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TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Date:

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Contact Person:

Identification Number:

Contact Number:

Employer Identification Number:

U.I.L. Nos.

501.03-15

4940.00-00

4941.04-00

4942.03-05

4943.03-00

4944.00-00

4945.04-05

513.00-00

4945.04-04

LEGEND

M =

X =

Dear Sir or Madam:

We have considered your request dated January 6, 2003 for rulings that X's proposed grants for various public works will further its exempt purposes under section 501(c)(3) of the Internal Revenue Code and will not result in unrelated business taxable income or liability under chapter 42.

Facts

X is a private foundation described in sections 501(c)(3) and 509(a) of the Code. X proposes to make two Grants to the Government of M (an impoverished foreign country), one for a "Street Project," and the other for a "Road Project," in M. The infrastructure of M is in substantial need of overhaul. The project is considered important to improving the quality of life and economy for the people of M, the majority of whom live below the officially recognized poverty level. The Street Project involves financing the design, construction, and improvement of public streets (and adjacent sidewalks, lights, signs, gutters, and landscaping) in the major city of M. The Road Project involves similar financing for public highways, railway bridges, and wastewater and water pipe supply systems. These public works are owned and operated by the Government of M. Access to the works will be made available to the public free of charge for a guaranteed specified number of years from the date of completion of construction.

The Grants involve the disbursement of funds as needed, up to certain maximum amounts. The Government of M is neither a disqualified person with respect to X nor controlled by disqualified persons. The Government has agreed that the terms of the Grant agreements will not be overridden or unduly burdened by taxes or other

laws in M. Under the terms of the Grant, the Government of M must: use the funds exclusively for the purpose of constructing the specified public works; immediately return to X any funds not so used; not disburse any Grant funds to any disqualified person with respect to X or for any purpose prohibited under section 4945(d)(1)-(3); hold Grant funds in a separate segregated account; maintain books and records on the progress of construction, available for inspection by X; and make progress reports to X. X may terminate the grant upon discovery of any diversion or misuse of funds, or without cause upon reasonable notice. The Government must use standardized bidding documents and procedures to secure contractors' services and supplies, except where the Government believes that a particular contractor is uniquely qualified for a portion of the work, and the project manager concurs and finds the contract terms fair and reasonable.

X contemplates hiring an on-site Project Manager (who will not be a disqualified person with respect to X) with expertise in road construction for assistance in supervising the project, monitoring the Government of M's compliance with the terms of the Grant Agreement, and approving requests for grant disbursements as funds are needed. X retains the right to approve the selection of contractors and requests for disbursements to ensure compliance with the Grant Agreement. X will also have the Government hire an on-site supervisor to enforce compliance with construction codes and design specifications.

Rulings Requested

X requests the following rulings:

A. The Grants are for exclusively charitable, program-related activities for purposes of the Code because they will be used exclusively in the impoverished country of M to create essential public works for the general public of M and will combat community deterioration.

B. The funds disbursed pursuant to the Grants will not cause the imposition of any of the private foundation excise taxes, and specifically:

1. The tax on net investment income under section 4940 does not apply because if any funds disbursed pursuant to the Grants are required to be repaid to X, such funds represent a repayment of principal not taxable under section 4940 rather than net investment income;
2. The Government of M is unrelated to X, and the funds disbursed pursuant to the Grants to the Government of M will not create any self-dealing pursuant to section 4941, and furthermore there is no indirect act of self-dealing under the facts described;
3. The funds disbursed pursuant to the Grants are qualifying distributions for purposes of meeting the minimum qualifying distribution amount under section 4942;
4. The funds disbursed pursuant to the Grants do not create any "business

holdings" within the meaning of section 4943;

5. The funds disbursed pursuant to the Grants do not create any jeopardizing investments within the meaning of section 4944;

6. The funds provided pursuant to the Grants are for exclusively charitable purposes and are not taxable expenditures pursuant to, and are not subject to the expenditure responsibility rules of, section 4945 because the Grants are made to the Government of M and the Government will make no secondary grants of the funds, but only payments of compensation for goods and services received; and

C. The Grants will not give rise to unrelated business taxable income under sections 511-513.

D. The payments to the Project Manager are fees for personal services rendered in connection with X's program-related charitable activities, and are qualifying distributions made in furtherance of X's exempt purposes, as compensation and not "grants."

Law

Sections 170(c)(2)(B) and 501(c)(3) of the Code both refer to organizations organized and operated exclusively for charitable purposes.

Section 511 of the Code imposes a tax on the unrelated business taxable income of exempt organizations.

Section 512 of the Code defines "unrelated business taxable income" as gross income derived from any unrelated trade or business regularly carried on by it, less certain deductions and modifications.

Section 513(a) of the Code defines "unrelated trade or business" as 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 exempt purpose or function.

Section 513(c) of the Code provides that "trade or business" includes any activity which is carried on for the production of income from the sale of goods or the performance of services. For purposes of the preceding sentence, an activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization. Where an activity carried on for profit constitutes an unrelated trade or business, no part of such trade or business shall be excluded from such classification merely because it does not result in profit.

Section 4940 of the Code imposes an excise tax on the net investment income of a

private foundation.

Section 4941 of the Code imposes an excise tax on each act of self-dealing between a disqualified person and a private foundation.

Section 4941(d)(1) of the Code defines self-dealing as any direct or indirect--

(A) sale or exchange, or leasing, of property between a private foundation and a disqualified person;

(B) lending of money or other extension of credit between a private foundation and a disqualified person;

(C) furnishing of goods, services, or facilities between a private foundation and a disqualified person;

(D) payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person;

(E) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation.

(F) agreement by a private foundation to make any payment of money or other property to a government official (as defined in section 4946(c)), other than certain employment agreements.

Section 4941(d)(2)(D) of the Code provides that the furnishing of goods, services, or facilities by a private foundation to a disqualified person shall not be an act of self-dealing if such furnishing is made on a basis no more favorable than that on which such goods, services, or facilities are made available to the general public.

Section 4942 of the Code imposes an excise tax on a private foundation's undistributed income, defined as its distributable amount less qualifying distributions.

Section 4942(g)(1)(A) of the Code defines a "qualifying distribution" as including any amount (including that portion of reasonable and necessary administrative expenses) paid to accomplish one or more purposes described in section 170(c)(2)(B), other than certain contributions to organizations controlled by the foundation or by disqualified persons or to private non-operating foundations.

Section 4943 of the Code imposes an excise tax on the excess holdings by a private foundation in business enterprises.

Section 4944 of the Code imposes an excise tax on a private foundation's making of an investment in such a manner as to jeopardize the carrying out of any of its exempt purposes.

Section 4944(c) of the Code provides that an investment is not jeopardizing if its primary purpose is to accomplish 170(c)(2)(B) purposes and no significant purpose is the production of income or the appreciation of property.

Section 4945 of the Code imposes an excise tax on each taxable expenditure of a private foundation.

Section 4945(d) of the Code defines a "taxable expenditure" by a private foundation as an amount paid or incurred--

- (1) to attempt to influence legislation,
- (2) to influence a specific public election or carry on a voter registration drive,
- (3) to grant funds to an individual for travel, study, or similar purposes unless certain requirements are met,
- (4) to grant funds to an organization unless it is described in sections 509(a)(1), (2), or (3) or 4940(d)(2) or unless the private foundation exercises expenditure responsibility with respect to the grant in accordance with section 4945(h), or
- (5) for a non-170(c)(2)(B) purpose.

Section 4946 of the Code defines "disqualified persons" with respect to a private foundation as substantial contributors, foundation managers, 20% owners of a substantial contributor, family members of an individual who is one of the above, entities 35% owned by one of the above, and certain government officials.

Section 1.501(c)(3)-1(d)(2) of the Income Tax Regulations provides that the term "charitable" includes relief of the poor and distressed or of the underprivileged; erection or maintenance of public buildings, monuments, or works; lessening of the burdens of Government; and promotion of social welfare by organizations designed to combat community deterioration.

Section 1.513-1(b) of the regulations provides that for purposes of section 513 the term "trade or business" has the same meaning it has in section 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of services.

Section 53.4941(d)-3(b)(1) of the regulations provides generally that under section 4941(d)(2)(D) of the Code, the furnishing of goods, services, or facilities by a private foundation to a disqualified person shall not be an act of self-dealing if such goods, services, or facilities are made available to the general public on at least as favorable a basis as they are made available to the disqualified person, so long as such goods, services, or facilities are functionally related to the exercise or performance by a private foundation of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501(c)(3).

Section 53.4941(d)-3(b)(2) of the regulations provides that for purposes of this paragraph, the term "general public" shall include those persons who, because of the particular nature of the

activities of the private foundation, would be reasonably expected to utilize such goods, services, or facilities. This paragraph shall not apply, however, unless there is a substantial number of persons other than disqualified persons who are actually utilizing such goods, services, or facilities. Thus, a private foundation which furnishes recreational or park facilities to the general public may furnish such facilities to a disqualified person provided they are furnished to him on a basis which is not more favorable than that on which they are furnished to the general public.

Section 53.4942(a)-3(a)(2) of the regulations defines a "qualifying distribution" as including any amount (including program-related investments and reasonable and necessary administrative expenses) paid to accomplish 170(c)(2)(B) purposes, other than certain contributions to organizations controlled by the foundation or one or more disqualified persons or to non-operating private foundations.

Section 53.4943-10(b) of the regulations provides that business holdings do not include program-related investments.

Section 53.4944-3(a)(1) of the regulations defines a "program-related investment" as an investment which possesses the following characteristics:

- (i) its primary purpose is to accomplish 170(c)(2)(B) purposes;
- (ii) No significant purpose is the production of income or the appreciation of property; and
- (iii) No purpose is to accomplish 170(c)(2)(D) purposes.

Section 53.4945-2(a)(5)(i) of the regulations provides that a grant by a private foundation to an organization described in section 509(a)(1), (2) or (3) of the Code does not constitute a taxable expenditure by the foundation under section 4945(d), other than under section 4945(d)(1), if the grant by the private foundation is not earmarked to be used for any activity described in section 4945(d)(2) or (5), is not earmarked to be used in a manner which would violate section 4945(d)(3) or (4), and there does not exist an agreement, oral or written, whereby the grantor foundation may cause the grantee to engage in any such prohibited activity or to select the recipient to which the grant is to be devoted. For purposes of this paragraph (a)(5)(i), a grant by a private foundation is earmarked if the grant is given pursuant to an agreement, oral or written, that the grant will be used for specific purposes.

Section 53.4945-2(a)(5)(ii) of the regulations provides that for purposes of section 53.4945-2, an organization shall be considered a section 509(a)(1) organization if it is treated as such under section 53.4945-5(a)(4) of the regulations.

Section 53.4945-2(a)(6)(ii) of the regulations provides that a grant by a private foundation to fund a specific project of a public charity is not a taxable expenditure by the foundation under section 4945(d)(1) of the Code to the extent that--

- (A) The grant is not earmarked, within the meaning of section 53.4945-2(a)(5)(i) of the regulations, to be used in an attempt to influence legislation, and

(B) The amount of the grant, together with other grants by the same private foundation for the same project for the same year, does not exceed the amount budgeted, for the year of the grant, by the grantee organization for activities of the project that are not attempts to influence legislation. If the grant is for more than one year, the preceding sentence applies to each year of the grant with the amount of the grant measured by the amount actually disbursed by the private foundation in each year or divided equally between years, at the option of the private foundation. The same method of measuring the annual amount must be used in all years of a grant. This paragraph (a)(6)(ii) applies without regard to whether the public charity has made the election under section 501(h).

Section 53.4945-2(a)(6)(iii) of the regulations provides that for purposes of determining the amount budgeted by a prospective grantee for specific project activities that are not attempts to influence legislation under section 53.4945-2(a)(6)(ii), a private foundation may rely on budget documents or other sufficient evidence supplied by the grantee organization (such as a signed statement by an authorized officer, director or trustee of such grantee organization) showing the proposed budget of the specific project, unless the private foundation doubts or, in light of all the facts and circumstances, reasonably should doubt the accuracy or reliability of the documents.

Section 53.4945-4(a)(2) of the regulations provides that, for purposes of section 4945 of the Code, the term "grants" shall include, but is not limited to, such expenditures as scholarships, fellowships, internships, prizes, and awards. Grants shall also include loans for purposes described in section 170(c)(2)(B) and "program related investments" (such as investments in small businesses in central cities or in businesses which assist in neighborhood renovation). Similarly, "grants" include such expenditures as payments to exempt organizations to be used in furtherance of such recipient organizations' exempt purposes whether or not such payments are solicited by such recipient organizations. Conversely, "grants" do not ordinarily include salaries or other compensation to employees. For example, "grants" do not ordinarily include educational payments to employees which are includible in the employees' incomes pursuant to section 61. In addition, "grants" do not ordinarily include payments (including salaries, consultants' fees and reimbursement for travel expenses such as transportation, board, and lodging) to persons (regardless of whether such persons are individuals) for personal services in assisting a foundation in planning, evaluating or developing projects or areas of program activity by consulting, advising, or participating in conferences organized by the foundation.

Section 53.4945-4(a)(4)(ii) of the regulations provides that a grant by a private foundation to an organization described in section 509(a)(1), (2), or (3) of the Code, which the grantee organization uses to make payments to an individual for purposes described in section 4945(d)(3), shall not be regarded as a grant by the private foundation to the individual grantee (regardless of the application of section 53.4945-4(a)(4)(i) of the regulations) if the grant is made for a project which is to be undertaken under the supervision of the section 509(a)(1), (2), or (3) organization and such grantee organization controls the selection of the individual grantee. This rule shall apply regardless of whether the name of the individual grantee was first proposed by the private foundation, but only if there is an objective manifestation of the section 509(a), (1), (2), or (3) organization's control over the selection process, although the selection need not be made completely independently of the private foundation. For purposes of this rule, an organization shall be considered a section 509(a)(1) organization if it is treated as such

under section 53.4945-5(a)(4).

Section 53.4945-5(a)(2) of the regulations cross-references section 53.4945-4(a) for the definition of grants for purposes of section 4945(d)(4) of the Code.

Section 53.4945-5(a)(4)(iii) of the regulations provides that a foreign government (or agency or instrumentality) is treated as a 509(a)(1) organization for purposes of section 53.4945-5 even if it is not described in section 501(c)(3) of the Code. However, a grant to any such organization must be made exclusively for 170(c)(2)(B) purposes.

Section 53.4945-5(a)(6)(i) of the regulations provides that a grant by a private foundation to a grantee organization which the grantee organization uses to make payments to another organization (the secondary grantee) shall not be regarded as a grant by the private foundation to the secondary grantee if the foundation does not earmark the use of the grant for any named secondary grantee and there does not exist an agreement, oral or written, whereby such grantor foundation may cause the selection of the secondary grantee by the organization to which it has given the grant. For such purpose, a grant described herein shall not be regarded as a grant by the foundation to the secondary grantee even though such foundation has reason to believe that certain organizations would derive benefits from such grant so long as the original grantee organization exercises control, in fact, over the selection process and actually makes the selection completely independently of the private foundation.

Rev. Rul. 71-29, 1971-1 C.B. 150, held that a grant by a 501(c)(3) organization to a city transit authority for the purpose of maintaining a mass transportation system qualified as a charitable disbursement in furtherance of the grantor's exempt purpose. The Service stated that the charitable element in facilitating public transportation is established in the Statute of Charitable Uses, 43 Eliz. I, c.4 (1601), which recognized as charitable the "repair of bridges, ports, havens, causeways . . . and highways."

Rev. Rul. 71-460, 1971-2 C.B. 231, held that a 501(c)(3) organization may conduct part or all of its charitable activities in a foreign country.

Rev. Rul. 74-125, 1974-1 C.B. 327, held that a private foundation's payments to consultants were not grants under section 4945(d)(3) of the Code. The foundation's activities included disseminating publications and developing and conducting training programs to assist educators in using improved educational methods. The consultants' services included the development of model curricula in a particular educational area and the design of materials to assist educators in the performance of their educational functions. The Service reasoned that the consultants' services were personal services assisting the foundation in planning and developing its projects under section 53.4945-4(a)(2) of the regulations.

Rev. Proc. 76-47, 1976-2 C.B. 670, provides guidelines for determining whether a grant made by a private foundation under an employer-related grant program to an employee or child is a scholarship or fellowship grant subject to the provisions of section 117(a) of the Code. Section 4.02 provides that selection of grant recipients must be made by a committee consisting wholly of individuals totally independent and separate from the private foundation, its organizer, and the

employer concerned. However, the forwarding of the selections by the independent selection committee to the employer or private foundation for the sole purpose of verifying the eligibility requirements and selection criteria followed by the committee in considering the candidates and in making its selection will not disqualify the program.

Rev. Rul. 76-459, 1976-2 C.B. 369, held that the use of a private foundation museum's private road for access to the adjacent headquarters and manufacturing plant of a corporation (disqualified person) during the same hours the road is used by the general public as a thoroughfare connecting two public streets was not an act of self-dealing under section 4941 of the Code.

Rationale

Each of the requested rulings is discussed in turn below.

A. Although there exist situations where roads and water/sewer lines are built or maintained for the private purposes of developers, land owners, or others, we are satisfied under the circumstances presented that the Grants will be made exclusively for the charitable purpose under sections 501(c)(3) and 170(c)(2)(B) of the Code of erecting or maintaining public works. Such activity will also help to alleviate distress in a poverty-stricken area and combat community deterioration. Moreover, X has taken reasonable steps to ensure that the Grants will be used exclusively for the intended charitable purposes and not diverted for non-charitable purposes.

B.1. The Grant program as described will not generate any net income or capital gain for X. Therefore, a return to X of grant funds would not result in net investment income that would be taxable under section 4940 of the Code.

B.2. Section 4941 of the Code defines self-dealing as certain direct or indirect transactions between a private foundation and a disqualified person. The Government of M is not a disqualified person with respect to X, and therefore the Grants are not direct acts of self-dealing. Moreover, we find no indirect self-dealing under the facts described.

B.3. A qualifying distribution under section 4942 of the Code generally includes a grant paid to a foreign government to accomplish charitable purposes. Since the foreign government is not controlled by disqualified persons with respect to X, the Grants will be qualifying distributions.

B.4. X will not receive anything in return for its Grants, including any kind of ownership interest in a business enterprise that would constitute a business holding under section 4943 of the Code. Moreover, X's making of such Grants is not itself a trade or business that would constitute a sole proprietorship of X or a joint venture with the Government of M.

B.5. X's Grants, in which X does not expect to receive back any principal and will

not in any event receive net income or gain, are not investments in the ordinary financial sense of the term. If the Grants were considered investments under section 4944 of the Code, then they would constitute program-related investments.

B.6. The Grants are not earmarked for purposes set forth in sections 4945(d)(1), (2), and (3) of the Code, and the Grant Agreements prohibit the use of Grant funds for such purposes. X need not exercise expenditure responsibility under section 4945(h) with respect to the Grants, because the Government of M is deemed a 509(a)(1) organization for such purposes, and the Government of M will make no secondary grants of the funds, but only payments of compensation for goods and services received. Moreover, X's review and approval of contracts to ensure conformity with the terms of the Grant agreement is not the equivalent of earmarking funds for such contractors.

C. X's Grant activity is not a trade or business within the meaning of section 513 of the Code, because there is no expectation of any profit (or even return of capital) from the activity. If the activity were considered a trade or business, then it would be a related trade or business, because it contributes importantly to the accomplishment of X's charitable purposes.

D. The services to be provided by the Project Manager are consulting services like those described in Rev. Rul. 74-125 to assist the foundation in planning and developing its projects. Thus, under sections 53.4945-4(a)(2) and 5(a)(2) of the regulations, X's payments to the Project Manager, while qualifying distributions made in furtherance of X's exempt purposes, are compensation and not grants.

Rulings

Accordingly, we rule as follows:

A. The Grants are for exclusively charitable, program-related activities for purposes of sections 501(c)(3) and 170(c)(2)(B) of the Code because they will be used exclusively in the impoverished country of M to create essential public works for the general public of M and will combat community deterioration.

B. The funds disbursed pursuant to the Grants will not cause the imposition of any of the private foundation excise taxes, and specifically:

1. The tax on net investment income under section 4940 does not apply because if any funds disbursed pursuant to the Grants are required to be repaid to X, such funds represent a repayment of principal not taxable under section 4940 rather than net investment income;
2. The Government of M is unrelated to X, and the funds disbursed pursuant to the Grants to the Government of M will not create any self-dealing pursuant to section 4941, and furthermore there is no indirect act of self-dealing under the facts described;

3. The funds disbursed pursuant to the Grants are qualifying distributions for purposes of meeting the minimum qualifying distribution amount under section 4942;

4. The funds disbursed pursuant to the Grants do not create any "business holdings" within the meaning of section 4943;

5. The funds disbursed pursuant to the Grants do not create any jeopardizing investments within the meaning of section 4944;

6. The funds provided pursuant to the Grants are for exclusively charitable purposes and are not taxable expenditures pursuant to, and are not subject to the expenditure responsibility rules of, section 4945 because the Grants are made to the Government of M and the Government will make no secondary grants of the funds, but only payments of compensation for goods and services received; and

C. The Grants will not give rise to unrelated business taxable income under sections 511-513.

D. The payments to the Project Manager are fees for personal services rendered in connection with X's program-related charitable activities, and are qualifying distributions made in furtherance of X's exempt purposes, as compensation and not "grants."

Except as we have ruled above, we express no opinion as to the tax consequences of the transaction under the cited provisions of the Code or under any other provisions of the Code.

This ruling is directed only to X. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Because this letter could help resolve future tax questions, you should keep a copy of this ruling in your permanent records.

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

Sincerely,

(signed) Terrell M. Berkovsky

Terrell M. Berkovsky
Manager, Exempt Organizations
Technical Group 2