



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

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Date: JUL 26 2004

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4941, 00-00

4942, 03-, 05

4943, 00-, 00

4944, 00-00

Employer Identification Number:

4945, 00-00

Legend:

B=

C=

x= \$

y= \$

Contact Person:

Identification Number:

Telephone Number:

T. ED. B 4

Dear

This is in response to your request for a private letter ruling concerning whether the proposed transaction described below will affect your exempt status under sections 501(c)(3) and also cause excise taxes to be imposed under sections 4941-4945 of the Internal Revenue Code.

Facts

You are an organization described in section 501(c)(3) and classified as a private foundation under Section 509(a). Your purpose is to promote charitable endeavors and provide financial support to organizations which are exempt under Section 501(c)(3).

C is the founder, president, secretary, treasurer, sole contributor and one of five members of your Board of Directors. The other four members of your Board of Directors are his children. C is a disqualified person within the meaning of Section 4946(a) of the Code with respect to you.

B is an organization described in Section 501(c)(3) and classified as a public charity under sections 509(a)(1) and 170(b)(1)(A)(ii) as a school. C was B's sole trustee at the time it was formed. The trustee was the sole governing body of B. Subsequently, B revised its Articles and Bylaws to incorporate a Board of Directors consisting of four Board members that would not be controlled by C. Currently, C is the president of B, and one of its Board members. The three other Board members are unrelated to C.

B is a private Christian religious based school whose sole purpose is to provide an academic oriented, college preparatory, spiritual education, to its students. B opened in September

and currently has first grade and kindergarten classes and anticipates expanding through grade 12. The land on which B was built was donated by a Family Limited Partnership created by C. B charges tuition for its students, but the tuition paid by students for the school year was not sufficient to meet its expenses.

B's Board of Directors passed a conflict of interest resolution forbidding any Board member from voting on any matter which is of a direct or indirect financial interest to that Board member, or that Board member's relatives.

C contributed \$x in . . . to B, and B needed additional funds in order to open the school for classes. Originally, you were planning to donate funds to B for the remainder of the needed funds. However, since B had not yet obtained its determination as to its tax exempt status from the IRS at that time, you were reluctant to contribute funds outright to B. As a result, C loaned \$y to B, so that it could complete the school, purchase supplies, and hire staff. The loan is interest free and evidenced by a promissory note. The promissory note, executed by Cat the time that he was the Trustee of B, was ratified by the current Board of Directors of B after B was reorganized.

All loan proceeds were used to purchase materials, equipment, desks and chairs for the use of the school, books and other supplies for students, construct the building, and for staff salaries. Loan proceeds were used to further the exempt purposes of B. None of the loan proceeds have been retained by B.

You plan to make a grant to B, so that it can repay its loan to C. The grant has no restrictions and the repayment of the loan to C would need approval of a majority of the Board of Directors of B.

Rulings Requested

Based upon the facts as set forth above, you request the following rulings:

1. Whether your Grant to B which may be used to repay the loan from C will constitute private inurement or private benefit under Section 501(c)(3) to you;
2. Whether your Grant to B is not an act of self-dealing under Section 4941;
3. Whether your Grant to B is a qualifying distribution under Section 4942(g);
4. Whether your Grant by to B will not result in excess business holdings under Section 4943 to you;
5. Whether your Grant to B is not a jeopardizing investment of you under Section 4944;
6. Whether your Grant to B is not a taxable expenditure under Section 4945 to you.

Law

Section 501(c)(3) of the Code describes corporations, trusts, and associations, organized and operated exclusively for charitable and other exempt purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(a)(1) of the Income Tax Regulations states that, in order to be exempt as an organization described in section 501(c)(3) of the Code, an organization must be both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational test or the operational test, it is not exempt.

Section 1.501(a)-1(c) of the regulations defines a "private shareholder or individual" as a person with a personal and private interest in the activities of the organization. These individuals are often referred to informally as "insiders." See American Campaign Academy v. Commissioner, 92 T.C. 1053, 1066.

Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Section 1.501(c)(3)-1(c)(2) of the regulations provides that an organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals. The terms "private shareholders or individuals" refers to persons having a personal and private interest in the activities of the organization.

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations states 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 subdivision, 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.

Section 4941 of the Code imposes excise tax on any act of self-dealing between a private foundation and any of its disqualified persons under section 4946 of the Code.

Section 4941(d)(1)(B) of the Code provides that the term "self-dealing" includes any "lending of money or other extension of credit between a private foundation and a disqualified person."

Section 4941(d)(2)(B) of the Code provides, in pertinent part, that any lending of money or other extension of credit between a private foundation and a disqualified person is an act of self-dealing. The lending of money by a disqualified person to a private foundation is not an act of self-dealing if the loan is without interest, or other charge, and if the proceeds of the loan are exclusively used for section 501(c)(3) purposes

Section 53.4941(d)-1(b)(1) of the Foundation and Similar Excise Taxes Regulations gives examples of exceptions of certain business transactions to the applicability of the indirect self-dealing rules of section 4941.

Section 53.4941(d)-1(b)(7) of the regulations gives examples of the applicability of statutory exceptions to indirect self-dealing under section 4941. The term "indirect self-dealing" does not include a transaction involving one or more disqualified persons to which a private foundation is not a party, in any case in which the private foundation, by reason of section 4941(d)(2), could itself engage in such a transaction.

Section 53.4941(d)-1(b)(8) of the regulations gives examples of self-dealing and indirect self-dealing under section 4941.

Section 53.4941(d)-2(c)(2) of the regulations provides that the rules of this section shall not apply to loans by a disqualified person to a private foundation if the loan is without interest or other charge.

Section 53.4941(d)-2(c)(3) of the regulations provides that the making of a promise, pledge, or similar arrangement to a private foundation by a disqualified person, whether evidenced by an oral or written agreement, a promissory note, or other instrument of indebtedness, to the extent motivated by charitable intent and unsupported by consideration, is not an extension of credit (within the meaning of this paragraph) before the date of maturity.

Under Section 4942(d), a private foundation's annual required distributable amount is equal to 1) its minimum investment return; 2) repayments of amounts previously treated as qualifying distributions; 3) amounts received or accrued from the sale of other distribution of property previously treated as a qualifying distribution; and 4) amounts previously set aside for charitable purposes but not necessary to be so used, reduced by taxes imposed on the foundation for such taxable year under subtitle A of the Code (the unrelated business income tax) and Section 4940 (the 2% tax on investment income) and increased by amounts received from certain charitable lead trusts. A distribution counting towards the private foundation's annual minimum required distribution is a "Qualifying Distribution."

Section 4942(g) of the Code defines the term "qualifying distributions," in general, as amounts paid to accomplish exempt purposes or to acquire an asset used or held for use directly in carrying out exempt purposes.

Under Section 4942(g)(1) a "Qualifying Distribution" is defined (in pertinent part) as 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 any contribution to (i) an organization controlled (directly or indirectly) by the foundation or one or more disqualified persons with respect to the foundation, except as provided in paragraph (3), or any amount paid to acquire an asset to be used directly in carrying out the charitable purpose.

Under Section 4942(g)(3) the term "qualifying distribution" includes a contribution to a Section 501(c)(3) organization if not later than the close of the first taxable year after its taxable year in which such contribution is received, such organization makes a distribution equal to the amount of such contribution and such distribution is a qualifying distribution (within the meaning of paragraph (1) or (2), without regard to this paragraph) which is treated under subsection (h) as a distribution out of corpus (or would be so treated if such Section 501(c)(3) organization

were a private foundation which is not an operating foundation), and the private foundation making the contribution obtains adequate records or other sufficient evidence from such organization showing that the qualifying distribution described in subparagraph (A) has been made by such organization.

Section 53.4942(a)-2(c)(3)(i) of the regulations provides that an asset is "used or held for use directly in carrying out the foundation's exempt purpose" if the asset is actually used in carrying out the exempt purpose or if immediate use in carrying out the exempt purpose is not practical and there are definite plans to commence such use within a reasonable period of time.

Section 53.4942(a)-2(c)(3)(ii) of the regulations illustrates this principle by including as examples of assets which are used (or held for use) directly in carrying out a foundation's exempt purpose: the portion of a building used by the foundation directly in its charitable, educational, or other similar exempt activities; and physical facilities used in such activities, such as paintings or other works of art owned by the foundation which are on public display, research facilities and related equipment.

Section 53.4942(a)-3(a)(3) of the regulations defines the term "controlled" for qualifying distributions listed in section 4942 of the Code, and the regulations thereunder.

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

Section 4943(c) of the Code states that "excess business holdings" means, with respect to the holdings of any private foundation in any business enterprise, the amount of stock or other interest in the enterprise which the foundation would have to dispose of to a person other than a disqualified person in order for the remaining holdings of the foundation in such enterprise to be permitted holdings.

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 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 53.4945-5(a)(6) of the regulations states 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.

Rationale

1. Private Inurement/Private Benefit

An organization that is organized and operated exclusively for charitable purposes will qualify for exemption under section 501(c)(3) of the Code. The regulations to section 501(c)(3) provide that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3) of the Code. 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 regulations to section 501(c)(3) provide that the organization must serve public rather than private interests.

Based on the information provided, your activities consist of providing financial support to organizations described in section 501(c)(3) to further your charitable purposes. You have provided an unrestricted grant to B in which they may repay a loan to C in which the loan proceeds were used for educational purposes. C has no control over B in order to compel them to repay his loan. B is under no requirement to use the grant to repay C. B has a conflicts of interest policy, which prohibits inurement to any of its board members from this transaction by a vote from any interested Board member.

Based on the information provided, your grant to B furthers your exempt purposes, and does not result in your loss of exempt status under section 501(c)(3).

2. Self-Dealing

Under Section 4941, a tax is imposed on each act of self-dealing between a disqualified person and a private foundation. The tax may be imposed on the self-dealer, the foundation manager, or both. Self-dealing is defined, in pertinent part, as "any direct or indirect lending of money or other extension of credit between a private foundation and a disqualified person, or transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation."

A direct or indirect loan between a private foundation and a disqualified person is an act of self-dealing, regardless of whether or not the private foundation is the lender or the borrower. See Section 4941(d)(1)(B). Based on the information provided, there is no direct act of self-

dealing between you and C, because the lending of money was between C and B, which is not a private foundation. However, a loan by a disqualified person to a private foundation is not an act of self-dealing if the loan is without interest and if the proceeds of the loan are used exclusively for purposes specified in Section 501(c)(3). See Section 4941(d)(2)(B); Regs. 53.4941(d)-2(c)(2).

Indirect self-dealing includes any transaction between a disqualified person and an organization controlled by a private foundation within the meaning of section 53.4941(d)-1(b)(5) of the regulations.

For purposes of indirect self-dealing rules, this transaction would not be a transaction between a disqualified person and an organization controlled by a disqualified person. B is not controlled by you within the meaning of Reg. 53.4941(d)-1 because a private foundation only legally controls an organization "if the foundation or one of its managers (acting in such capacity) may, only by aggregating their votes or positions of authority, require the organization to engage in a transaction which if engaged in with the private foundation would constitute self-dealing." B is run by a majority vote of a board of four directors, of which C is only one of the directors. C cannot require that B engage in a self-dealing transaction. Thus, the self-dealing rules of Sec. 4941 have not been violated here by C.

Also, the transaction described here is not an act of indirect self-dealing because it meets the exception test set out in section 53.4941(d)-1(b)(1) of the regulations. Indirect self-dealing does not include any business transaction between a disqualified person and an organization controlled by a private foundation if the transaction results from a business relationship which was established before such transaction constituted an act of self-dealing, the transaction was at least as favorable to the organization controlled by the foundation as an arm's-length transaction with an unrelated person, and the organization controlled by the foundation could have engaged in the transaction with someone other than a disqualified person only at a severe economic hardship to such organization. In this case, the loan was made between C and B prior to any distribution of funds by you to B which would be used to repay the loan, and there was no assurance that you would make such a distribution or that there would be no adverse tax consequences to such a transaction. Thus, you have met one of the exceptions to set out in section 53.4941(d)-1(b)(1) of the regulations listed above.

Also, since the loan to B is interest free, it is more favorable to B than an arm's-length transaction from any third-party. It is highly unlikely that B could have engaged in such a favorable transaction with another individual or entity, and as a result, could not have carried out its purpose due to lack of funds. Thus, you have met another one of the exceptions to set out in section 53.4941(d)-1(b)(1) of the regulations listed above.

Even if B were controlled by you, the transaction would not constitute indirect self-dealing because the funds were not "earmarked" for the use of a disqualified person. B will have ultimate control of funds contributed by you, and B will not be bound to use any of the contributed funds for repayment of the loan.

The funds used to repay the loan here are not considered to be used by, or for the benefit of, a disqualified person. The reasons for this statement are as follows: 1) the funds were actually used by and benefited a public charity (B) and not C, a disqualified person; and 2) C gains no financial advantage from the transaction (i.e. his repayment will be no greater than the amount he loaned B).

Based on the above analysis, the Grant from you to B for the purpose of providing funds to B, which it will subsequently use to repay the loan from C, does not constitute an act of self-dealing by you.

3. Qualifying Distribution.

Under section 4942(g)(1) of the Code, a qualifying distribution is an amount paid to accomplish one or more purposes described in section 170(c)(2)(B) other than a contribution to an organization controlled (directly or indirectly) by the foundation or one or more disqualified persons with respect to the foundation, except as described in section 4942(g)(3), or any amount to acquire an asset to be used directly in carrying out its charitable purpose. Your contribution of funds to B is a qualifying distribution because the funds will be used to accomplish the educational purposes of B under Section 170(c)(2)(B). The proceeds were used to pay for construction and materials for a school building, purchase textbooks and equipment, desks and chair, kitchen and playground equipment (i.e. assets used to carry out the school's charitable purpose) and the balance was used for expenditures such as payment of staff salaries.

You do not control B within the meaning of section 53.4942(a)-3(a)(3) of the regulations. The majority of the Board of Directors of B must vote in order for action to be taken. There are four Board members of B, and a majority of B's Board are independent of C. C is the only member of the Board in common with B and you. The other members of the B board are not related to C and are not subject to control by him. C does not serve as the Treasurer of B. Thus, B is not controlled by you.

4. Excess Business Holdings

Section 4943 imposes an excise tax on the excess business holdings of a private foundation. "Excess Business Holdings" means, with respect to the holdings of any private foundation in any business enterprise, the amount of stock or other interest in the enterprise which the foundation would have to dispose of to a person other than a disqualified person in order for the remaining holdings of the foundation in such enterprise to be permitted holdings. See Sec. 4943(c). Since your contribution to B would constitute a grant, not an equity investment, the contribution does not result in Excess Business Holdings to you.

5. Jeopardizing Investment

Section 4944 imposes an excise tax if a private foundation invests any amount in such a manner as to jeopardize the carrying out of any of its exempt purposes. Since your contribution to B would constitute a grant, not an equity investment, the contribution is not a jeopardizing investment to you.

6. Taxable Expenditure

Section 4945 imposes an excise tax on each taxable expenditure made by a private foundation. Your grant to B does not constitute a taxable expenditure because an amount paid by a private foundation as a grant to a Section 509(a)(1) public charity (i.e., B) is not defined under Section 4945 as a taxable expenditure.

A grant to a public charity (B) by a private foundation is a taxable expenditure if the foundation "earmarks" the grant for an individual. Your grant has been made without any condition as to its use. The B Board of Directors will make the decision as to the use of the funds, rather than you. Thus, you have not made any taxable expenditure here under Section 4945.

Conclusions

1. Your Grant to B, which may be used by B to repay the loan from C does not constitute private inurement or private benefit to you resulting in a loss of Section 501(c)(3) status;
2. Your Grant to B is not an act of self-dealing under Section 4941;
3. Your Grant to B is a qualifying distribution under Section 4942(g);
4. Your Grant to B does not result in excess business holdings of you under Section 4943;
5. Your Grant to B is not a jeopardizing investment of you under Section 4944;
6. Your Grant to B is not a taxable expenditure of you under Section 4945.

This ruling is based on the understanding that there will be no material changes in the facts upon which it is based. Any changes that may have a bearing upon the Foundation's tax status should be reported to the Ohio Tax Exempt and Government Entities (TE/GE) Customer Service Office, which deals with exempt organizations matters. The mailing address is: Internal Revenue Service, TE/GE Customer Service, P.O. Box 2508, Cincinnati, OH 45201.

We are sending a copy of this ruling to the Ohio TE/GE Office. Because this letter could help resolve any questions about the Foundation's tax status, the Foundation should keep it with its permanent records.

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

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,

Debra J. Kaweck, Esq.
Manager, Exempt Organizations
Technical Group 4