



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

200431018

Date: MAY - 6 2004

Contact Person:

Identification Number:

Telephone Number:

T:EO:B3

SIN: 4942.03-05
513.00-00

Employer Identification Number:

LEGEND:

U =
V =
W =
X =
Y =
Z =
a =
b =
c =
d =

Dear

We have considered your ruling request dated August 27, 2003, relating to the tax consequences of a proposed transaction involving W, X, Y, and Z.

W is an organization exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code (hereinafter "the Code") and is classified as a private operating foundation under section 4942(j)(3) of the Code. W's purposes are the following: (1) to own and operate a housing facility for the elderly; (2) own and operate an assisted living center for the physically disabled; and (3) to carry out all other purposes permitted under state charity law and section 501(c)(3) of the Code.

Y is an accredited university that offers degrees in a wide range of educational programs and subjects. One educational program Y operates is Z (the school of U). Z offers educational and clinical activities in U (hereinafter "U program"). Y represents that Z is experiencing a significant decline in state funding needed to support the U program. Consequently, Y and Z have asked W for assistance, and W has agreed to operate Z's U program.

Under the proposed transaction as described in the proposed agreement (submitted on proposed lease agreement and proposed bill of sale, W will acquire and operate Z by creating X, a single member limited liability company, for such purpose. W is the sole member of X and treats X as a disregarded entity for federal income tax purposes. X will purchase from Y all fixtures and equipment used for the U program for one dollar. X cannot acquire the existing land and buildings where the U program is currently located due to stipulations on transfer of the real estate imposed by the state, and because physically moving the school and the program is not a feasible alternative. Therefore, X will lease from Y the land and buildings (excluding grant-related research space) for twenty years. X will pay rent in the amount of \$a per year (increased to reflect inflation after the first ten years), which the parties represent as fair market value. The name of the school will be changed from Z to V one year after the date the lease is signed.

Simultaneously, X and Y will enter into a 20-year management agreement (cancelable by either party with or without cause after 10 years and earlier under specified conditions) for Y to manage the school and its U program in accordance with Y's section 501(c)(3) educational mission. Under the proposed management agreement Y, as an agent for X, collects and remits to X certain revenues, such as tuition, fees and other charges, derived from the U program and pays all expenses incurred by the veterinary school of medicine. The revenues X does not receive include research grants (governmental or private), endowment income, endowment gifts, rent from buildings, income generated by Y's biotechnology program, and any revenues not generated by the U program. X will reimburse Y for all expenses up to the amount of the unrestricted revenues received. X can review, comment upon, and discuss with senior officials of Y any and all individual non-salary expenses paid to any supplier, vendor or other entity in connection with the U program if such expenses are greater than \$ or in the aggregate exceed \$ in any single year.

If the U program incurs a financial operating deficit in a particular year, X pays up to \$b to eliminate the deficit (increase to reflect inflation after the first ten years). The annual deficit funding obligation carries over for up to two future years to the extent the entire \$b is not used in any one year. Moreover, X may increase the deficit funding to a maximum of \$c per year for any two of the first four years of the term of the management agreement, provided that the aggregate deficit funding for the first 10 years does not exceed \$d. Y is responsible for any operating deficits in excess of the deficit funding. If the management agreement is terminated for any reason or expires under its terms, the lease also terminates, and Y must purchase from X for an agreed-upon amount of \$ all of the tangible personal property (as described in the bill of sale) related to the school and for the U program.

The U program is supervised by a board of overseers, whose duties include reviewing the activities of the school and U program. Under the proposed agreement, W will appoint a majority of the members of the board of overseers during the term of the management agreement. The appointed members will not be employees of Y.

Y remains the accredited institution that grants degrees in U and operates the financial aid programs. Y continues to make all determinations regarding recruiting, admission and enrollment of students, tuition, fees and other institutional charges, the awarding and administration of student financial assistance, selection and employment of faculty, and the academic program, including without limitation, course content, instructional methods, and awarding of academic credits. X reviews and comments upon all academic program and related activities conducted by Y. The U program will continue to meet the non-discrimination requirements of Rev. Proc. 75-50, 1975-2 C.B. 587.

LAW:

Section 4942(j)(3) of the Code defines "operating foundation" to mean any organization –

- (A) which makes qualifying distributions (within the meaning of paragraph (1) or (2) of subsection (g)) directly for the active conduct of the activities constituting the purpose or function for which it is organized and operated equal to substantially all of the lesser of (i) its adjusted net income (as defined in subsection (f)) or (ii) its minimum investment return; and
- (B) (i) substantially more than half of the assets of which are devoted directly to such activities or to functionally related businesses, or to both, or are stock of a corporation which is controlled by the foundation and substantially all of the assets of which are so devoted, (ii) which formally makes qualifying distributions directly for the active conduct of the activities constituting the purpose or function for which it is organized and operated in an amount not less than two-thirds of its minimum investment return, or (iii) substantially all of the support (other than gross investment income as defined in section 509(e)) of which is normally received from the general public and from 5 or more exempt organizations which are not described in section 4946(a)(1)(H) with respect to each other or the recipient foundation; not more than 25 percent of the support (other than gross investment income) of which is normally received from any one such exempt organization; and not more than half of the support of which is normally received from gross investment income.

Notwithstanding the provisions of subparagraph (A), if the qualifying distributions (within the meaning of paragraph (1) or (2) of subsection (g)) of an organization for the taxable year exceed the minimum investment return for the taxable year, clause (ii) of subparagraph (A) shall not apply unless substantially all of such qualifying distributions are made directly for the active conduct of the activities constituting the purpose or function for which it is organized and operated.

Section 4942(g)(1) of the Code generally defines a "qualifying distribution" as any amount paid to accomplish purposes described in section 170(c)(2)(B), including charitable purposes, except for a distribution made to (i) an organization controlled (directly or indirectly) by the foundation or one or more disqualified persons (as defined in section 4946) with respect to the foundation, except as provided in section 4942(g)(3), or (ii) a private foundation which is not an

operating foundation (as defined in section 4942(j)(3)), except as provided in section 4942(g)(3), or (B) any amount paid to acquire an assets used (or held for use) directly in carrying out one or more purposes described in section 170(c)(2)(B). Section 170(c)(2)(B) purposes include religious, educational and charitable purposes.

Section 53.4942(a)-3 (a)(2)(i) of the Foundation and Similar Excise Taxes Regulations ("regulations") provides in relevant part that any amount (including program-related investments, as defined in section 4944(c), and reasonable and necessary administrative expenses) paid to accomplish one or more purposes described in section 170(c)(1) or (2)(B).

Section 53.4942(b)-1(b)(1) of the regulations provides in relevant part that qualifying distributions are not made by a foundation "directly for the active conduct of activities constituting its charitable, educational, or other similar exempt purpose" unless such qualifying distributions are used by the foundation itself, rather than or through one or more grantee organizations which receive such qualifying distributions directly or indirectly from such foundation. Thus, grants made to other organizations to assist them in conducting activities which help to accomplish their charitable, educational, or other similar exempt purpose are considered an indirect, rather than direct, means of carrying out activities constituting the charitable, educational, or other similar exempt purpose of the grantor foundation, regardless of the fact that the exempt activities of the grantee organization may assist the grantor foundation in carrying out its own exempt activities. However, amounts paid to acquire or maintain assets which are used directly in the foundation's exempt activities, such as the operating assets of a museum, public park, or historic site, are considered direct expenditures for the active conduct of the foundation's exempt activities. Likewise, administrative expenses (such as staff salaries and traveling expenses) and other operating costs necessary to conduct the foundation's exempt activities (regardless of whether they are "directly for the active conduct" of such exempt activities) shall be treated as qualifying distributions expended directly for the active conduct of such exempt activities if such expenses and costs are reasonable in amount.

Section 53.4942(b)-2(b) of the regulations provides in relevant part that a foundation will satisfy the endowment test under the provisions of this paragraph if it normally makes qualifying distributions directly for the active conduct of activities constituting its charitable, educational, or other similar exempt purposes in an amount not less than two-thirds of the foundation's minimum investment return. In determining whether the amount of such qualifying distributions is not less than an amount equal to two-thirds of the foundation's minimum investment return, the foundation is not required to trace the source of such expenditures to determine whether they were derived from investment income or from contributions.

Section 53.4942(b)-2(c) of the regulations provides in relevant part that a foundation will satisfy the support test under the provisions of this paragraph if

- (i) Substantially all of its support (other than gross investment income as defined in section 509(e)) is normally received from the general and from five or more exempt organizations which are not described in section 4946(a)(1)(H) with respect to each other or the recipient foundation;
- (ii) Not more than 25 percent of its support (other than gross investment income) is

- normally received from any one such exempt organization; and
- (iii) Not more than half of its support is normally received from gross investment income.

Section 511 of the Code imposes a tax on the unrelated business taxable income (defined in section 512) of organizations exempt from tax under section 501(c).

Section 512(a)(1) of the Code defines the term "unrelated business taxable income" to mean the gross income derived by any organization from any unrelated trade or business (defined in section 513) regularly carried on by it, less the allowable deductions which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).

Section 513(a) of the Code provides that the term "unrelated trade or business" means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption.

Section 1.513-1(d)(2) of the Income Tax Regulations ("regulations") provides that a trade or business is "related" to exempt purposes only where the conduct of the business activities has a causal relationship to the achievement of exempt purposes (other than through the production of income). Further, it is "substantially related," for purposes of section 513, only if the causal relationship is a substantial one. For this relationship to exist, the production or the performance of the service from which the gross income is derived must contribute importantly to the accomplishment of exempt purposes. Whether the activities productive of gross income contribute importantly to such purposes depends, in each case, upon the facts and circumstances involved.

ANALYSIS:

Ruling Request 1:

W's proposes to expand its charitable activities to include the operation of Y's U program through its wholly owned and controlled entity, X. We note that the U program has a scheduled curriculum, a faculty and an enrolled body of students. The U program meets the non-discrimination requirements of Rev. Proc. 75-50, 1975-2 C.B. 587. W's proposed activity is clearly an educational activity and, therefore, is described in section 501(c)(3) of the Code. See section 1.501(c)(3)-1(d)(3)(ii) of the regulations. Hence, W's operation of Z's U program (school is to be renamed V) through X will not adversely affect its status as an organization described in section 501(c)(3) of the Code. The question of whether the proposed transaction will adversely affect W's status as a private operating foundation under section 4942(j)(3) is discussed under ruling request 2 below.

Ruling Request 2:

The issues are the following: (1) whether the disbursements that W makes through its

wholly owned and controlled entity X to operate the U program are treated as qualifying distributions within the meaning of sections 4942(g)(1) and (2), and section 4942(j)(3) of the Code; (2) whether Y's management of the U program as an agent of X meets the "direct conduct of activities" requirement described in section 4942(j)(3)(A) and section 53.4942(b)-1(b)(1) of the regulations (i.e. "the income test") for purposes of W's private operating foundation status; (3) whether W's use of its assets to operate the U program qualifies as assets which are devoted directly to the active conduct of the activities constituting the purpose or function for which W was organized and operated within the meaning of section 4942(j)(3)(B)(ii) and section 53.4942(b)-2(b) of the regulations (i.e. "the endowment test"); and (4) whether the revenue derived from operation of the U program constitutes support from the general public for purposes of section 4942(j)(3)(B)(iii) and section 53.4942(b)-2(c) of the regulations (i.e. "the support test").

Concerning the first issue, section 53.4942(a)-3(a)(2)(i) of the regulations provides in relevant part that the term "qualifying distribution" means any amount (including program related investments, as defined in section 4944(c), and reasonable and necessary administrative expenses) paid to accomplish one or more purposes described in section 170(c)(1) or (2)(B) of the Code. Such purposes include religious, charitable, scientific, literary or educational. Operating a school of U is clearly an educational activity and falls within the meaning of section 170(c)(2)(B) of the Code. We conclude that the disbursements W will make through X to support the operation of U program are qualifying distributions within the meaning of sections 4942(g)(1) and (2), and section 4942(j)(3) of the Code.

Concerning the second issue, section 4942(j)(3) (A) of the Code and section 53.4942(b)-1(b)(1) of the regulations provide that a private operating foundation must use the qualifying distributions directly for the active conduct of the activities constituting its purpose or function for which it is organized and operated. The question is whether Y's activities on behalf of X under the proposed management agreement will be treated as activities of W. That is, if W's payments made through X to Y are treated as qualifying distributions made directly for W's active conduct of its exempt activities, then such qualifying distributions would be included in determining its status as a private operating foundation under the income test of section 4942(j)(3)(A) and the regulations issued thereunder.

Based on the terms of the proposed management agreement and the particular representations provided by W, we conclude that the qualifying distributions that W makes through X to Y for the operation of the U program constitute qualifying distributions directly for the active conduct of activities constituting W's exempt purpose. Therefore, such distributions may be used to satisfy the income test of section 4942(j)(3)(A) of the Code and section 53.4942(b)-1(c) of the regulations. Our conclusion is based on the fact that Y will be managing the school under the authority and directions of W. We note that W, via X, has the authority to review all expenditures made for the operation of the U program to review and comment upon the academic program and related activities of the program. We also note that the school's name will be changed to reflect W's operation of the program. See also Rev. Rul. 78-315, 1978-2 C.B. 271, which provides that a private operating foundation's may form a corporation to act in a fiduciary capacity to conduct its exempt program activity and would not jeopardize its status as a private operating foundation. Furthermore and significantly, through W's

appointment of a majority of the school's board of overseers, W will ensure that its assets and the activities Z conducts are used to further W's exempt purposes on W's own terms separate from Y.

Concerning the third issue, based on the terms of the proposed management agreement, proposed lease agreement, proposed bill of sale, and proposed agreement, we conclude that W's use of its assets to operate the U program through X may be used to satisfy the endowment test of section 4942(j)(3)(B)(i) of the Code and section 53.4942(b)-2(b) of the regulations until the time the management agreement is terminated. Our conclusion is based on the rationale discussed previously. Concerning the fourth issue, we conclude that the revenue (tuition, fees and other related revenue) derived from operation of U program may be treated as support from the general public for purposes of the "support test" of section 4942(j)(3)(B)(iii) of the Code and section 53.4942(b)-2(c) of the regulations.

Ruling Request #3:

We conclude in rulings 1 and 2 that W's proposed operation of the U program through X is an activity that contributes importantly to the accomplishment of W's exempt purposes and thus is substantially related and within the meaning of section 513(a) of the Code. Hence, the revenue W received from the U program would not constitute unrelated business taxable income.

RULINGS:

1. The proposed expansion of W's charitable activities to include the funding, owning assets, leasing educational property, and involvement in the U program do not adversely affect W's tax exempt status under section 501(c)(3) of the Code. W continues to qualify as a private operating foundation under section 4942(j)(3) assuming it continues to satisfy the requirements of this Code section.
2. The disbursements made by X on behalf of W for the operation of the U program may be treated by W as qualifying distributions within the meaning of sections 4942(g)(1) and (2) of the Code. The disbursements may be treated as qualifying distributions for purposes of section 4942(j)(3)(A) of the Code.
3. The disbursements may also be used for purposes of determining W's private operating foundation status under sections 4942(j)(3)(B)(ii) and (iii) of the Code.
4. The revenue W's receives from the medicine veterinary program does not result in unrelated business taxable income within the meaning of section 512 of the Code.

Except as we have ruled above, we express no opinion as to the tax consequences of the transaction under any provisions of the Code. This ruling is provided only to the organization that requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent

200431018

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) Robert C. Harper, Jr.

Robert C. Harper, Jr.
Manager, Exempt Organizations
Technical Group 3