

Internal Revenue Service
Appeals Office
55 S. Market St., Ste. 440
San Jose, CA 95113

Release Number: **201331008**
Release Date: 8/2/2013
Date: May 10, 2013

Department of the Treasury

Taxpayer Identification Number:

Person to Contact:

Employee ID#:
Tel:
Fax:
Contact Hours:
Tax Period(s) Ended:

UIL: 0501.33-00

Certified Mail

Dear :

This is a final adverse determination regarding your exempt status under section 501(c)(3) of the Internal Revenue Code (the "Code"). It is determined that you do not qualify as exempt from Federal income tax under section 501(c)(3) of the Code effective January 1, 2006.

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

- You are not operated exclusively for exempt purposes as described in section 501(c)(3) of the Code.
- You operate for the substantial non-exempt purpose of acting as a tool to enhance the sales of health products of a for-profit entity.
- Most of your membership fees are returned to a for-profit entity for products the for-profit entity sends to your members.
- You operate for the substantial non-exempt purpose of investing in for-profit entities.
- You have made distributions to for-profit entities without exercising the requisite discretion and control to ensure that the funds were spent for exempt purposes.

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

You are required to file Federal income tax returns on Forms 1120 for the tax periods stated in the heading of this letter and for all tax years thereafter. File your return with the appropriate Internal Revenue Service Center per the instructions of the return. For further instructions, forms, and information please visit www.irs.gov.

If you were a private foundation as of the effective date of revocation, you are considered to be taxable private foundation until you terminate your private foundation status under section 507 of the Code. In addition to your income tax return, you must also continue to file Form 990-PF by the 15th Day of the fifth month after the end of your annual accounting period.

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 Code.

If you decide to contest this determination, you may file an action for declaratory judgment under the provisions of section 7428 of the Code in one of the following three venues: 1) United States Tax Court, 2) the United States Court of Federal Claims, or 3) the United States District Court for the District of Columbia. A petition or complaint in one of these three courts must be filed within 90 days from the date this determination letter was mailed to you. Please 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. See also Publication 892.

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 matters that may not have been resolved through normal channels get prompt and proper handling. If you want Taxpayer Advocate assistance, please contact the Taxpayer Advocate for the IRS office that issued this letter. You may call toll-free, 1-877-777-4778, for the Taxpayer Advocate or visit www.irs.gov/advocate for more information.

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

Sincerely Yours,

Appeals Team Manager

Enclosure: Publication 892

cc:

**Internal Revenue Service
Tax Exempt and Government Entities Division
3730 Elizabeth Ave.
Independence, MO 64057**

Department of the Treasury

Date: November 9, 2010

LEGEND

ORG - Organization name
XX - Date Address - address

**ORG
ADDRESS**

Taxpayer Identification Number:

Form:

Tax Year(s) Ended:

Person to Contact/ID Number:

Contact Telephone Number:

Contact Fax Number:

**CERTIFIED MAIL - RETURN RECEIPT
REQUESTED**

Dear

We have enclosed a copy of our report of examination explaining why we believe revocation of your exempt status under section 501(c)(3) of the Internal Revenue Code 509(a)(2) is necessary.

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

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

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

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

If we do not hear from you within 30 days from the date of this letter, we will process your case based on the recommendations shown in the report of examination. If you do not protest this proposed determination within 30 days from the date of this letter, the IRS will consider it to be a failure to exhaust your available administrative remedies. Section 7428(b)(2) of the Code provides, in part: "A declaratory judgment or decree under this section shall not be issued in any proceeding unless the Tax Court, the Claims Court, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted its administrative remedies within the Internal Revenue Service." We will then issue a final revocation letter. We will also notify the appropriate state officials of the revocation in accordance with section 6104(c) of the Code.

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

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

Thank you for your cooperation.

Sincerely,

Nanette M. Downing
Director, EO Examination

Enclosures:
Publication 892
Publication 3498
Report of Examination

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

LEGEND:

ORG - Organization name ORG-1 - ORG-1 EIN - EIN XX - Date
 State - state motto - motto Country - country Book - book
 DIR-1 through DIR-6 - 1st through 6th DIR Director - Director CO-1
 through CO-14 - 1st through 14th COMPANIES RA-1 - 1st RA

ISSUES:

Whether ORG is operated exclusively for exempt purposes within the meaning Section 501(c)(3) of Internal Revenue Code.

FACTS:

ORG (Foundation), Employer Identification Number EIN, was incorporated in the State of State on March 16, 19XX as CO-1. The Internal Revenue Service (IRS) recognized the CO-1 (now the Foundation) as a tax-exempt organization described in section 501(c)(3) of the Internal Revenue Code by letter dated January 26, 19XX.

The Foundation states its mission on its Form 990 for 20XX as follows: "To educate the public about and to support and fund scientific research to develop new methods of Motto."

On its Form 990 for 20XX, the Foundation states, "Its goal is the extension of the Motto. In achieving its goals, ORG supports groundbreaking research on therapies to extend the Motto by seeking methods to

On its Form 990 for 20XX, the Foundation states that it "is dedicated to finding new scientific methods for eradicating old age, disease and death. Its exempt purpose includes groundbreaking research on therapies to extend the Motto by seeking methods to

In a letter dated November 25, 20XX, the Foundation states that its "primary activity is to provide grants for scientific research in the field of -biological research."

The Foundation reported no compensation to any of its Directors, DIR-1, DIR-2, DIR-3, DIR-4, DIR-5, and DIR-6 on its Form 990 for 20XX. In addition, it reported no compensation of the five highest paid employees other than officers, directors, and

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trustees and no compensation of the five highest paid independent contractors (for other than professional services) during 20XX. Further, it reported no salaries and wages of employees not included in the above categories on Part II, Line 26 of its Form 990 for 20XX. In Statement 5 attached to its Form 990 for 20XX, the Foundation did report "Salary-Executive Director" in the amount of \$ and "Payroll Taxes" in the amount of \$.

The Foundation also states in its Form 990 for 20XX that it "funded through grants, in excess of \$ to the following research facilities CO-2, CO-3, CO-4, CO-5, and CO-6. "

When asked to provide a copy of the grant application used by the Foundation, it responded in its letter dated November 25, 20XX, "The Foundation does not have a formal grant application." In the same letter, it described its criteria for grant award decisions as follows:

Initially, the funding decisions were made based upon the types of research already being conducted by the recipient entities and scientists. The world of -biological research is conducted by a limited number of scientists, and so the scientists on the Board of Directors were generally familiar with the organizations and scientists who were best positioned to conduct the types of research that the Foundation wished to fund in furtherance of its exempt purpose. These decisions were made through an ongoing process of oral discussions, board meetings, review of scientific results, and laboratory site visits by Board members.

The Foundation is funded primarily by amounts it terms as "membership dues and assessments" and "Royalty Income - Co-9." For 20XX, it reported revenue on its Form 990 in the amount of \$ in Part 1, Line 3, from "Membership dues and assessments." It also reported "Other revenue" in the amount of \$\$ in Part 1, Line 11. In Part VII, Line 103b, it reported the source of the amount of \$\$ as "Royalty Income - Co-9." As noted above, it reports no key employees and no salaries paid to directors.

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In Part VII of its Form 990 for 20XX, the Foundation explains how each activity for which income is reported in column E of Part VII contributed importantly to the accomplishment of the organization's exempt purpose (other than by providing funds for such purposes) as follows:

"To support scientific and medical research and gather and publish information relating to Motto."

During the on-site examination, the Foundation provided brochures used by the Foundation. In one brochure, CO-7 members are encouraged to "Sign up for ORG Membership!" and receive (1) a 6-month subscription to the CO-8, (2) discounts of % to % on all ORG products, (3) direct access via toll-free numbers to knowledgeable health advisors "who can help you personalize a unique ORG program . . . ," (4) a ORG Product Directory ("a comprehensive listing of products and therapies from around the world, many available only from ORG," (5) "access to mail-order blood testing kits that can help you identify correctable disease risk factors," and (6) "[o]ne bottle of ORG's Vitamin."

All these benefits are provided for a six-month membership fee of \$. The brochure also states that ORG is "the world's largest non-profit organization dedicated to ongoing research in Motto" and that "ORG offers you the most advanced ORG therapies in the world as they are developed."

Another brochure offers 12 issues of CO-8 and a free one-year membership for \$. The brochure states that the offer expires February 28, 20XX.

A third brochure states that "ORG is the world's premier organization dedicated to investigating scientific therapies to promote Motto." It also states the following:

The ORG financially supports innovative research projects seeking to Motto. ORG maintains contact with leading medical and Researchers around the world to obtain the latest breakthroughs. The ORG is a renowned leader in developing pharmaceutical grade and pharmaceutical quality supplements.

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This brochure provided a brief description of some of the most popular products ORG members take to stay healthy.

A letter to former members provides a brochure describing "only a few of the 600 pharmaceutical quality supplements available to Foundation members at near **wholesale prices.**" The letter offers renewal of membership for \$ and "up to \$ (retail value) worth of any products offered by the ORG - **ABSOLUTELY FREE.**" The letter states that the offer expires October 30, 20XX.

The activities of the Foundation and CO-9 are intertwined. "Royalty fees" paid to the Foundation are likely included in deductions taken by the CO-9 as are salary expenses.

The magazines sent to members contain many advertisements for nutritional supplements sold by CO-9 and include CO-9 order forms for the products advertised. Further, an advertisement for a particular product often follows an article touting its benefits. In a letter dated November 25, 20XX, the Foundation stated that the "CO-9 provides the magazines free of charge to the Foundation and its members." In the same letter, the Foundation stated, "The CO-9 does not have any members."

The top inside cover of January of 20XX issue of the "ORG" magazine states the following: "At the end of each year, prices are discounted on all products offered by the ORG. The annual sale enables members to obtain pharmaceutical-grade supplements at prices substantially **below** what commercial companies charge."

At the bottom of the inside cover, the same issue states the following: "The sale extends to January 31, 20XX. Members traditionally take advantage of the sale to stock up on a year's supply of their favorite supplements. To place your order, call # or visit website. (sale pricing available only to members in the US, Country, and Country.)"

The same issue of the magazine contains a 12-page order form in the back that lists over 1,000 different supplements, 40 books, and 25 different blood tests that can be ordered.

The name "ORG" was used by another organization until June 15, 20XX, when CO-1 and the former ORG agreed that CO-1, would

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change its name to ORG and the former ORG would change its name to ORG-1 See **Exhibit I**.

Exhibit III, pages 4 and 5 states, in 19XX, the directors of the ORG-1, (Society) formerly ORG, stated that its involvement in health product sales was interfering with its charitable and educational activities. The Society directors also determined that CO-1, (now the Foundation) was in a better position to sell the health nutrients and health supplements activities to a for-profit entity. The transfer of the Society's health products sales operation to CO-1, (now the Foundation) occurred on December 31, 19XX; the Foundation then sold the health supplements sales operation to for-profit corporation ORG, (CO-9) on the same day, Dec. 31, 19XX. The transaction did not include ownership rights to "DIRECTOR" (including associated goodwill), membership list or non-operating assets or liabilities. Please also refer to Exhibit II.

The CO-9 was incorporated in State on December 6, 19XX. On December 31, 19XX, it purchased "inventory, licensing rights, customer mailing lists and certain other intangibles [from the Foundation] for \$." (See Exhibit VII, p. 3 of CO-9 stock valuation report.) The CO-9 employed 120 people in 20XX; its corporate headquarters are located in State. It also maintains a distribution center in State. Id. In 20XX, the CO-9 had 112,000 active members and 23,000 subscribers to its monthly magazine. Id. We note that the CO-9 stock valuation report's statement concerning the number of members of the CO-9 contrasts with the response by the Foundation that the CO-9 had no members.

Accounting and Trust Agreement (Exhibit II)

On December 31, 19XX, the health product business was transferred from the original ORG (now Society) to CO-1 (now Foundation). The health product business was then sold to CO-9 a for-profit entity. See the "Recitals" section of the Accounting and Trust Agreement, **Exhibit II**.

The Accounting and Trust Agreement recites the following: ORG, (now Society), CO-1 (now Foundation), and the CO-9 engaged in two transactions on Dec. 31, 19XX: (1) ORG, (now Society) transferred certain assets and liabilities to the CO-1 (now

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Foundation). The assets included its mailing list, inventory of certain vitamins, health supplements and related items, its name, logo, trademarks, tradenames, and certain other intangible assets. (2) In the second transaction, CO-1 (now Foundation) transferred to the CO-9 certain assets and liabilities. The assets transferred consisted generally of the sale the health nutrients and health supplements business, the granting of licensing rights by CO-1 (now Foundation), and the licensing of the mailing list.

According to the "Recitals" in the Accounting and Trust Agreement, on May 28, 19XX, effective December 31, 19XX, the parties executed a contract of Sale and Assignment of Lease to document the transfer of inventory items and a Royalties Agreement to document the granting of licensing rights and mailing list license agreement. This formal agreement was not executed until July 20, 19XX, even though the transfer of assets took place on Dec. 31, 19XX. Other agreements, including oral agreements were in place before the Accounting and Trust Agreement was formalized in writing.

The Accounting and Trust Agreement affirms the health product business was not conducted by the Foundation, but was initially conducted by the Society. The Society transferred its health product business to the Foundation; the health product business was then purchased from the Foundation by the CO-9.

The CO-9 is owned by the following: DIR-3 Revocable Trust is a percent shareholder, Trustees DIR-3 and DIR-2; CO-10 is a percent shareholder, Trustee DIR-2; and percent is now owned by the Foundation.

Business Valuation Report (Exhibit III)

The fair market value of the health products business transferred to CO-1, (now Foundation) by the Society was determined in an appraisal dated January 19, 20XX. The nature of the business was described as mail-order vitamins, vitamin supplements and retail outlets. The fair market value of the business transferred to the Foundation by the Society was determined to be \$, as of December 31, 19XX.

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The fair market value of the business sold to the CO-9 by the Foundation was determined to be \$, as of Dec. 31, 19XX. The business transferred to the CO-9 specifically excluded the name, logos, trademarks, trade names, service marks, and related goodwill, the membership list; and the non-operating assets and liabilities.

Amended Royalties and License Agreement (Exhibit IV)

The Amended Royalties and License Agreement between the Foundation and the CO-9, dated March 1, 20XX states at Recital B, "The parties have agreed that CO-9 shall pay Foundation a royalty as specified herein, based upon CO-9's sales, for CO-9's use of Foundation's name, logo, trademarks, service marks, tradenames, trade dress, and other intangible assets, (collectively, "DIRECTOR") all of which are owned by Foundation." The Foundation reported receipt of yearly royalties in the amounts of \$\$ in 20XX, \$ in 20XX, and \$ in 20XX on its Forms 990.

Product Expense Agreement (Exhibit V)

The Foundation entered into a Product Expense Agreement with the CO-9 on February 20, 20XX. In the Product Expense Agreement, the Foundation agrees to distribute annual renewal notices to individuals who are currently members. The renewal notices encourage members to pay annual dues to the Foundation in order to receive educational material, discounts on health products sold by the CO-9 and other benefits. The Foundation and the CO-9 agreed that the Foundation will pay \$ to the CO-9 for each renewing member for the cost of health products shipped to each renewing member. The Product Expense Agreement states that the approximate retail value of the health products offered to each renewing member is \$ and that the \$ valuation was determined as of January 1, 20XX.

The Foundation reported receipt of total membership fees for the years 20XX, 20XX, and 20XX, in the respective amounts of \$, \$, and \$. Of these amounts, the Foundation reported paying to the CO-9 the amounts of \$, \$, and \$ for products offered to members for membership fees.

Expense Agreement (Exhibit VI)

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The Foundation also entered into an Expense Agreement with the CO-9. The Expense Agreement states the following:

The parties agree that expenses shall be shared between the parties in the following percentages: CO-9 shall pay % of said expenses and Foundation shall pay % of said expenditures based upon the parties' relative interests in said mailings. The parties' relative interests reflect the historical relationship of the parties and the historical pattern of payments for the above-defined expenses after an arm's length negotiation.

The Expense Agreement addresses the sharing of expenses for the distribution of educational materials, materials distributed to attract new members, and printing and postage expenses related to the membership drives.

**Convertible Debentures and CO-9 Stock Valuation
(Exhibit VII)**

The Foundation purchased two convertible debentures, one each from the DIR-3 Revocable Trust and the CO-10, issued by the CO-9 on September 18, 20XX. Each debenture was valued at \$ and reported as an investment on the 20XX Form 990 balance sheet. Unless paid earlier, all accrued interest and the unpaid amount will be due on September 18, 20XX. The Foundation provided a valuation opinion of CO-9 stock as of December 15, 20XX, prepared by CO-11 which valued a 1 percent common stock interest in the CO-9 at \$.

Promissory Note/Payments Received (Exhibits VIII-A and VIII-B)

When the CO-9 initially purchased the health product business, the venture was financed through the Foundation. During the tax years 20XX, 20XX, and 20XX, various amounts were due to be paid to the Foundation by the CO-9. In January 13, 20XX a promissory note, the CO-9 promised to pay \$ to the Foundation on demand or before 90 days from the date of the note. The note had a provision for interest and the amount due was paid to the

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Foundation. Loans and notes between the Foundation and the CO-9 were generally unsecured loans. See **Exhibit VIII-A**. During 20XX the CO-9 made payments of principal and interest to the Foundation in the total amount of \$; at the end of 20XX, the total amount due to the Foundation from the CO-9 was \$. See **Exhibit VIII-B**.

Grants

The Foundation's primary expenditures were in the form of grants provided to section 501(c)(3) organizations and for-profit organizations that were conducting research relating to extending human life. During the 20XX tax year, grants in the amount of \$ were provided to both exempt and for-profit research organizations. The following grants were provided to for-profit research organizations during 20XX: \$ to CO-08; \$ to CO-12; \$ to CO-13; and \$ to CO-14.

The Foundation provided research grants in the total amount of \$ in 20XX, generally to for-profit organizations: The total amount of \$ was provided to the following for-profit entities: \$ to CO-08; \$ to CO-12; \$ to CO-13; and \$ to CO-14.

The Foundation provided research grants in the total amount of \$ in 20XX. The total amount of \$ was provided to for-profit organizations: \$ to CO-08; \$ to CO-12; \$ to CO-13; and \$ to CO-14.

DIR-3, the Foundation's board member and part owner of the CO-9 (though his trust), serves on the Board of Directors of the four for-profit research organizations that were provided with grants; DIR-3 was also acting as Chief Executive Officer of CO-14 in 20XX. RA-1, also a member of the Foundation's board and part owner of the CO-9, serves on the board for CO-14. RA-1 owns _____ shares out of more than _____, or less than .% of the shares in CO-08. The majority of the shares of stock in CO-13 and CO-08 are owned by the Foundation. Although the Foundation publicizes the grants that it awards in scientific trade journals, it has no formal grant application process. The Foundation states that its directors continually reviewed the progress of its funded research and awards grants based upon that progress. (See Letter dated November 25, 20XX). Initially, the funding decisions were based upon the type of research

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already being conducted by the recipient entities and scientists. The world of -biological research was being conducted by a limited number of scientists, and the scientists on the Foundation Board who were familiar with the scientists would provide insight to who should be funded.

The Foundation stated that funding decisions were made through ongoing discussions, board meetings, review of scientific results and laboratory site visits by the board members. The supported for-profit organizations did not provide any financial reports regarding how the funds were used, but did provide reports regarding the research that is being conducted. CO-08 provided an operating budget for 20XX, with financial information. The intellectual property funded by the grants is owned by the research facilities that are conducting the research. To avoid any appearance of private benefit flowing to these research facilities as a result of the funded research, the Foundation has required that the for-profit research facilities issue stock to the foundation, so that if any of the products are successful as a result of the research, the Foundation will also benefit.

Employees/Donated Services

Generally, the Foundation does not have any employees and the services that are provided to operate the organization are provided by the CO-9. During 20XX, the Foundation had an executive director, but the Foundation determined that it was more cost efficient to operate the Foundation with the CO-9's employees. The Foundation reports that donated services are generally provided by the CO-9. The Foundation stated that the following donated services were provided in 20XX by the CO-9: executive allocation in the amount of \$, accounting services in the amount of \$, marketing services in the amount of \$ and shipping in the amount of \$. The Foundation indicated that the donated services are of a volunteer nature and consist of bookkeeping services, legal services, mailing and postage services and medical consulting services to the Foundation's members.

Website

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The membership information is posted on the CO-9's website, . The Foundation stated that this website is the property of the CO-9. The website was purchased by the CO-9 and is now maintained by the CO-9. The Royalties Agreement entered into between the parties in December of 19XX provided for a payment to the Foundation from the CO-9 for use of the Foundation's name on the website. The CO-9 website is used to sell health products, nutrients and health supplements for the CO-9. The membership information on the website applied to the Foundation.

When a membership is purchased, the following benefits are generally available to the Foundation's members:

- The cover price is \$, but is sent #-page reference book called **BOOK**. to new ORG members without additional charge.
- *CO-8*, an over 100-page monthly publication, filled with medical research findings, scientific reports, and practical guidance about using nutritional supplements and hormones to _____. The magazine is produced by the CO-9 and is the property of the CO-9; it contains articles and advertising that promotes health products sales.
- Access to a toll-free phone line where members can speak with health advisors and medical doctors about their nutrition and health concerns. These advisors can also help members design a personalized health maintenance program that includes nutritional supplements and hormones.
- The *ORG Product Directory* a comprehensive listing of vitamins, _____ supplements, and hormones.
- A % discount on nutritional supplements, vitamins and mail-order blood testing services.

See Exhibits IX and X.

Membership mailings

The Foundation has various mailings to attract members; the mailings generally offer the following to its members:

- A 6 month subscription to CO-8.
- Discounts of % to % on all CO-9's products. Special sales throughout the year enable members to receive higher discounts on these products.

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- Direct access via a special toll-free-phone number to health advisors who can help personalize a ORG program and provide answers to health questions.
- ORG Product Directory - a listing of products and therapies from around the world, many available only from the CO-9.
- Access to mail-order blood testing kits to help identify correctable disease risk factors.
- Free product such as a bottle of "Vitamin".

See Exhibit XI.

Membership Expenditures

The following membership expenditures are stated on the Foundation's Forms 990: (1) For 20XX, membership expenditures included postage and shipping in the amount of \$ and printing and publications costs of \$; (2) for 20XX, membership expenditures included postage and shipping in the amount of \$ and printing and publications costs of \$; and (3) for 20XX, membership expenditures included printing and postage in the amount of \$.

LAW:

Section 501(a) of the Internal Revenue Code provides that an organization described in section 501(c)(3) is exempt from income tax. Section 501(c)(3) of the Code exempts from federal income tax corporations that are organized and operated exclusively for charitable, educational, and other specified purposes, provided that no part of the net earnings inure to the benefit of any private shareholder or individual.

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

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Treasury Regulation section 1.501(c)(3)-1(d)(1)(ii) provides that an organization is not organized or operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. Thus, to meet the requirements of this subsection, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests, such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests. Prohibited private interests include those of unrelated third parties as well as insiders. Christian Stewardship Assistance, Inc. v. Commissioner, 70 T.C. 1037 (1978); American Campaign Academy v. Commissioner, 92 T.C. 1053 (1989). Private benefits include an "advantage; profit; privilege; gain; [or] interest." Retired Teachers Legal Fund v. Commissioner, 78 T.C. 280, 286 (1982).

Treasury Regulation section 1.501(c)(3)-1(d)(3) provides that the "term 'educational', as used in section 501(c)(3) relates to" the following:

- (a) The instruction or training of the individual for the purpose of improving or developing his capabilities; or
- (b) The instruction of the public on subjects useful to the individual and beneficial to the community.

Treasury Regulation section 1.501(c)(3)-1(e)(1) provides that 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 purposes of carrying on an unrelated trade or business. In Better Business Bureau of Washington D.C., Inc. v. United States, 326 U.S. 279 (1945), the Supreme Court found that the trade association had an "underlying commercial motive" that distinguished its educational program from that carried out by a university.

In American Institute for Economic Research v. United States, 302 F.2d 934 (Ct. Cl. 1962), the Court considered the status of an organization that provided analyses of securities and

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industries and of the economic climate in general. It sold subscriptions to various periodicals and services providing advice for purchases of individual securities. The Court noted that education is a broad concept, and assumed for the sake of argument that the organization had an educational purpose. The Court concluded, however, that the totality of the organization's activities, which included the sale of many publications as well as the sale of advice for a fee to individuals, was more indicative of a business than that of an educational organization. The Court held that the organization had a significant non-exempt commercial purpose that was not incidental to the educational purpose and that the organization was not entitled to be regarded as exempt.

The Claims Court in Easter House v. United States, 12 Cl. Ct. 476 (1987) held that an organization that provided health services to unmarried mothers and their children as a part of its adoption service did not operate exclusively for an exempt purpose since the health services were provided only as a part of the adoption services that were similar to those provided by commercial businesses.

In Old Dominion Box Co. v. United States, 477 F2d 344 (4th Cir. 1973), the court held that operating for the benefit of private parties constitutes a substantial non-exempt purpose.

Leon A. Beeghly v. Commissioner, 35 T.C. 490 (1960), provided that where an exempt organization engages in a transaction with a related interest with the intent to benefit the private interest rather than the organization, exemption may be lost even though the transaction ultimately proves profitable for the exempt organization.

In Basic Bible Church v. Commissioner, 74 T.C. 846 (1980), the court found that although the organization did serve religious and charitable purposes, it existed to serve the private benefit of its founders, and thus failed the operational test of section 501(c)(3). Control over financial affairs by the founder created an opportunity for abuse and the need to be open and candid about financial matters; the applicant failed to provide information concerning financial affairs..

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In United States v. American Bar Endowment, 106 S.Ct. 2426 (1986), the Supreme Court held that an 501(c)(3) organization's insurance program constituted both the sale of goods and performance of services and, therefore constituted a trade or business for purposes of the computation of tax on unrelated business income. The court determined that the manner in which the American Bar Endowment conducted the activity was like that of a for-profit insurance broker.

Payments for the use of trademarks, trade names, service marks, or copyrights, whether or not payment is based on the use made of such property, are ordinarily classified as royalties for federal tax purposes. See Commissioner v. Affiliated Enterprises, Inc., 123 F.2d 665 (10th Cir. 1941); Commissioner v. Wodehouse, 337 U.S. 369 (1949); Rohmer v. Commissioner, 153 F.2d 61 (2d Cir. 1946); and Sabatini v. Commissioner, 98 F.2d 753 (2d Cir. 1938). Royalties are excluded from the computation of unrelated business income of exempt organizations. I.R.C. § 512(b)(2).

In Revenue Ruling 68-489, 1968-2 C.B. 210, the Service determined that a section 501(c)(3) organization will not jeopardize its exemption even though it distributes funds to organizations that are not themselves charities if the exempt organization "ensure[s]" that the funds are used for permitted purposes by limiting distributions to specific projects that further its own purposes. The exempt organization must also retain control and discretion as to the use of the funds and maintain records establishing that the funds were used for section 501(c)(3) purposes.

Taxpayer's Position:

The Foundation states that it works to further its charitable purpose through promoting the healthy extension of life through publications that are provided to its members, such as the CO-8, the book, BOOK, and articles and information posted on the website.

The Foundation also states that its primary activity is to provide grants for scientific research in the field of biological research. It states further that the grants provided to the for-profit organizations are charitable in nature, even

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though formal grant applications and financial accounting are not required. In addition, the Foundation states, "Due to the specific specialized nature of the scientific research, it is primarily conducted by a small number of research facilities, in addition to scientists at certain universities." It adds that the research facilities equipped to conduct this type of research are well aware of the Foundation as a potential funding source for -biological research.

The Foundation also indicated that the Board of Directors, in particular DIR-3, closely supervises the scientific research and serves on the Board of Directors of the supported for-profit organizations. The Foundation stated that it makes the research results available to the general public and that the Foundation has required the for-profit organizations to issue stock to the Foundation so that the Foundation will benefit if any products are successful as a result of this research.

The Foundation's position concerning the agreements such as the Accounting and Trust Agreement, Royalties Agreements, Product Expense Agreement, Expense Agreement, Debentures, and Promissory Notes to the CO-9 is that they are arm's-length transactions. The Foundation obtained appraisals or used historical information to determine reasonable interest rates and compensation to be paid by the CO-9. The Foundation also maintains that the original purchase agreement with the CO-9 was at arm's-length. The Foundation states that it did not find it necessary to require securitization of the CO-9's debt.

The Foundation stated that the website is the property of the CO-9 and that the CO-9 entered into a Royalties Agreement for the use of the Foundation's name. In addition to being used to solicit sales of the CO-9's products, the website is also used to provide the results of the scientific research to both members and to the general public and to solicit membership in the Foundation. The CO-9 does not have any members.

It is the Foundation's position that the Product Expense Agreement's provision for payments from the Foundation to the CO-9 for the products provided to the Foundation's members provides reimbursement for products provided to the Foundation's members. Rather than percent of the membership dues being paid to the Foundation, CO-9 first receives the membership dues

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and then divides the money pursuant to the Product Expense Agreement. The Foundation states that the Product Expense Agreement is an arm's-length transaction.

Government's Position

The Foundation appears to have provided some funding for research and the magazines and additional information sent to its members appear to provide some educational information on nutrition and health; nevertheless, the Foundation operates to a more than insubstantial extent for the non-exempt purpose of aiding in the sale of nutritional supplements, publications, and blood testing services by a for-profit entity.

In addition, much of the funding for research aids for-profit research organizations with which the founders of the Foundation are associated. The Foundation has no written grant application form and no published criteria for grant selection. No financial reports were provided to ensure that the funds were spent for exempt purposes. See Rev. Rul. 68-489, 1968-2 C.B. 210.

Since the Foundation receives stock from the research organizations to which it awards grants, the grant funding could be viewed as the purchase of stock rather than distribution of grant funds. The selection committee for the grants consists of the Foundation's board, of which DIR-3 and DIR-2 are members. DIR-3 serves on the Board of Directors of the four for-profit organizations (CO-08, CO-13, CO-14, and) that received yearly grants. DIR-3 was also acting as Chief Executive Officer of CO-14 in 20XX; served on CO-14 Board of Directors.

The sale of the health product business to the CO-9 may not have been an arm's-length transaction. The health product business was sold to the CO-9, of which the shareholders were the DIR-3 Revocable Trust and of the CO-9) and DIR-2's CO-10. Although the health product business was sold on December 31, 19XX, the official appraisal regarding the value of the health product business was not obtained until January 19, 20XX. See Exhibits II and III.

The Product Expense Agreement requires the Foundation to distribute annual renewal notices to individuals who are

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currently members. The members pay annual dues to the Foundation to receive educational material, discounts on health products sold by the CO-9 and other benefits relating to improving and extending life. The Foundation and the CO-9 agreed that the Foundation will pay \$ to the CO-9 for each renewing member for the cost of health products shipped to each renewing member. The publications received by the renewing members are marketing tools for the sale of the CO-9's products. Total membership fees reported for the years 20XX, 20XX, and 20XX, respectively, were \$, \$, and \$. During the years 20XX, 20XX, and 20XX, respectively, the amounts of \$, \$ and \$ were paid to the CO-9 for products, based on the Product Expense Agreement.

The website is owned by CO-9 and the Royalties Agreement allows for the use of the Foundation's name on the website. Of the amount paid by each renewing member, \$ is paid to the CO-9 for the cost of health products shipped to each. As noted above, during the years 20XX, 20XX, 20XX, respectively, the amounts of \$, \$, and \$ of the renewing membership dues were paid to the CO-9 for products based the Product Expense Agreement. A large portion of the membership dues ostensibly paid to the Foundation is actually paid to the CO-9 for the health product sales.

The touted membership benefits of the Foundation, such as the magazine subscription, book, website information, CO-9 discounts, personal health plans all help to increase the sale of the CO-9's products.

Although the magazines, books, website, and personal plan information have provided some educational information to the Foundation's members on nutrition and good health, like the organization in American Institute for Economic Research v. United States, 302 F.2d 934 (Ct. Cl. 1962), a more than insubstantial purpose of the Foundation appears to be the sale of CO-9's products. Similarly, like Easter House, *supra*, its exempt activities appear to be provided as a part of its activities to further marketing of products in a manner similar to those provided by commercial businesses rather than as the exclusive purpose. The Foundation also resembles the trade association in Better Business Bureau, *supra*, in that its educational materials appear to have an "underlying commercial motive."

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Conclusion:

The Foundation is not operated exclusively for exempt purposes within the meaning Section 501(c)(3) of Internal Revenue Code. The marketing of health products to the benefit of a for-profit business is a more than insubstantial purpose of the Foundation. The Foundation's tax-exempt status under Internal Revenue Code 501(c)(3) should be revoked as of January 1, 20XX.

If you agree, please sign the attached Form 6018 and return it to the contact person. If you agree, please submit Forms 1120 (U.S. Corporation Income Tax Return) for the tax years 20XX, 20XX, 20XX and 20XX.