and wife), respectively. ORG's board secretary was Secretary.

ORG filed with the IRS a Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code, on May 13, 20XX. On February 3, 20XX, the IRS issued a ruling letter to ORG, recognizing it as a tax-exempt public charity under section 501(c)(3) of the Internal Revenue Code ("Code"), effective April 26, 20XX.

On April 28, 20XX, ORG filed a Plan of Conversion with the State of State to convert back to for-profit status as of June 1, 20XX. The State of State certified this conversion. According to a valuation prepared by CO-2 ORG's value was appraised to be zero. This was primarily due to ORG's outstanding debt of $$* * * to CO-3 ("CO-3"). President owns * * *% of CO-3's stock. At conversion, the debt was extinguished in exchange for ORG's stock. ORG formally changed its name from CO-1 to ORG on December 13, 20XX.

The examining IRS agent contacted ORG president President on December 8, 20XX and advised him of the audit of ORG's year 20XX Form 990. The agent mailed the audit letter to ORG on December

10, 20XX. The agent conducted the field audit at the City office of ORG's representative, CPA, CPA on January 10, 20XX. CPA was replaced as representative by CPA, CPA, on March 2, 20XX.

BACKGROUND OF ORG

ORG operated as a for-profit corporation from 19XX until 20XX. ORG was incorporated in City, State on December 13, 19XX. It was a correspondence school organized to train individuals in various self-improvement techniques developed by its founder, Founder. Founder is the father of President.

CO-3 was ORG's predecessor. It was incorporated November 12, 19XX as a for-profit State corporation. All of the rights, title and interest in programs, training, books, recordings and videos were held either by CO-3 or Founder, personally. Ownership of CO-3 passed from Founder to President in 20XX.

According to ORG's meeting minutes dated September 18, 20XX, ORG's board voted unanimously to remove Founder from his position as president of the board of ORG. President was voted to take the position as president.

Following Founder' termination, he demanded that ORG and CO-3 cease using his registered marks, name and likeness. ORG and CO-3, however, continued to use his marks, name and likeness in their print advertisements and on their web sites. As a result, President brought suit against ORG, CO-3, President, and Vice-President. Founder was granted a Motion for Temporary Restraining Order on March 6, 20XX.

Forms 990 and Payments to Officers

ORG's Forms 990 for the years under examination reported as follows:

Figure 1: Forms 990

Among the disbursements ORG made during the years under examination were the following:

Figure 2 — Payments 20XX

Figure 3 — Payments 20XX

Figure 4 — Payments 20XX

Secretary' City Apartment

The payments to CO-4, in 20XX and 20XX, were for ORG board secretary Secretary' apartment at Address in City, State. ORG did not report these payments as compensation to Secretary on its own Forms 990, or on Secretary' Forms W2.

The revenue agent asked ORG, in Information Document Request ("IDR") #3, issued March 16, 20XX, the following question regarding these payments:

Question: What was the reason for not including the value of the City apartment in the W2 of Secretary as a fringe benefit?

ORG's response to IDR #3, received May 16, 20XX, included the following answer to the above question:

Answer: We did not include the value of the City apartment in the W2 of Secretary due to an

oversight. We would be issuing a 1099 for this.

On December 13, 20XX, Secretary sent the agent an email regarding the $$* * * in apartment payments in the year 20XX, which stated as follows:

Unfortunately, I was unable to locate the email correspondence via my old laptop as the PC was non-functional. I had hoped to find the email stating that I was accepting the position with the information included that housing was a condition of employment. As such, for now, I have paid the $$* * * to ORG and have attached evidence of this.

Attached to the email was a scanned check written by Secretary to ORG for $$* * *, and a scanned letter from ORG, signed by President, acknowledging receipt of the check.

On February 8, 20XX, Secretary sent the agent an email regarding the $$* * * in apartment payments in the year 20XX, which stated as follows:

ORG did not report the payment to me of the apartment I resided in as compensation. As I stated in my earlier correspondence with you, as well as, via telephone, provision of housing was offered by the university as part of my original offer of employment. I also indicated to you previously, that the correspondence which references this is unavailable.

There is no discussion in ORG's Board Meeting minutes of paying for Secretary' apartment as part of her compensation or as a condition of her working for ORG.

Payments to President and Vice-President

The agent requested source documents (e.g. invoices or receipts) to support the payments made to President and Vice-President in 20XX via IDRs #2 and #3. ORG did not initially provide any source documents.

With respect to check #* * * for $* * * ORG stated that $* * * of this went to President "for his 20th anniversary gift in 20XX, to be included in his 20XX payroll". ORG stated that the other $* * * went to Vice-President "for her 10th anniversary gift in 20XX, included in her 20XX payroll".

Regarding the $* * * payment to CO-5, ORG's explanation was as follows:

The payment to CO-5 was classified as consulting fee due to the styling, makeup and other tips they were giving us during the big public relations push to increase marketing. Once we understood the styling tips there were (sic) no need for their services anymore. Their services include hair maintenance and make up services. These were for the benefit of President, President and Lead Trainer.

With respect to check #* * * for $* * *, ORG stated that $* * * of it went to two employees' payroll, and the other $* * * went to Vice-President for "personal" purposes. ORG stated that this amount was "to be included in her 20XX payroll".

On October 11, 20XX, the agent sent reports to President and Vice-President, proposing excise taxes on excess benefit transactions ("EBTs"), as described in Code section 4958, for the year 20XX disbursements shown in Figure 2, above.

On January 17, 20XX, CPA responded to the reports on behalf of the President and Vice-President1. The response had attached to it five "employee expense reports", none of which are legible. It also had attached about 30 receipts, many of which are also not legible. The response included the

following statements:

Taxpayers will agree to reimburse the Company for $* * * for the watch that was purchased for Vice-President.

Taxpayers will agree to reimburse the Company for the $$* * * 20th Anniversary gift to President.

The response argued that the $$* * * payment to CO-5 was justified because, at the time, President was having to make TV appearances to talk about RA-1 (a former ORG student) and the deaths at his State sweat lodge, in an effort to save ORG's public image. The examining agent later viewed footage of President' TV appearances, including one on the CO-6 show.

The response argued that the $$* * * of the $$* * * from check ##* * * that went to Vice-President was included in her reported 20XX compensation prior to the examining agent's January 10, 20XX initial audit appointment, and that it should therefore not be included in EBTs.

Finally, the response went on to state that the President and Vice-President could only produce $$* * * of the requested receipts2. It argued, however, that all of the remaining disbursements to the President and Vice-President were for reimbursements of travel expenses related to conducting ORG's exempt activities, and that the per diem for the dates and locations of this travel amounts to $$* * * for President and $$* * * for Vice-President. The response argues that these per diem amounts, when added to the receipts, comes to $$* * * ($$* * * + $$* * * + $$* * *) and that, compared to this amount, the disbursements made to the President and Vice-President in the year 20XX were reasonable.

On March 26, 20XX, the agent requested source documents to support the disbursements to the President and Vice-President in 20XX and 20XX (in Figures 3 and 4) via IDRs #6 and #7. On May 10, 20XX, ORG responded by providing a CD with a number of receipts and invoices. Many of these receipts are either illegible or bear no relationship to carrying out ORG's exempt activities. For example, ORG submitted, in support of checks #* * * and #* * *, two receipts from CO-7, a luxury watch dealer in City, State and City, State. The receipts reflect the purchase of four Rolex watches; two "Oyster" models" one "Yachtmaster", and one "Submariner", totaling $$* * *. For check #* * *, ORG submitted $$* * * in receipts from CO-8, CO-9, and the CO-10 boutique in City. In support of check #* * *, ORG produced a receipt for a $$* * * CO-11 men's bag.

The agent reviewed all legible receipts that could conceivably be related to ORG's exempt activities, and subtracted them from the corresponding disbursements in Figures 3 and 4. The detailed analysis of valid and invalid receipts is attached as Exhibit A. The results are as follows:

Figure 5 — Unsubstantiated Payments 20XX

Figure 6 — Unsubstantiated Payments 20XX

Figure 7 — Unsubstantiated Payments 20XX

LAW

Internal Revenue Code

Section 501(c)(3) of the Internal Revenue Code provides for exemption from Income Tax for 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, 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.

Section 4958(c) defines the term “excess benefit transaction” as any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit. For purposes of the preceding sentence, an economic benefit shall not be treated as consideration for performance of services unless such organization clearly indicated its intent to so treat such benefit.\

Section 4958(e) defines “applicable tax-exempt organization” as an organization described in either section 501(c)(3) or 501(c)(4) of the Internal Revenue Code or an organization which was so described at any time during the five-year period ending on the date of the excess benefit transaction.

Section 4958(f)(1) defines a “disqualified person” as (A) any person who was, at any time during the five-year period ending on the date of such transaction, in a position to exercise substantial influence over the affairs of the organization, (B) a member of the family of a disqualified person, and (C) a 35% controlled entity.

Section 4958(f)(6) of the Code defines “correction”, with respect to any excess benefit transaction, as the undoing of the excess benefit to the extent possible, and taking any additional measures necessary to place the organization in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards.

Treasury Regulations

Section 1.501(c)(3)-1(a)(1) of the Treasury Regulations (“Regs”) 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)(2) of the Regs 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.

Section 1.501(c)(3)-1(f)(2)(ii) of the Regs provides that, in determining whether to continue to recognize the tax-exempt status of an applicable tax-exempt organization described in section 501(c)(3) that engages in one or more excess benefit transactions that violate the prohibition on inurement under section 501(c)(3), the Commissioner will consider all relevant facts and circumstances, including, but not limited to, the following:

(A) The size and scope of the organization’s regular and ongoing activities that further exempt purposes before and after the excess benefit transaction or transactions occurred;

(B) The size and scope of the excess benefit transaction or transactions (collectively, if more than one) in relation to the size and scope of the organization’s regular and ongoing activities that further exempt purposes;

(C) Whether the organization has been involved in multiple excess benefit transactions with one or more persons;

(D) Whether the organization has implemented safeguards that are reasonably calculated to prevent

excess benefit transactions; and

(E) Whether the excess benefit transaction has been corrected (within the meaning of section 4958(f)(6) and section 53.4958-7), or the organization has made good faith efforts to seek correction from the disqualified person(s) who benefited from the excess benefit transaction.

Section 53.4958-3(c)(2) of the Regs describes individuals having "substantial influence over the affairs of the organization" (per Code section 4958(f)(1)) as including presidents, chief executive officers, chief operating officers, or any person who, regardless of title, has ultimate responsibility for implementing the decisions of the governing body or for supervising the management, administration, or operation of the organization. A person who serves as president, chief executive officer, or chief operating officer has this ultimate responsibility unless the person demonstrates otherwise. If this ultimate responsibility resides with two or more individuals (e.g., co-presidents), who may exercise such responsibility in concert or individually, then each individual is in a position to exercise substantial influence over the affairs of the organization.

Section 53.4958-4(a)(4) provides that certain economic benefits are disregarded for purposes of section 4958, including (i) Nontaxable fringe benefits. An economic benefit that is excluded from income under section 132, except any liability insurance premium, payment, or reimbursement that must be taken into account under paragraph (b)(1)(ii)(B)(2) of this section, and (ii) Expense reimbursement payments pursuant to accountable plans. Amounts paid under reimbursement arrangements that meet the requirements of section 1.62-2(c) of this chapter.

Section 53.4958-4(c)(1) provides that an economic benefit is not treated as consideration for the performance of services unless the organization providing the benefit clearly indicates the intent to treat the benefit as compensation when the benefit is paid. An applicable tax exempt organization is treated as clearly indicating its intent to provide an economic benefit as compensation for services only if the organization provided written substantiation that is contemporaneous with the transfer of the economic benefit at issue. If an organization fails to provide this contemporaneous substantiation, any services provided by the disqualified person will not be treated as provided in consideration for the economic benefit for purposes of determining the reasonableness of the transaction. In no event shall an economic benefit that a disqualified person obtains by theft or fraud be treated as consideration for the performance of services.

Section 53.4958-4(c)(3)(i)(A) provides that an organization's reporting constitutes contemporaneous substantiation to treat a benefit as compensation if the organization reports the benefit as compensation on an original Federal tax information return with respect to the payment (e.g., Form W-2 or 1099); or the recipient disqualified person reports the benefit as income on the person's original Federal tax return (e.g., Form 1040); or there is an approved written employment contract executed on or before the date of the transfer indicating the benefit is compensation; or there is documentation by the organization's authorized body approving the transfer as compensation for services on or before the date of the transfer; or there was written evidence in existence before the due date of the applicable Federal tax return indicating a reasonable belief by the organization that the benefit was a nontaxable benefit as described in Regs section 53.4958-4(c)(2).

Section 53.4958-7(e) provides that when the applicable tax-exempt organization is no longer described in section 501(c)(3), the disqualified person must make correction to another organization described in sections 501(c)(3) and 170(b)(1)(A) (other than sections 170(b)(1)(A)(vii) or (viii)) which has been so described for at least 60 months ending on the date of correction. It further provides that the disqualified person must not be a disqualified person with respect to the organization which receives the correction, and that the organization receiving the correction amount must not allow the disqualified person to make or recommend any grants or distributions by the organization.

Section 1.62-2(b) provides that for purposes of determining “adjusted gross income,” section 62(a)(2)(A) allows an employee a deduction for expenses paid by the employee, in connection with the performance of services as an employee of the employer, under a reimbursement or other expense allowance arrangement with a payor. Section 62(c) provides that an arrangement will not be treated as a reimbursement or other expense allowance arrangement for purposes of section 62(a)(2)(A) if —

(1) Such arrangement does not require the employee to substantiate the expenses covered by the arrangement to the payor, or

(2) Such arrangement provides the employee the right to retain any amount in excess of the substantiated expenses covered under the arrangement.

(c) Reimbursement or other expense allowance arrangement — (1) Defined. For purposes of sections 1.62-1, 1.62-1T, and 1.62-2, the phrase “reimbursement or other expense allowance arrangement” means an arrangement that meets the requirements of paragraphs (d) (business connection), (e) (substantiation), and (f) (returning amounts in excess of expenses) of this section.

(2) Accountable plans — (i) In general. Except as provided in paragraph (c)(2)(ii), if an arrangement meets the requirements of paragraphs (d), (e), and (f) of this section, all amounts paid under the arrangement are treated as paid under an “accountable plan.”

(ii) Special rule for failure to return excess. If an arrangement meets the requirements of paragraphs (d), (e), and (f) of this section, but the employee fails to return, within a reasonable period of time, any amount in excess of the amount of the expenses substantiated in accordance with paragraph (e) of this section, only the amounts paid under the arrangement that are not in excess of the substantiated expenses are treated as paid under an accountable plan.

(3) Nonaccountable plans — (i) In general. If an arrangement does not satisfy one or more of the requirements of paragraphs (d), (e), or (f) of this section, all amounts paid under the arrangement are treated as paid under a “nonaccountable plan.” If a payor provides a nonaccountable plan, an employee who receives payments under the plan cannot compel the payor to treat the payments as paid under an accountable plan by voluntarily substantiating the expenses and returning any excess to the payor.

(ii) Special rule for failure to return excess. If an arrangement meets the requirements of paragraphs (d), (e), and (f) of this section, but the employee fails to return, within a reasonable period of time, any amount in excess of the amount of the expenses substantiated in accordance with paragraph (e) of this section, the amounts paid under the arrangement that are in excess of the substantiated expenses are treated as paid under a nonaccountable plan.

(4) Treatment of payments under accountable plans. Amounts treated as paid under an accountable plan are excluded from the employee’s gross income, are not reported as wages or other compensation on the employee’s Form W-2, and are exempt from the withholding and payment of employment taxes.

(5) Treatment of payments under nonaccountable plans. Amounts treated as paid under a nonaccountable plan are included in the employee’s gross income, must be reported — as wages or other compensation on the employee’s Form W-2, and are subject to withholding and payment of employment taxes (FICA, FUTA, RRTA, RURT, and income tax). See paragraph (h) of this section. Expenses attributable to amounts included in the employee’s gross income may be deducted, provided the employee can substantiate the full amount of his or her expenses (i.e., the amount of

the expenses, if any, the reimbursement for which is treated as paid under an accountable plan as well as those for which the employee is claiming the deduction) in accordance with sections 1.274-5T and 1.274(d)-1 or section § 1.162-17, but only as a miscellaneous itemized deduction subject to the limitations applicable to such expenses (e.g., the 80-percent limitation on meal and entertainment expenses provided in section 274(n) and the 2-percent floor provided in section 67).

(d) Business connection — (1) In general. Except as provided in paragraphs (d)(2) and (d)(3) of this section, an arrangement meets the requirements of this paragraph (d) if it provides advances, allowances (including per diem allowances, allowances only for meals and incidental expenses, and mileage allowances), or reimbursements only for business expenses that are allowable as deductions by part VI (section 161 and the following), subchapter B, chapter 1 of the Code, and that are paid or incurred by the employee in connection with the performance of services as an employee of the employer. The payment may be actually received from the employer, its agent, or a third party for whom the employee performs a service as an employee of the employer, and may include amounts charged directly or indirectly to the payor through credit card systems or otherwise. In addition, if both wages and the reimbursement or other expense allowance are combined in a single payment, the reimbursement or other expense allowance must be identified either by making a separate payment or by specifically identifying the amount of the reimbursement or other expense allowance.

(3) Reimbursement requirement — (i) In general. If a payor arranges to pay an amount to an employee regardless of whether the employee incurs (or is reasonably expected to incur) business expenses of a type described in paragraph (d)(1) or (d)(2) of this section, the arrangement does not satisfy this paragraph (d) and all amounts paid under the arrangement are treated as paid under a nonaccountable plan. See paragraphs (c)(5) and (h) of this section.

(ii) Per diem allowances. An arrangement providing a per diem allowance for travel expenses of a type described in paragraph (d)(1) or (d)(2) of this section that is computed on a basis similar to that used in computing the employee’s wages or other compensation (e.g., the number of hours worked, miles traveled, or pieces produced) meets the requirements of this paragraph (d) only if, on December 12, 1989, the per diem allowance was identified by the payor either by making a separate payment or by specifically identifying the amount of the per diem allowance, or a per diem allowance computed on that basis was commonly used in the industry in which the employee is employed. See section 274(d) and section 1.274(d)-1. A per diem allowance described in this paragraph (d)(3)(ii) may be adjusted in a manner that reasonably reflects actual increases in employee business expenses occurring after December 12, 1989.

(e) Substantiation — (1) In general. An arrangement meets the requirements of this paragraph (e) if it requires each business expense to be substantiated to the payor in accordance with paragraph (e)(2) or (e)(3) of this section, whichever is applicable, within a reasonable period of time. See section 1.274-5T or section 1.162-17.

(2) Expenses governed by section 274(d). An arrangement that reimburses travel, entertainment, use of a passenger automobile or other listed property, or other business expenses governed by section 274(d) meets the requirements of this paragraph (e)(2) if information sufficient to satisfy the substantiation requirements of section 274(d) and the Regs thereunder is submitted to the payor. See section 1.274-5. Under section 274(d), information sufficient to substantiate the requisite elements of each expenditure or use must be submitted to the payor. For example, with respect to travel away from home, section 1.274-5(b)(2) requires that information sufficient to substantiate the amount, time, place, and business purpose of the expense must be submitted to the payor. Similarly, with respect to use of a passenger automobile or other listed property, section 1.274-5(b)(6) requires that information sufficient to substantiate the amount, time, use, and business purpose of the expense must be submitted to the payor. See section 1.274-5(g) and (j), which grant the

Commissioner the authority to establish optional methods of substantiating certain expenses. Substantiation of the amount of a business expense in accordance with rules prescribed pursuant to the authority granted by section 1.274-5(g) or (j) will be treated as substantiation of the amount of such expense for purposes of this section.

(3) Expenses not governed by section 274(d). An arrangement that reimburses business expenses not governed by section 274(d) meets the requirements of this paragraph (e)(3) if information is submitted to the payor sufficient to enable the payor to identify the specific nature of each expense and to conclude that the expense is attributable to the payor's business activities. Therefore, each of the elements of an expenditure or use must be substantiated to the payor. It is not sufficient if an employee merely aggregates expenses into broad categories (such as "travel") or reports individual expenses through the use of vague, nondescriptive terms (such as "miscellaneous business expenses"). See section 1.162-17(b).

(f) Returning amounts in excess of expenses — (1) In general. Except as provided in paragraph (f)(2) of this section, an arrangement meets the requirements of this paragraph (f) if it requires the employee to return to the payor within a reasonable period of time the amount paid under the arrangement in excess of the expenses substantiated in accordance with paragraph (e) of this section. The determination of whether an arrangement requires an employee to return amounts in excess of substantiated expenses will depend on the facts and circumstances. An arrangement whereby money is advanced to an employee to defray expenses will be treated as satisfying the requirements of this paragraph (f) only if the amount of money advanced is reasonably calculated not to exceed the amount of anticipated expenditures, the advance of money is made on a day within a reasonable period of the day that the anticipated expenditures are paid or incurred, and any amounts in excess of the expenses substantiated in accordance with paragraph (e) of this section are required to be returned to the payor within a reasonable period of time after the advance is received.

GOVERNMENT'S POSITION

ORG's 501(c)(3) status should be revoked, effective January 1, 20XX, based on the substantial inurement evidenced by the payments shown in Figures 5, 6, and 7 above. The examining agent has requested documentation and explanations for the above payments. ORG, the President and Vice-President, and Secretary have provided what documentation and explanations they could. The payments to or for these individuals that have either been acknowledged as benefiting them, or that still remain unsubstantiated total $* * * for 20XX, $* * * for 20XX, and $* * * for 20XX. This inurement violates section 501(c)(3) of the Internal Revenue Code and section 1.501(c)(3)-1(c)(2) of the Treasury Regulations.

The payments for Secretary' City apartment constitute inurement and EBTs. They benefited her through the provision of free housing. There was no contemporaneous substantiation that it was ORG'S intent to treat these payments as compensation for services.

The $$* * * from check ##* * * constitutes inurement and an EBT to President. It was not reported as compensation to President on any Form W2 issued to him, nor on any of ORG's Forms 990s filed prior to the December 20XX commencement of the IRS examination. This payment should have been included in President' year 20XX Form W2, issued in January of 20XX. The President and Vice-President acknowledged in the January 17th response that this $$* * * "gift" should be reimbursed.

The $* * * from check #* * * constitutes inurement and an EBT to Vice-President. The January 17th response acknowledged that this was for the purchase of a watch for Vice-President, and that it should be reimbursed.

The $$* * * from check ##* * * constitutes inurement and an EBT to Vice-President. It was not reported as compensation to Vice-President on any Form W2 issued to her, nor on any of ORG's Forms 990s filed prior to the December 20XX commencement of the IRS examination. This payment should have been included in Vice-President' year 20XX Form W2, issued in January of 20XX. In any event, ORG's issuing of Vice-President' 20XX W2 in January 20XX came after the commencement of the IRS examination. It therefore does not meet the contemporaneous substantiation requirement of Regs section 53.4958-4(c)(3)(i)(A). ORG's inclusion of this amount on President and Vice-President compensation for the year 20XX is not a mitigating factor.

The rest of the unsubstantiated payments to President and Vice-President, shown in Figures 5, 6, and 7 also constitute inurement and EBTs. They benefited the President and Vice-President in the form of outright cash payments, mostly in $* * * denominations. These payments were not part of an accountable plan. They failed, variously, sections (d), (e), and (f) of Regs section 1.62-2. The shopping at CO-11 and other boutiques, and purchases of multiple Rolex watches fail the section 1.62-2(d) business connection requirement. And the rest of the unexplained excess reimbursements fail both the section 1.62-2(e) and (f) substantiation and return of excess requirements.

The argument in the January 17th response to the Code section 4958 reports that the total of receipts should be added to the total of per diem is not logical. Reimbursement arrangements are either "actual" or "per diem". To the extent that ORG had a particular reimbursement arrangement in place, it is clear, from the fact that it used "employee expense reports", that it was not based on per diem. It should be noted that this report only cites the excess of reimbursements over what has been substantiated as having a business connection. An employee would never be entitled to "reimbursement" of both actual and per diem, as was suggested in the response. The unsubstantiated payments in Figures 5, 6, and 7 thus constitute inurement and EBTs.

With respect to section 1.501(c)(3)-1(f)(2)(ii) of the Treasury Regs, the analysis of the five factors set forth therein is as follows:

(A) The size and scope of the organization's regular and ongoing activities that further exempt purposes before and after the excess benefit transaction or transactions

No evidence was gathered during the examination to suggest that there was any fluctuation in ORG's activities. Furthermore, due to the frequency of the payments at issue, being evenly spread throughout each year, no distinction can be made between ORG's activities "before and after" these payments. The qualification of ORG's activities for 501(c)(3) status are not being challenged in this report. Thus, this factor weighs neither in favor of, nor against, revocation.

(B) The size and scope of the excess benefit transaction or transactions in relation to the size and scope of the organization's regular and ongoing exempt activities

ORG does not have any "ongoing" exempt activities. It voluntarily became a for-profit entity on June 1, 20XX. Inasmuch as ORG's revenues reflect its exempt activities, its revenues during the years under examination, while it was still exempt, was $* * *. The inurement and EBTs cited above total $* * *, or about * * *%. This is a significant amount of inurement and EBTs, and weighs in favor of revocation.

(C) Whether the organization has been involved in multiple excess benefit transactions with one or more persons

ORG engaged in over sixty EBTs during the years under examination. These transactions involved three different officers; President, Vice-President, and Secretary. This weighs in favor of revocation.

(D) Whether the organization has implemented safeguards that are reasonably calculated to prevent excess benefit transactions

ORG forfeited its own 501(c)(3) exemption June 1, 20XX. At issue, then, is whether its exemption should also be revoked for the period of January 1, 20XX to May 31, 20XX. It is evident that no safeguards were put in place to prevent EBTs from 20XX to 20XX, or from 20XX to 20XX. On the contrary, President has even more unfettered control over ORG's assets, now that ORG is owned by his wholly-owned company, CO-3. This factor weighs in favor of revocation.

(E) Whether the excess benefit transaction has been corrected (within the meaning of section 4958(f)(6)), or the organization has made good faith efforts to seek correction from those who benefited from the excess benefit transaction

As of the date of this report, ORG is no longer described in section 501(c)(3) of the Internal Revenue Code. Repayments to ORG would not qualify as "correction" within the meaning of section 4958(f)(6). Therefore, per Regs section 53.4958-7(e), any correction to be made by the President and Vice-President or Secretary would have to go to a different 501(c)(3) organization. As of the date of this report, no correction has been made to such a 501(c)(3) organization. Therefore, applying this factor would weigh in favor of revocation.

TAXPAYER'S POSITION

ORG has not yet taken a position with respect to this report.

CONCLUSION

ORG's earnings have inured to the benefit of three of its officers, President, Vice-President, and Secretary. This inurement totaled $* * * during the years 20XX, 20XX, and 20XX. This is a substantial amount of inurement, and violates section 1.501(c)(3)-1(c)(2) of the Treasury Regs. Given the routine and continuous nature of the inurement, this warrants revocation of ORG's 501(c)(3) status effective January 1, 20XX. ORG should file Form 1120, U.S. Corporation Income Tax Return, for the years 20XX and 20XX, and for the period ended May 31, 20XX. If the proposed revocation becomes final, appropriate State officials will be notified in accordance with Code section 6104(c).

FOOTNOTES

1 CPA also represented the President and Vice-President in their Code section 4958 examinations until March 20XX, when they appointed CPA as their representative.

2 The agent found that the legible receipts only totaled $$* * * which included $$* * * in hotel receipts. The $$* * * CO-5 invoice was discussed separately and so presumably was not included in the $$* * *.