IRS LETTER RULINGS

Letter Ruling Alert

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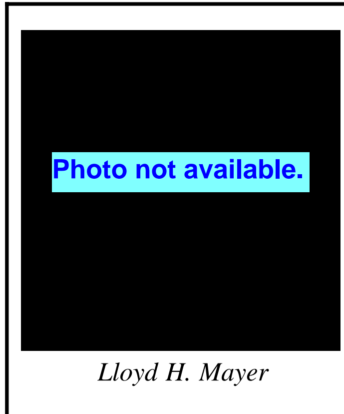
A New Option for Private Foundation Investing



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Introduction

Section 4943 limits the percentage interest that a private foundation, in combination with its disqualified persons, can hold in a "business enterprise." In a recent private letter ruling, 199939046 (for the full text, see p. 274), the Service examined the definition of the term "business enterprise" in the context of an investment partnership created by a group of related foundations. Looking beyond the statute's literal language to its underlying purposes, the Service concluded that the partnership was not a "business enterprise" for purposes of section 4943.

Facts

The ruling involved 15 private foundations. The private foundations were disqualified persons with respect to each other under section 4946(a)(1)(H).

The subject of the ruling request was an investment plan proposed by the foundations. The foundations planned to form a general partnership in order to make certain investments. Each foundation would make a maximum dollar commitment to the partnership, and the partnership would issue capital calls to the foundations in proportion to their commitments as investment opportunities arose. Participation in distributions and allocation of profits and losses would be in the same proportion. The capital calls would not exceed the initial commitment amounts, but funding of the capital calls up to those amounts would be mandatory upon the request of the manager partner. The managing partner would be one of the foundations; this foundation would also make payments to the partnership to cover the partnership's administrative costs. The same company that provided investment management services to the foundations individually would provide investment management and administrative services to the partnership at no charge. While not stated explicitly in the ruling, the Service's analysis makes it clear that this company was a disqualified person with respect to all of the foundations.

Each foundation would determine its maximum dollar commitment based on its own investment portfolio, but it was anticipated that such commitment would not exceed 20 percent of the foundation's total investment portfolio. Each foundation's other investments would include the normal mix of typical foundation investments: cash, cash equivalents, U.S. government obligations, corporate debt securities, equity mutual funds, and publicly traded corporate stock.

The purpose of the general partnership was to enable the foundations to pool their funds in order to allow them to invest in equity interests in private businesses and private equity funds not otherwise available to them, and to achieve greater diversification in investments. Such investments generally were not available to the foundations individually, except possibly to the one or two largest foundations, because the investments generally required investors to have a minimum financial size and to make a minimum dollar commitment for administrative and securities laws reasons. These investments generally would be made by purchasing limited partnership interests. The foundations' investment management company would not manage any of the limited partnerships.

The foundations anticipated that they might create a new investment partnership along these lines each year. The creation of new partnerships each year would allow each foundation to determine its need for these types of investments on an annual basis, without complicating the administration of the existing investment partnerships.

The general partnership agreement contained a number of significant limitations on the partnership's activities. Only private foundations could be partners. The partnership agreed not make any investments that would result in excess business holdings by a foundation partner and its disqualified persons under section 4943, to not directly engage in an operating business, and to not make any jeopardizing investments that would subject one or more of the foundation partners to tax under section 4944. The partnership also agreed not to engage in property or credit transactions with any disqualified persons of the foundation partners that would constitute self-dealing under section 4941(d)(1)(A) and (B), or to purchase or sell investments in an attempt to provide an advantage to a disqualified person.[1] The partnership also planned to not hold more than a 20 percent interest in any limited partnership.

The partnership was not, however, limited to receiving passive income, such as dividends, interests, royalties, and rents, through its limited partnership interests. In fact, it was anticipated that some of the limited partnerships would engage in active trade or businesses, and that the foundations

would pay unrelated business income tax on their allocable share of the income from such activities.

The foundation serving as the managing partner of the general partnership requested rulings that the formation and operation of the general partnership would not (1) constitute an act of self-dealing under section 4941; (2) result in excess business holdings under section 4943; or (3) constitute a taxable expenditure under section 4945.

IRS Conclusions and Rationale

Section 4941

The Service noted that while the 15 foundations were disqualified persons with respect to each other for purposes of section 4943, they were not disqualified persons with respect to each other for purposes of section 4941.[2] The Service then noted that the formation of the general partnership did not involve a sale or exchange or an extension of credit between a private foundation and a disqualified person, or a transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation. As for the investment management services, the Service noted that the provision of services by a disqualified person at no charge does not constitute self-dealing,[3] and that even if general partnership paid the investment company for those services, payment of reasonable compensation to a disqualified person for investment management services is not an act of self-dealing.[4] The Service therefore concluded that the formation and operation of the general partnership did not constitute an act of self-dealing under section 4941.

Section 4945

The Service found that none of the expenditures by the foundations would be for noncharitable purposes as long as both the expenditures by the partnership and the administrative payments by the managing partner to the partnership were reasonable. The Service therefore concluded that the formation and operation of the general partnership did not constitute a taxable expenditure under section 4945.

Section 4943

By far the most interesting aspect of the ruling is the Service's discussion relating to section 4943. Section 4943 limits the percentage interest that a foundation and its disqualified persons can together own in a "business enterprise."[5] The limit is generally 20 percent, although it increases to 35 percent if the foundation can demonstrate that an unrelated person or persons has effective control over the business enterprise.

For purposes of section 4943, disqualified persons include related private foundations described in section 4946(a)(1)(H). Under this section, one foundation is a disqualified person with respect to another foundation if the two foundations either are controlled by the same person or persons, or substantially all (85 percent) of the contributions received by one foundation were from disqualified persons of the other foundation (not including contributions from entities that are disqualified persons simply because a disqualified person owns a 35 percent interest in them).

The foundations here were disqualified persons with respect to each other under section 4946(a)(1)(H). Their combined ownership interest of 100 percent in the general partnership exceeded the ownership interest allowed by section 4943. Therefore the only way for the planned arrangement to be consistent with section 4943 was if the general partnership did not constitute a "business enterprise" for section 4943 purposes.

The term "business enterprise" includes "the active conduct of a trade or business, including any activity which is regularly carried on for the production of income from the sale of goods or the performance of services and which constitutes an unrelated trade or business under section 513."[6] Section 513(c) broadly defines a trade or business as "any activity which is carried on for the production of income from the sale of goods or the performance of services."[7] The foundation initially argued that the general partnership did not constitute a trade or business, citing the definition of a trade or business in other contexts within the code, but the Service disagreed with this argument, apparently based on the breadth of the section 513(c) definition of a trade or business. The Service also considered whether the general partnership would be excluded from the definition of an unrelated trade or business because of the investment company's volunteer investment management services, but found that the company's services were not a material income-producing factor and so this exclusion did not apply.[8]

The only exceptions to this definition of a business enterprise are functionally related businesses, program-related investments, and businesses that derive at least 95 percent of their gross income from passive sources.[9] The first two exceptions did not apply because the activities of the general partnership and the limited partnerships would not be charitable and therefore would not be related to the foundations' exempt purposes.

With regard to the last exception, the Service initially noted that a strict reading of the relevant statutory and regulatory provisions would limit the application of this provision to gross income from a specified set of passive sources, i.e., sources that produced dividends, interest, annuities, royalties, rent, or gains from the disposition of certain property.[10] Under this strict reading, such sources would not include limited partnership interests. However, the Service then rejected this strict reading and held instead that since the general partnership's only activity would consist of investment in private businesses, mainly as a limited partner in limited partnerships, and since the general partnership would not be managing the businesses of the limited partnerships, the limited partnerships represented passive investments comparable to stock and securities. The general partnership's investments would therefore be limited to passive investments, so the Service concluded that the general partnership was not a business enterprise for purposes of section 4943.

In support of this conclusion, the Service examined the purposes underlining section 4943. Before 1969, private foundations had an unfettered ability to invest in ongoing businesses. A significant number of foundations took advantage of this ability, with the result that foundations controlled

a wide variety of business corporations, including banks, hotels, clothing manufacturers, and retail stores. According to a report prepared by the U.S. Treasury Department, of the 1300 foundations surveyed, 180 owned 10 percent or more in an outstanding class of stock of at least one business corporation, and over 100 owned a 20 percent or larger interest.[11]

This ability created a significant planning opportunity for families who controlled businesses and wanted to pass control of the businesses to the next generation while minimizing exposure to estate and gift taxes. Rather than leaving their entire interest in a business to the next generation, and thereby subjecting that interest to estate and gift taxes, the family would instead transfer a significant portion of that interest to a family foundation. The transferred portion would not be subject to estate and gift taxes but would remain under the family's control, through the foundation. In addition, the donating family members might also receive significant charitable contribution deductions for the value of the donated stock.

Congress also viewed this ability as raising two additional concerns. First, Congress felt that owning a significant or controlling interest in a business would distract a foundation from its purported primary purpose of furthering charitable, educational, or other exempt purposes. Second, Congress felt that foundation-owned businesses would have a unfair competitive advantage over their competitors. This advantage would arise both because foundations could serve as easy sources of capital and because foundations would probably not be very demanding shareholders in terms of requiring high dividend payments, thereby allowing foundation-owned businesses to retain more profits than otherwise would be the case.[12] Therefore as part of the 1969 private foundation legislation, which included most of the provisions found in Chapter 42 of the code, Congress enacted section 4943.

Citing the legislative history summarized above, the Service found that its conclusion was consistent with the purposes of section 4943. The Service relied in particular on the fact that in describing the exception for "passive holding companies," i.e., companies receiving substantially all of their income from passive sources, the legislative history provided the following: "stock in a passive holding company is not to be considered a business holding, even if the holding company is controlled by the foundation. Instead, the foundation is to be treated as owning its proportionate share of the underlying assets of the holding company. The committee also made it clear that passive investments generally are not to be considered business holdings. For example, the holding of a bond issue is not a business holding, nor is the holding of stock of a company which itself derives income in the nature of a royalty to be treated as a business holding."[13]

The Service noted that the general partnership would not engage directly in an active business, but would merely hold an interest as a limited partner in various limited partnerships. The Service further noted that section 4943 allowed the foundations to own the interests that the general partnership would instead hold, as the general partnership would be limiting its holdings to 20 percent or less and no disqualified persons would be holding an interest in any of the limited partnerships. The Service concluded that it would be inconsistent for the foundations to be able to hold these interests directly but not to be able to hold these interests through a general partnership.

The Service also turned to the constructive ownership rule of section 4943(d)(1) to confirm its conclusion. Section 4943(d)(1) and reg. sections 53.4943-8(a)(1), and -8(d) provide that a private foundation or a disqualified person that owns an interest in a corporation, partnership or other entity is treated as the owner of a pro rata share of any business enterprise owned by that entity. Here, the foundations would be treated as owning the limited partnership interests owned by the general partnership. Since the general partnership agreed to limit its limited partnerships interests so as not to raise excess business holdings issues for any of its partners, applying this rule would not result in the foundations violating section 4943.

As a final note, the Service emphasized that its analysis only applied for section 4943 purposes and not for section 513 (unrelated trade or business taxable income) purposes. This note was important because in reaching this section 4943 conclusion the Service chose not to look through the limited partnerships to their sources of income in order to determine whether the general partnership received passive income, but instead treated the limited partnerships as separate entities and the character of income from the limited partnerships as passive as long as the general partnership's role with respect to the limited partnerships was passive. This treatment is in contrast to the statutorily mandated treatment of partnerships for UBIT purposes.

Under section 512(c)(1), if an unrelated trade or business is carried on by a partnership in which an exempt organization is a partner, the exempt organization partner's share of the partnership's gross income and deductions are included in the partner's unrelated business taxable income. In other words, for UBTI purposes the code treats partnerships as aggregates, with the character of income (related or unrelated) being determined at the partnership level, i.e., by whether the partnership is receiving income from related or unrelated activities. Here in contrast, the Service for purposes of section 4943 treated the limited partnerships as separate entities, with the character of income (passive or active) being determined at the partner level, i.e., by whether the partner (here, the general partnership) is actively involved in the management of the limited partnership.

Comment

This ruling indicates that the Service is willing to think creatively about the application of section 4943 in order to ensure that foundations are not unduly and unnecessarily limited in their investment options. A purely mechanical reading of section 4943 could have led to the conclusion that limited partnership interests are not passive sources of income and more than 5 percent of the income being received by the foundations originated in active trade or businesses, albeit trade or businesses conducted directly by limited partnerships. Instead, the Service chose to treat the limited partnership interests as themselves passive investments, thereby allowing the general partnership to avoid classification as a business enterprise.

This willingness to think creatively about the application of section 4943 may contain significant planning opportunities for private foundations. Private foundations can use the model contained in this letter ruling to develop similar collaborative investment vehicles. It does not appear necessary, however, for foundations to slavishly follow the pattern in the ruling to avoid any violations of section 4943 or the Chapter 42 provisions.

For example, it was not necessary for the investment management company to provide its services at no charge even though it was a disqualified person with respect to the foundations. As the Service noted in the ruling, payment of reasonable compensation for the investment company's management services is allowed under the self-dealing rules of section 4941.[14]

It also appears that the general partnership did not need to limit itself to holding a 20 percent or less interest in any limited partnership. If the general partnership was only a limited partner in the other partnerships, and the rest of the partners in the limited partnership were unrelated to the general partnership, unrelated persons should have effective control of the limited partnerships. Therefore, the higher, 35 percent limit on excess business holdings should apply.

Presumably other types of investments could also be considered passive investments for purposes of determining whether an organization is a section 4943 business enterprise. For example, interest in a limited liability company might be a passive investment if certain conditions are met, such as the interest not granting any right to participate in the governance of the LLC.

In sum, the Service has indicated in this ruling that it will not be limited to a strict reading of the passive source income exception to the definition of a business enterprise under section 4943. Instead, the Service will apply a definition of passive sources that is consistent with the purposes and constructive ownership rules of section 4943 but does not unduly limit the definition of passive source income. This flexibility provides an opportunity for private foundations and their advisors to think creatively about possible investment structures that could further foundation investing while passing muster under section 4943. As always, however, it is advisable when going beyond the clear statutory and regulatory language to consider obtaining a private letter ruling, as the foundations did here, to confirm that the Service would agree that a particular investment arrangement is consistent with section 4943 and the other provisions of Chapter 42 of the code.

Endnotes

[1]*See* reg. section 53.4941(d)-2(f)(1) (including in the definition of self-dealing the purchase or sale of stock or other securities by a private foundation if the purchase or sale is made in an attempt to manipulate the price of the stock or other securities to the advantage of a disqualified person).

[2]*See* section 4946(a)(1)(H) (stating that the related foundation provision only applies for purposes of section 4943); reg. section 53.4946-1(a)(8) (stating the for purposes of section 4941 only, the term "disqualified person" does not include any organization described in section 501(c)(3), other than an organization described in section 509(a)(4) (public safety organizations)).

[3]*See* section 4941(d)(2)(C).

[4]*See* section 4941(d)(2)(E); reg. section 53.4941(d)-3(c)(2), Example (2).

[5]For section 4943 purposes, disqualified persons include a private foundation's substantial contributors and managers, a 20 percent owner of a substantial contributor, a family member of a person in one of these two categories, an entity owned 35 percent or more by the persons in these two categories or their family members, and certain related private foundations. Section 4946(a)(1).

[6]Reg. section 53.4943-10(a)(1).

[7]*See* reg. section 1.513-1(b) (stating that under section 513 the term "trade or business" has the same meaning it has in section 162 (relating to deductions for trade or business expenses)). Certain exceptions apply to the section 513 definition of trade or business, but none of them are relevant here. See section 513(d)-(i).

[8]*See* section 513(a)(1) (excluding from the definition of an unrelated trade or business a trade or business in which substantially all the work is performed for the organization by volunteers (noncompensated); Rev. Rul. 78-144, 1978-1 C.B. 168 (holding that this exclusion does not apply when the volunteer labor is not a material income-producing factor for the business).

[9]Section 4943(d)(3); reg. section 53.4943-10(b).

[10]*See* section 4943(d)(3); reg. section 53.4943-10(c)(2).

[11]U.S. Treasury Department, *Report on Private Foundations* (Feb. 2, 1969), at 31.

[12]*See Staff of the Joint Comm. on Taxation*, 91st Cong., 2d Sess., General Explanation of the Tax Reform Act of 1969, at 40-41 (Comm. Print 1970); S. Rep. No. 552, 91st Cong., 1st Sess. 38-39 (1969); H.R. Rep. No. 413 (Part. 1), 91st Cong., 1st Sess. 27 (1969).

[13]S. Rep. No. 522, 91st Cong., 1st Sess. 41 (1969).

[14]Section 4941(d)(2)(E); reg. section 53.4941(d)-3(c)(2), Example (2).

Technical Advice Memorandums

Section 162 — Business Expenses

PULL-TAB REVENUES EARMARKED FOR CHARITY ARE DEDUCTIBLE. The Service has ruled in technical advice that an exempt organization may deduct pull-tab revenues as section 162 business expenses to offset unrelated business income when state law requires the revenues to be paid to the charity.

The section 501(c)(3) organization promotes amateur hockey and conducts bingo and pull-tab games in accordance with Washington state law, which requires all gambling revenues to be devoted exclusively to the organization's purposes. Gambling revenues were kept in a separate gaming account and then transferred to the organization's general account. The organization filed returns and paid tax on the pull-tab revenue as unrelated business income but later filed amended returns claiming a section 162 business expense deduction when the pull tab revenues were transferred to the organization and spent.

The Service analyzed the situation under *South End Italian Independent Club Inc. v. Commissioner*, 87 T.C. 11 (1986) and *Women of the Motion Picture Industry, et al. v. Commissioner*, T.C. Memo 1997- 518 and determined that the cases and relevant state law were similar. The Service noted state law required the funds to be expended in a particular manner as a requirement of maintaining a gambling license, making the payments ordinary and necessary and deductible under section 162. The deductions could not be taken, however, until the expenditures were made. Consequently, the Service said, the organization couldn't take the deduction at the time the funds were transferred between accounts.

The Service also advised that gaming revenues had to be allocated between exempt bingo revenues and unrelated business income pull-tab revenues. If no allocations were made, it warned, all the funds could be attributed to unrelated business income.

Full Text Citations: *TAM 199941043; Doc 1999-33443 (9 original pages); 1999 TNT 200-14*; reprinted at p. 270 of this edition.

Section 2055 — Estate Tax Charitable Deduction

ESTATE NOT ELIGIBLE FOR CHARITABLE DEDUCTION. The Service ruled in technical advice that an estate may not take a charitable deduction for the present value of a remainder interest of a charitable remainder trust because the trust doesn't meet the requirements of section 2055(e)(2) and isn't a reformable interest.

An individual established a revocable trust that would be split into a marital trust and charitable remainder unitrust on his death. The individual amended the trust eight times and deleted the dispositive provisions related to the charitable remainder unitrust.

When the individual died, the trust, as amended, required the trustee to pay the trust income for life to four beneficiaries. On the death of the last beneficiary, the trust directed the trustee to distribute the trust property and accrued income to several enumerated charities. The estate took a charitable deduction for the present value of the remainder interest in the charitable remainder trust as originally established.

The Service concluded that the charitable remainder trust doesn't meet the requirements of section 2055(e)(2). The Service also ruled that the trust isn't a reformable interest because the payments from the charitable remainder trust to the noncharitable beneficiaries aren't expressed either in specified dollar amounts or a fixed percentage of the fair market value of the property. Therefore, the Service concluded that the estate may not take a charitable deduction for the present value of the remainder interest of the charitable remainder trust.

Full Text Citations: *TAM 199941004; Doc 1999-33404 (8 original pages); 1999 TNT 200-17*; reprinted at p. 266 of this edition.

Section 2503 — Taxable Gifts

PREPAID TUITION PAYMENTS ARE QUALIFIED TRANSFERS. The Service ruled in technical advice that prepaid tuition payments made by a grandmother to an education institution are qualified transfers for purposes of the gift tax exclusion under section 2503(e).

In 1994, a grandmother entered into a series of tuition payment arrangements with a private school providing classes for preschool through twelfth grade. Under the arrangements, the school sent the grandmother an invoice covering tuition for her two grandchildren for multiple future years. The payments were not refundable and grandmother's son agreed to pay any increase in tuition not paid by the grandmother.

Because the payments were made directly to an educational organization to be used exclusively for the payment of specified tuition costs for designated individuals, the Service concluded that the grandmother's payments are qualified transfers under section 2503(e).

Full Text Citations: *TAM 199941013*; *Doc 1999-30895 (3 original pages); 1999 TNT 200-18*; reprinted at p. 269.

Summaries

Section 42 — Low-Income Housing Credit

AGENCY MAY CORRECT ADMINISTRATIVE ERROR. The Service ruled that an agency may correct an administrative error in a carryover allocation for a low-income housing credit.

A limited partnership that plans to build, own, and operate a low-income housing apartment complex with residential and office/multi-purpose buildings applied for a reservation of low-income housing credits from an agency. The initial application, however, reflected the wrong number of residential buildings.

The Service concluded that the agency committed an administrative error when it failed to identify the actual number of residential buildings in the project, and because of that error, the carryover allocation is incorrect. The Service also ruled that the agency must correct the administrative error and provided the steps the agency must take.

Full Text Citations: *LTR 199937024; Doc 1999-30254 (5 original pages); 1999 TNT 181-12; LTRServ,* Sept. 27, 1999, p. 7210

Section 146 — Private Bond Volume Cap

EXTENSION GRANTED TO FILE BOND VOLUME CAP CARRYFORWARD ELECTION. The Service granted a county an extension to elect under section 146(f) to carry forward its excess private activity bond volume cap.

The county applied for an allocation of bond volume cap to finance the construction of a solid waste disposal facility. Although the county was promised a specific amount of the state's 1999 volume cap, it was asked to accept some of the unused 1998 bond volume cap toward the amount promised. The issuing authority later realized that the carryforward election for 1998 had not been filed.

Full Text Citations: *LTR 199937044; Doc 1999-30274 (3 original pages); 1999 TNT 181-14; LTRServ,* Sept. 27, 1999, p. 7240

EXTENSION GRANTED TO FILE BOND VOLUME CAP CARRYFORWARD ELECTION. The Service granted a county an extension to elect under section 146(f) to carry forward its excess private activity bond volume cap.

The county applied for an allocation of bond volume cap and was allocated a portion of the state's 1998 volume cap for use after 1998 for residential rental housing bonds. In early 1999, a county employee noticed that the carryforward election hadn't been filed.

Full Text Citations: *LTR 199937045; Doc 1999-30275 (3 original pages); 1999 TNT 181-15; LTRServ,* Sept. 27, 1999, p. 7241

Section 403(b) — Tax-Deferred Annuities

CHURCH PLAN QUALIFIES. The Service ruled that a plan established by a church satisfies the requirements of section 403(b)(9). An employee who participates in the plan may exclude from gross income contributions made under the plan, including elective deferrals, if the employee doesn't exceed the applicable limitations under sections 403(b)(2) and 415.

Full Text Citations: *LTR 199937052; Doc 1999-30282 (6 original pages); 1999 TNT 181-22; LTRServ,* Sept. 27, 1999, p. 7254

Section 404 — Plan Contributions

ESOP DIVIDENDS DEDUCTIBLE. The Service ruled that an employer may deduct stock dividends paid to participants directly or to an ESOP trustee, provided the trustee distributes them to plan participants no later than 90 days after the close of the plan year in which they are paid to the ESOP. The Service also ruled that compensation deferred by the employees to offset their dividend receipts won't be treated as taxable wages.

Full Text Citations: *LTR 199938040; Doc 1999-30922 (6 original pages); 1999 TNT 186-21; LTRServ,* Oct. 4, 1999, p. 7343

Section 414(e) — Church Plans

CHURCH PLAN QUALIFIES. The Service ruled that a defined benefit plan qualifies as a church plan. The plan was established by a not-for-profit corporation that operates in accordance with a church's principles.

Full Text Citations: *LTR 199937047; Doc 1999-30277 (12 original pages); 1999 TNT 181-26; LTRServ,* Sept. 27, 1999, p. 7243

CHURCH PLAN QUALIFIED. The Service ruled that retirement and welfare plans qualify as church plans. The plans were established by an association of two churches united for the purpose of providing for the housing and medical needs of the elderly.

Full Text Citations: *LTR 199938049; Doc 1999-30931 (6 original pages); 1999 TNT 186-23; LTRServ,* Oct. 4, 1999, p. 7366

Section 501(c)(3) — Charities

EXEMPT HOSPITAL'S REORGANIZATION WON'T JEOPARDIZE STATUS OR RESULT IN UBIT. The Service ruled that a reorganization of an exempt hospital will not affect its section 501(c)(3) status or result in unrelated business income tax.

The hospital formed a private foundation to operate a health care system. Under the reorganization, the foundation will become the hospital's parent and will elect its board and control its budgets.

The Service determined that the reorganization will further the hospital's continued exempt purposes. Accordingly, the reorganization will not jeopardize the exempt status of the hospital or its parent foundation. In addition, the sharing of personnel, services, and expenses, or the transfer of assets will not create unrelated business taxable income.

Full Text Citations: *LTR 199939044; Doc 1999-31914 (8 original pages); 1999 TNT 191-20; LTRServ,* Oct. 11, 1999, p. 7476

REORGANIZATION WON'T AFFECT EXEMPT STATUS, RESULT IN UBIT. The Service ruled a corporate reorganization of a health care network will not affect the exempt status of its members or result in unrelated business income tax.

The network is made up of five section 501(c)(3) organizations and provides various services including nursing facility and home health care. Under the reorganization plan, one organization will remain independent, while three organizations will become the subsidiaries of another.

The Service determined that the reorganization will be primarily a change in membership structure and will not adversely affect the exempt status of any of the organizations. In addition, the Service concluded that any transfers of funds or assets or the sharing of services, personnel, or facilities will not constitute unrelated business taxable income.

Full Text Citations: *LTR 199939045; Doc 1999-31915 (8 original pages); 1999 TNT 191-21; LTRServ,* Oct. 11, 1999, p. 7479

Section 501(c)(4) — Civic Leagues, etc.

TAXABLE SUB'S ACTIVITIES WON'T BE ATTRIBUTED TO EXEMPT PARENT. The Service ruled that a taxable subsidiary's activities, including marketing and licensing for its exempt parent, will not be attributed to the parent for purposes of determining the parent's continued qualification for exempt status or liability for tax on unrelated business income.

The parent, a section 501(c)(4) social welfare organization, appears to be AARP (formerly the American Association of Retired Persons). AARP licenses its logo and loans its mailing list to companies that provide other services to its members. To ensure that its activities do not jeopardize its exempt status, AARP proposed that its taxable subsidiary take over operations relating to the service provider contracts.

The Service determined that AARP formed the sub for bona fide business purposes. Further, the Service found that enough independence existed for the sub to not be considered an instrumentality of AARP. Accordingly, the sub's activities will not be attributed to AARP and will not result in unrelated business taxable income.

Full Text Citations: *LTR 199938041; Doc 1999-30923 (16 original pages); 1999 TNT 186-26; LTRServ,* Oct. 4, 1999, p. 7346

Section 507 — Foundation Termination Tax

FOUNDATIONS' TRANSFER WON'T RESULT IN TERMINATION TAX. The Service ruled that the transfer of assets from two private foundations to related foundations will not result in the foundation termination tax or adversely affect the foundations' exempt status.

The Service also ruled that the transfer will not be a jeopardy investment under section 4944, and won't result in tax on investment income under section 4940 or in excess business holdings under section 4943. Further, the Service concluded, the transfer won't be a taxable expenditure under section 4945 or an act of self-dealing under section 4941.

Full Text Citations: *LTR 199937053; Doc 1999-30283 (10 original pages); 1999 TNT 181-27; LTRServ,* Sept. 27, 1999, p. 7257

FOUNDATION'S ASSET TRANSFER WILL BE REORGANIZATION. The Service ruled that a private foundation's transfer of all its assets to two newly created foundations will not result in termination but will be a reorganization under section 507(b)(2).

The foundation was created by a husband and wife. The couple is divorcing and wants to split the foundation's assets between two new foundations.

The Service determined the transfer will not be a termination of the first foundation's status but will qualify as a reorganization. In addition, the Service ruled that transfer will not subject the foundations to foundation excise taxes.

Full Text Citations: *LTR 199938039; Doc 1999-30921 (9 original pages); 1999 TNT 186-27; LTRServ,* Oct. 4, 1999, p. 7339

TRANSFER WON'T RESULT IN TERMINATION TAX, EXCISE TAXES. The Service ruled that grants from a private foundation to a related foundation will not result in foundation termination or excise taxes.

Both foundations were formed by members of the same family. The first foundation plans to make a capital endowment grant to the second foundation so that the second may expand its activities. The Service determined that the grant will not be a transfer of assets pursuant to a reorganization and will not result in the section 507 termination tax. In addition, the Service ruled the grant will not be investment income under section 4940, an act of self-dealing under section 4942, or a section 4944 jeopardy investment.

Full Text Citations: *LTR 199938050; Doc 1999-30932 (15 original pages); 1999 TNT 186-28; LTRServ,* Oct. 4, 1999, p. 7369.

Section 2055 — Estate Tax Charitable Deduction

REFORMATION OF TRUST IS A QUALIFIED REFORMATION. The Service ruled that the reformation of a trust is a qualified reformation under section 2055(e)(3).

Under an individual's will, the estate's residue was to be transferred to a trust for 10 years and the income distributed to 11 charities. The transfer, as written, doesn't qualify for the estate tax charitable deduction.

The trustee proposes to reform the trust by dividing it into two equal trusts. One trust will pay a unitrust amount to the charities for 10 years and then distribute the remaining trust principal to the individual beneficiaries. The other trust will pay all the trust income to the charities for 10 years and then distribute the remaining trust principal to the charities.

The Service ruled that the reformation will be a qualified reformation under section 2055(e)(3), and the trust paying the unitrust amount will meet the requirements of a charitable remainder unitrust. Also, the Service concluded that both trusts will qualify for an estate tax charitable deduction.

Full Text Citations: *LTR 199936010; Doc 1999-29400 (8 original pages); 1999 TNT 176-41; LTRServ,* Sept. 20, 1999, p. 7075.

IRA AND PLAN ASSETS PASSING TO CHARITY QUALIFY FOR DEDUCTION. The Service ruled that the value of IRAs and qualified plans will be includable in an individual's gross estate, but that the estate will qualify for a charitable deduction under section 2055(a) because the IRA and plan proceeds will pass to a private charitable foundation.

The individual created a private charitable foundation and named the foundation as beneficiary of the proceeds of his IRAs and his qualified retirement plans.

The Service also ruled that the proceeds from the IRAs and plans will be income in respect of a decedent to the private

foundation when distributed to the foundation. The proceeds will not, however, be income in respect of a decedent to the estate or the estate's beneficiaries.

Full Text Citations: *LTR 199939039; Doc 1999-31909 (4 original pages); 1999 TNT 191-37; LTRServ,* Oct. 11, 1999, p. 7466

Section 2522 — Charitable Gifts

CHARITABLE DEDUCTION ALLOWED FOR GUARANTEED ANNUITY INTEREST. The Service ruled that an individual may take a charitable deduction for the present value of a guaranteed annuity interest qualifying under section 2522, and that the gift qualifies for the gift tax charitable deduction.

The individual is the grantor of a revocable trust that holds stock in an S corporation. The individual proposes to establish an irrevocable family charitable trust and direct the trustees of the revocable trust to transfer the S corporation stock to the irrevocable trust. The family charitable trust will qualify as a guaranteed annuity trust under section 2522.

The Service concluded that the family charitable trust will satisfy the requirements of a guaranteed annuity, and the stock transfer will qualify for a gift tax charitable deduction. Also, the Service ruled that the individual will be allowed a charitable deduction under section 170 for the value of the annuity. The family charitable trust, said the Service, is an eligible shareholder of the S corporation and the trust won't be includable in the individual's gross estate. The Service also determined that the family charitable trust won't have excess business holdings.

Full Text Citations: *LTR 199936031; Doc 1999-29421 (12 original pages); 1999 TNT 176-43; LTRServ,* Sept. 20, 1999, p. 7109

Section 2702 — Transfers of Interests in Trusts

TRUST IS A CHARITABLE LEAD UNITRUST. The Service ruled that a trust is a charitable lead unitrust, and it qualifies for a gift tax charitable deduction under section 2522(a). The Service also concluded that section 2702 doesn't apply to the trust.

A couple proposes to establish an irrevocable charitable lead unitrust. Under the trust's terms, the trustee will pay a percentage of the trust's net fair market value to a charity for a 12-year term. At the end of the term, the remaining income and principal of the trust will be distributed to a trust to benefit the couple's grandchildren.

Full Text Citations: *LTR 199936038; Doc 1999-29428 (4 original pages); 1999 TNT 176-44; LTRServ,* Sept. 20, 1999, p. 7121

Section 3121 — Social Security Definitions

ORGANIZATION IS RELIGIOUS ORDER. The Service ruled that an organization operated by a church is a religious order for federal tax purposes. The IRS concluded that the organization possessed "to a substantial degree" all of the characteristics enumerated in Rev. Proc. 91-20, 19991-1 C.B. 524, for determining whether an organization is a religious order. Members made long-term commitments to and personal sacrifices for the organization; they also lived communally and worshipped regularly.

Full Text Citations: *LTR 199937013; Doc 1999-30243 (3 original pages); 1999 TNT 181-46*; LTR Serv., Sept. 27, 1999, p. 7199

ORGANIZATION IS RELIGIOUS ORDER. The Service ruled that an organization is a religious order for federal tax purposes and not subject to FICA withholding requirements. The organization's purpose was to provide Christian education for young people and care for the sick and elderly.

Analyzing the facts in light of Rev. Proc. 91-20, 19991-1 C.B. 524, which enumerates characteristics for determining whether an organization is a religious order, the IRS concluded that the organization met the requirements of the revenue procedure "to a substantial degree." The Service noted that the organization qualified for 501(c)(3) status and required its members to make long-term commitments to and personal sacrifices for the organization, as well as to live communally and worship regularly.

Full Text Citations: LTR 199938013; *Doc 1999-30895 (5 original pages); 1999 TNT 186-47*; LTR Serv., Oct. 4, 1999, p. 7307.

Section 4941 — Foundation Self-Dealing

FOUNDATIONS' INVESTMENT PARTNERSHIP WON'T RESULT IN EXCISE TAXES. The Service ruled that the participation in an investment partnership by 15 related private foundations will not result in foundation excise taxes.

The foundations intend to form a general partnership so they can invest in private businesses and equity funds. One of the foundations will serve as managing partner, and a family company will provide management and administrative services for the partnership.

The Service ruled that neither the foundations nor the partnership will be disqualified persons for purposes of section 4941. It also ruled that the partnership's formation and operation will not result in taxable expenditures under section 4945.

Questioning whether the partnership is a business enterprise under section 4943, the Service noted that, under a strict reading of the regulations, the partnership might not qualify as a "passive holding company." The Service concluded, however, that the partnership's investments could represent passive investments. Accordingly, it said, the partnership will not be treated as a business enterprise.

Full Text Citations: *LTR 199939046; Doc 1999-31916 (11 original pages); 1999 TNT 191-42; LTRServ,* Oct. 11, 1999, p. 7483; reprinted at p. 274 of this edition.

Section 4945 — Taxable Expenditures

SCHOLARSHIP GRANTS AREN'T TAXABLE EXPENDITURES. The Service ruled that expenditures for a private foundation's scholarship program are not taxable under section 4945(d)(3) and are, therefore, excludable from income under section 117(a).

Full Text Citations: *LTR 199936050; Doc 1999-29440 (4 original pages); 1999 TNT 176-45; LTRServ,* Sept. 20, 1999, p. 7134

GRANTS AREN'T TAXABLE EXPENDITURES. The Service ruled that expenditures for an organization's scholarship program comply with section 4945(g)(1), and the grants awarded under the program will not be taxable expenditures.

An organization will make annual contributions to a scholarship fund for children of employees of a company. The scholarship fund will prepare and furnish application forms, receive all applications, determine the recipients and amount to be awarded, notify the recipients of the award, confirm enrollment in an educational institution, pay the award, and supervise and investigate the use of grant funds by the recipients in their educational programs. The scholarships will be granted based on scholastic aptitude test performance, class rank, counselor appraisal, and extracurricular activities. The grants will be awarded only to students that plan to enroll in institutions that meet the requirements of section 170(b)(1)(A)(ii). They will not be used as inducements to recruit employees for the company, nor will they be terminated if employees leave.

The IRS approved the program provided the awards remain objective and nondiscriminatory. Accordingly, the Service ruled that the grants comply with the requirements of section 4945(g)(1) and will not be taxable expenditures. Moreover, the grants are excludable from the recipient's gross income if they are used for qualified tuition and related expenses.

Full Text Citations: *LTR 199937048; Doc 1999-30278 (3 original pages); 1999 TNT 181-50; LTRServ,* Sept. 27, 1999, p. 7247

FOUNDATION GRANTS AREN'T TAXABLE EXPENDITURES. The Service ruled that a private foundation's grant programs comply with section 4945(g)(1) and (3) and the grants awarded under the programs will not be taxable expenditures.

The foundation awards two types of grants: one based on individually submitted proposals, and the other awarded through public competitions. Grant proposals are evaluated for merit and the relationship of the proposal to the foundation's program activities. Grants awarded through publicly awarded competitions are intended for primary and secondary school teachers, college students, and graduate students. Recipients are expected to report courses taken and grades received, if any, and educational institutions must verify the reports at least once a year.

The Service concluded that if the grants continue to be made in an objective and nondiscriminatory manner, the procedures for awarding the grants comply with section 4945(g)(1), and that the grants are not taxable expenditures under section 4945(d)(3). Finally, the Service noted that the procedures for selecting nonscholarship grants satisfy the requirements of section 4945(g)(3), serve to further the professional development of the grantees, and are not taxable expenditures under section 4945(d)(3).

Full Text Citations: *LTR 199937051; Doc 1999-30281 (6 original pages); 1999 TNT 181-51; LTRServ,* Sept. 27, 1999, p. 7252

SCHOLARSHIP GRANTS AREN'T TAXABLE EXPENDITURES. In seven rulings, the Service ruled that a company's grants to a scholarship program administered by an independent foundation are not "taxable expenditures" under section 4945(d)(3).

An independent nonprofit organization administers tests at the high school level, then identifies and honors students scoring in the top 2 percent of graduating high school seniors. It designates fewer than 1 percent of the seniors in each state as semifinalists; semifinalists who demonstrate high academic standing in high school are designated as finalists.

Each year, the company sponsors a specific number of scholarships for children of its employees. The scholarships will be administered by the organization in a manner substantially similar to its own scholarship program. A committee designated by the organization and independent from the company awards the scholarships, and the number of scholarships won't exceed the number of children who qualify as finalists. The scholarship program will not be used to recruit employees, nor will a grant be terminated if an employee leaves the company.

The Service concluded that the procedure for awarding the scholarships complies with section 4945(g)(1). Therefore, the grants are not "taxable expenditures" under section 4945(d)(3), and can be excluded from income under section 117(a) to the extent that the grants are actually used for qualified tuition and related expenses.

Full Text Citations

- *LTR 199938042; Doc 1999-30924 (5 original pages); 1999 TNT 186-48; LTRServ,* Oct. 4, 1999, p. 7352
- *LTR 199938043; Doc 1999-30925 (4 original pages); 1999 TNT 186-49; LTRServ,* Oct. 4, 1999, p. 7354
- *LTR 199938044; Doc 1999-30926 (5 original pages); 1999 TNT 186-50; LTRServ,* Oct. 4, 1999, p. 7356
- *LTR 199938045; Doc 1999-30927 (5 original pages); 1999 TNT 186-51; LTRServ,* Oct. 4, 1999, p. 7358
- *LTR 199938046; Doc 1999-30928 (5 original pages); 1999 TNT 186-52; LTRServ,* Oct. 4, 1999, p. 7360

- *LTR 199938047; Doc 1999-30929 (5 original pages); 1999 TNT 186-53; LTRServ,* Oct. 4, 1999, p. 7362

- *LTR 199938048; Doc 1999-30930 (5 original pages); 1999 TNT 186-54; LTRServ,* Oct. 4, 1999, p. 7364

Section 4975 — Prohibited Plan Transaction Tax

EMPLOYER'S S CORP. ELECTION TROUBLESOME FOR ESOP. The Service refused to rule on whether an employer's S corporation election will affect the qualified status of its ESOP. The Service did rule, however, that earnings from unallocated shares held in the ESOP's suspense account may be used to repay an exempt ESOP loan.

In 1995 an ESOP borrowed money from its sponsoring employer to acquire most of the employer's stock. The ESOP loan was structured as an exempt loan under reg. section 54.4975-7(b)(1)(iii). The unallocated shares were held in a suspense account and were allocated to participants as the loan was repaid through deductible employer contributions to the ESOP.

The employer is a C corporation that intends to elect S corporation status. It also intends to amend its ESOP to become a stock bonus and money purchase pension plan that will continue to invest primarily in the employer's stock. The employer requested a ruling on the federal income tax effects of the election, particularly on the ESOP loan.

Citing Rev. Proc. 99-4, 1999-1 IRB 115, the Service declined to rule on whether the S corporation election would affect the ESOP's qualified plan status. A determination letter, said the IRS, is the appropriate vehicle for deciding that issue.

As for the loan's status, the Service said the loan would continue to be qualified under section 4975(d)(3) to the extent that it was repaid with earnings attributable to the unallocated suspense account shares. Using the earnings attributable to the allocated shares, however, would violate the reg. section 54.4975-7(b)(3) and 54.4975-7(b)(5) requirements, causing the ESOP loan to fail to qualify under section 4975(d)(3).

Full Text Citations: *LTR 199938052; Doc 1999-30934 (4 original pages); 1999 TNT 186-55; LTRServ,* Oct. 4, 1999, p. 7377

Full Text TAMs

Estate Not Eligible for Charitable Deduction

TAM 199941004

The Service has ruled in technical advice that an estate may not take a charitable deduction for the present value of a remainder interest of a charitable remainder trust because the trust doesn't meet the requirements of section 2055(e)(2) and isn't a reformable interest.

Index (UIL) No.: 2055-00.00
Release Date: 10/15/1999

Date: May 27, 1999

Internal Revenue Service National Office
Technical Advice Memorandum

CC:DOM:P&SI:B7

CASE MIS No.: TAM-102743-99

District Director * * *
Taxpayer's Name: * * *
Taxpayer's Address: * * *
Taxpayers Identification No: * * *
Years Involved: * * *
Date of Conference: * * *
LEGEND
Decedent = * * *
Date 1 = * * *
Date 2 = * * *
Date 3 = * * *
Date 4 = * * *
Date 5 = * * *
Date 6 = * * *
Date 7 = * * *
Date 8 = * * *
Date 9 = * * *
Date 10 = * * *
Date 11 = * * *
X = * * *

Issue

Does the charitable remainder trust created under Decedent's Trust satisfy the requirements of section 2055(e) of the Internal Revenue Code so that Decedent's estate is eligible for a deduction under section 2055 for the present value of the remainder interest of the charitable remainder trust?

Conclusion

Because the charitable remainder trust created under Decedent's Trust is not in the form required in section 2055(e)(2) and is not a reformable interest under section 2055(e)(3),

Decedent's estate is not eligible for a charitable deduction under section 2055 for the present value of the remainder interest of the charitable remainder trust.

Facts

On Date 1, Decedent established Decedent's Trust. As originally drafted on Date 1, Decedent's Trust provided for a revocable trust during Decedent's lifetime. Paragraph IV A of Decedent's original revocable trust provided that on Decedent's death, the trustee was to create a marital deduction trust for Decedent's spouse, to pay Decedent's debts, taxes and expenses, to make a specific pecuniary bequest and to create a charitable remainder unitrust with the remainder of the original revocable trust principal and any unpaid income of the original revocable trust.

Under the terms of Decedent's Trust, as originally drafted, trustee was to pay a unitrust amount equal to five percent of the net fair market value of the trust assets valued as of the first day of each taxable year of the unitrust. The terms of the original revocable trust provided that the trustee pay the unitrust amount to Decedent's spouse for life. On the death of Decedent's spouse, the trustee was to pay the unitrust amount proportionally to thirteen individual beneficiaries for ten years or life, whichever was shorter. Upon the death of the last survivor of those beneficiaries or at the end of the 10-year term (whichever occurred first), trustee was to distribute the entire trust principal and any unpaid income to thirteen charitable organizations.

Decedent amended Decedent's Trust 8 times, on Date 2, Date 3, Date 4, Date 5, Date 6, Date 7, Date 8, and Date 9. The amendments to Decedent's Trust deleted the original post-death dispositive provisions and added new dispositive provisions. In particular, the amendments to Decedent's Trust deleted the dispositive provisions related to the charitable remainder unitrust.

Decedent died testate on Date 10. On Date 10, Decedent's Trust became irrevocable. The final terms of Decedent's Trust, as amended, required trustee to "pay [trust] income annually for life in equal shares" to four beneficiaries, if those beneficiaries survived Decedent. In the event any of the four beneficiaries predeceased Decedent, their life interest in the income lapsed and their life interest was to be divided and distributed to the survivors. At the death of the last remaining member of the class of income beneficiaries, the terms of Decedent's Trust provide that the trust will terminate, and the trust property and accrued income shall be distributed outright to several enumerated charities that are "tax- exempt" charities.

A federal estate tax return for Decedent's estate was filed timely on Date 11. On Schedule O of the return, the estate claimed a charitable deduction of x dollars. Taxpayer represents that this figure is the present value of the remainder interest in the charitable remainder trust established under Decedent's Trust dated Date 1.

Law

Section 2055(a) provides, in part, that the value of the taxable estate shall be determined by deducting from the value of the gross estate the amount of all bequests, legacies, devises, and transfers to or for a corporation or certain other organizations organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes.

Congress added section 2055(e)(2) in section 201(d)(1) of the Tax Reform Act of 1969, 1969-3 C.B. 1 at 51. Language in the legislative history indicates that Congress was concerned that, under law prior to 1969, taxpayers were allowed a charitable deduction for a gift of a remainder interest in trust to a charity and the charitable deduction was substantially in excess of the amount of the gift the charity ultimately received[.] Section 2055(e) was added to the code to prevent this perceived abuse by allowing a charitable deduction for bequests of partial interests in property only if the bequests are in a prescribed form. H.R. Rep. 99-413, 1969-3 C.B. 237, 238.

Section 2055(e)(2) provides that where an interest in property (other than an interest described in section 170(f)(3)(B) passes or has passed from decedent to a person, or for a use, described in section 2055(a) and an interest (other than an interest that is extinguished upon the decedent's death) in the same property passes or has passed (for less than an adequate and full consideration in money or money's worth) from the decedent to a person or for a use not described in section 2055(a), no deduction shall be allowed under section 2055 for the interest that passes or has passed to the person, or for the use, described in section 2055(a) unless —

(A) in the case of a remainder interest, such interest is in a trust which is a charitable remainder annuity trust or a charitable remainder unitrust (described in section 664), or a pooled income fund (described in section 642(c)(5), or

(B) in the case of any other interest, such interest is in the form of a guaranteed annuity or is a fixed percentage distributed yearly of the fair market value of the property (to be determined yearly).

Section 664(d)(1), as in effect for transfers in trust on or before Date 10, provides that a charitable remainder annuity trust is a trust —

(A) from which a sum certain (which is not less than 5 percent of the initial net fair market value of all property placed in trust) is to be paid, not less often than annually, to one or more persons (at least one of which is not an organization described in section 170(c) and, in the case of individuals, only to an individual who is living at the time of the creation of the trust) for a term of years (not in excess of 20 years) or for the life or lives of such individual or individuals,

(B) from which no amount other than the payments described in section 664(d)(1)(A) may be paid to or for the use of any person other than an organization described in section 170(c), and

(C) following the termination of the payments described in section 664(d)(1)(A), the remainder interest in

the trust is to be transferred to, or for the use of, an organization described in section 170(c) or is to be retained by the trust for such a use.

Section 664(d)(2), as in effect for transfers in trust on or before Date 10, provides that a charitable remainder unitrust is a trust —

(A) from which a fixed percentage (which is not less than 5 percent) of the net fair market value of its assets, valued annually, is to be paid, not less often than annually, to one or more persons (at least one of which is not an organization described in section 170(c) and, in the case of individuals, only to an individual who is living at the time of the creation of the trust) for a term of years (not in excess of 20 years) or for the life or lives of such individual or individuals,

(B) from which no amount other than the payments described in section 664(d)(2)(A) may be paid to or for the use of any person other than an organization described in section 170(c), and

(C) following the termination of the payments described in section 664(d)(2)(A), the remainder interest in the trust is to be transferred to, or for the use of, an organization described in section 170(c) or is to be retained by the trust for such a use.

Section 642(c)(5) provides that a pooled income fund is a trust —

(A) to which each donor transfers property, contributing an irrevocable remainder interest in such property to or for the use of an organization described in section 170(b)(1)(A) (other than in clauses (vii) or (viii)), and retaining an income interest for the life of one or more beneficiaries (living at the time of such transfer),

(B) in which the property transferred by each donor is commingled with property transferred by other donors who have made or make similar transfers,

(C) that cannot have investments in securities that are exempt from income tax,

(D) that includes only amounts received from transfers which meet the requirements of section 642(c)(5),

(E) that is maintained by the organization to which the remainder interest is contributed and of which no donor or beneficiary of an income interest is a trustee, and

(F) from which each beneficiary of an income interest receives income, for each year for which he is entitled to receive the income interest referred to in section 642(c)(5)(A), determined by the rate of return earned by the trust for such year.

Section 2055(e)(3) provides rules under which interests in a trust may be reformed to comply with section 2055(e)(2). Section 2055(e)(3)(A) provides that a deduction is allowed under section 2055(a) for any qualified reformation.

Section 2055(e)(3)(B) defines the term "qualified reformation" to mean a change of a governing instrument by reformation, amendment, construction, or otherwise that changes a reformable interest into a qualified interest, but only if —

(i) any difference between (I) the actuarial value (determined as of the date of the decedent's death) of the qualified interest, and (II) the actuarial value (as so determined) of the reformable interest does not exceed 5 percent of the actuarial value (as so determined) of the reformable interest,

(ii) in the case of (I) a charitable remainder interest, the nonremainder interest (before and after the qualified reformation) terminated at the same time, or, (II) any other interest, the reformable interest and the qualified interest are for the same period, and

(iii) the change is effective as of the date of the decedent's death.

Section 2055(e)(3)(C)(i) defines the term "reformable interest" to mean any interest for which a deduction would be allowable under section 2055(a) at the time of the decedent's death but for section 2055(e)(2).

Section 2055(e)(3)(C)(ii) provides that generally the term "reformable interest" does not include any interest unless, before the remainder vests in possession, all payments to persons other than an organization described in section 2055(a) are expressed either in specified dollar amounts or a fixed percentage of the fair market value of the property.

Section 2055(e)(3)(C)(iii) provides that section 2055(e)(3)(C)(ii) shall not apply to any interest if a judicial proceeding is commenced to change the interest into a qualified interest not later the 90th day after —

(1) if an estate tax return is required to be filed, the last date (including extensions) for filing such return, or

(2) if no estate tax return is required to be filed, the last date (including extensions) for filing the income tax return for the 1st taxable year for which such a return is required to be filed by the trust.

Section 2055(e)(3)(C)(iv) provides that, in the case of any interest passing under a will executed before January 1, 1979, or under a trust created before such date, section 2055(e)(3)(C)(ii) shall not apply.

Section 2055(e)(3)(D) defines the term "qualified interest" to mean an interest for which a deduction is allowable under section 2055(a).

Analysis

Section 2055(e)(2)(A) disallows an estate tax charitable deduction for the remainder interest in a charitable remainder trust unless the trust is in the form of a charitable remainder annuity trust or a charitable remainder unitrust (described in section 664) or a pooled income fund (described in section 642(c)(5)).

Under section 2055(e)(3), a "reformable interest" (meaning an interest for which a deduction would have been allow-

able at the time of the decedent's death under section 2055(a) but for section 2055(e)(2)) may be converted into a "qualified interest" (meaning an interest that meets the requirements of section 2055(e)(2)) by a "qualified reformation."

Section 2055(e)(3)(C)(ii) provides that, generally, a "reformable interest" does not include any interest unless, before the remainder vests in possession, all payments to the noncharitable beneficiaries are expressed either in specified dollar amounts or a fixed percentage of the fair market value of the property. Section 2055(e)(3)(C)(iii) and (iv), however, provides two exceptions to the general rule. First, section 2055(e)(3)(C)(iii) provides, in part, that section 2055(e)(3)(C)(ii) does not apply to any interest if not later than 90 days after the last date (including extensions) for filing an estate tax return a judicial proceeding is commenced to change the interest into a qualified interest. Second, section 2055(e)(3)(C)(iv) provides that, in the case of any interest passing under a will executed before January 1, 1979, or under a trust created before such date, section 2055(e)(3)(C)(ii) shall not apply.

Section 1.664-1(a)(4) provides that, for purposes of section 664 and the regulations thereunder, a trust is deemed to be created at the earliest time that neither the grantor nor any other person is treated as the owner of the entire trust under Subpart E, Part 1, Subchapter J, Chapter 1, Subtitle A of the code (relating to grantors and others treated as substantial owners). Under the rules contained in section 1.664-1(a)(4), Decedent's Trust is deemed to be created at the earliest time that neither the grantor nor any other person is treated as the owner of the entire trust under Subpart E, Part 1, Subchapter J, Chapter 1, Subtitle A of the code. In this case, because Decedent retained the power to revoke, alter, and amend Decedent's Trust until her death, Decedent was treated as the owner of the entire trust corpus under the grantor trust rules until her death on Date 10, a date after December 31, 1978. See section 1.664-1(a)(6), example (1). Thus, the charitable remainder trust created under Decedent's Trust, as amended, is considered to be created on Date 10.

Further, Decedent amended Decedent's Trust several times after December 31, 1978. The amendments to Decedent's Trust deleted the original post-death dispositive provisions, including the dispositive provisions creating the charitable remainder unitrust, and added new charitable dispositive provisions that were not in the form required in section 2055(e)(2)(A) or (B).

Based on the facts presented, the charitable remainder trust created under Decedent's Trust is not a "reformable interest" as that term is defined in section 2055(e)(3)(C) because the payments from the charitable remainder trust to the noncharitable beneficiaries are not expressed either in specified dollar amounts or a fixed percentage of the fair market value of the property and the requirements in the two special rules that are exceptions to the general rule are not satisfied. The special rule contained in section 2055(e)(3)(C)(iii) is not satisfied, because a timely judicial proceeding was not commenced within the time limit prescribed in section 2055(e)(3)(C)(iii) which, under the facts of this case, requires the proceeding to be commenced not later than the 90th day after the last date for filing the estate tax return (including extensions). Further, the special rule contained in section 2055(e)(3)(C)(iv) applicable to any interest passing under a will executed before January 1, 1979, or under a trust created before January 1, 1979 is not applicable in this case, because the charitable interest passed under a trust created after December 31, 1978, for purposed [sic] of section 2055(e)(3).

Because the charitable remainder trust created under Decedent's Trust, as amended, is not in the form required in section 2055(e)(2) and because the trust is not a reformable interest, we conclude that Decedent's estate is not eligible for a charitable deduction under section 2055 for the present value of the remainder interest of the charitable remainder trust.

Caveat(s)

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) provides that it may not be used or cited as precedent.

Prepaid Tuition Payments Are Qualified Transfers

TAM 199941013

The Service has ruled in technical advice that prepaid tuition payments made by a grandmother to an education institution are qualified transfers for purposes of the gift tax exclusion under section 2503(e).

Index (UIL) No.: 2503.12-00
Release Date: 10/15/1999

Date: July 9, 1999

Internal Revenue Service National Office Technical Advice Memorandum

CC:DOM:P&SI:B4
CASE MIS No.: TAM-104569-99

LEGEND:
Decedent = * * *
School = * * *
Father = * * *
Grandchild 1 = * * *
Grandchild 2 = * * *

Issue

Whether prepaid tuition payments made by Decedent on behalf of Grandchild 1 and Grandchild 2 to School, an educational institution described in section 170(b)(1)(A)(ii) of the Internal Revenue Code, qualify as qualified transfers for purposes of the gift tax exclusion under section 2503(e).

Conclusion

The prepaid tuition payments made by decedent to school qualify as qualified transfers under section 2503(e).

Facts

Beginning in 1994, the Decedent entered into a series of tuition payment arrangements with school, a private school providing classes for preschool through 12th grade. Under the arrangements, School sent Decedent an invoice covering tuition for her two grandchildren, Grandchild 1 and Grandchild 2, for multiple future years.

The decedent made the following payments:

February 16, 1994 = $18,015 for tuition for 1994-1995.

June 1, 1994 = $49,395 for tuition for 1995-1996, 1996-1997, and 1997-1998.

February 16, 1995 = $20,000 for tuition for 1998-1999.

July 30, 1996 = $94,000 for tuition for 1999-2000, 2000-2001, 2001-2002, 2002-2003, and 2003-2004.

Grandchild 1 and Grandchild 2 were students at school during the years the above payments were made by decedent. With the exception of the February 1994 payment, all payments were for tuition for years other than the year in which the payment was made. Beginning with the June 1994 payment, decedent and school entered into written agreements regarding the payments. Under the agreements, the payments were to be applied in payment of tuition for Grandchild 1 and Grandchild 2 for specified years. The payments were not refundable. If, for example, the grandchildren ceased to attend school, then school would retain the funds. Furthermore, decedent and father, the parent of Grandchild 1 and Grandchild 2, agreed that if the cost of tuition at school increased, with respect to any year, then school would be paid the additional funds necessary to cover the increase in tuition cost. Father provided a letter to the school confirming his agreement to pay any tuition increase not paid by Decedent.

Law and Analysis

Section 2503(e)(1) provides that any "qualified transfer" shall not be treated as a transfer of property by gift. Under section 2503(e)(2)(A), a qualified transfer includes:

> paid on behalf of an individual —
>
> (A) as tuition on to an educational organization described in section 170(b)(1)(A)(ii) for the education or training of such individual.
>
> * * *

Section 25.2503-6(b)(2) of the Gift Tax Regulations provides that the unlimited exclusion is permitted for tuition expenses of full-time or part-time students paid directly to the qualifying educational organization providing the education. The exclusion is available only for amounts paid as direct tuition costs. Section 25.2503-6(c), Example 2, considers a situation where the donor, *A*, transfers $100,000 to a trust the terms of which require the trustee to use the trust funds to pay tuition expenses for *A*'s grandchildren. The example concludes that *A*'s transfer to the trust is a completed gift for gift tax purposes and is not a direct transfer to an educational organization and does not qualify for the unlimited exclusion under section 2503(e).

In the instant case, Grandchild 1 and Grandchild 2 were attending school during the periods the payments were made. Decedent paid the amounts to school in payment of specified tuition costs with respect to designated individuals. The payments were not subject to refund and were to be forfeited in the event the grandchildren ceased to attend school. Thus, the payments were made directly to an educational organization to be used exclusively for the payment of specified tuition costs for designated individuals. Accordingly, the payments constituted an "amount paid on behalf of an individual as tuition to an educational organization . . . for the education or training of such individual," for purposes of section 2503(e)(2). This is in contrast to the situation presented in section 25.2503-6(c), Example 2, where the payments were not made to an educational organization in payment of specific tuition costs for a designated individual.

Accordingly, we conclude that Decedent's payments qualify as qualified transfers under section 2503(e).

Caveat

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Pull-Tab Revenues Earmarked for Charity Are Deductible

TAM 199941043

The Service has ruled in technical advice that an exempt organization may deduct pull-tab revenues as section 162 business expenses to offset unrelated business income when state law requires the revenues to be paid to the charity.

Date: June 28, 1999

District Director * * *

LEGEND:
Taxpayer's Name = * * *
Taxpayer's Address = * * *
Taxpayer's Identification Number = * * *
Years Involved = * * *
Conference = * * *

Facts

The taxpayer was incorporated under the laws of the state of Washington on August 1, 1978. Its exempt purpose is to encourage and promote the growth of amateur hockey in accordance with accepted youth movement objectives, among which are: teaching physical skills; fair play; discipline; respect for authority and competitiveness; and such other purposes within the meaning of section 501(c)(3) of the Internal Revenue Code. The taxpayer has been recognized as exempt under section 501(c)(3) since 1978.

In 1991, the taxpayer obtained a permit from the Washington State Gambling Commission to conduct bingo games and sell pull-tabs during the games. It has been conducting these activities continuously since then. From 1991 through 1996, the taxpayer filed Form 990-T and paid the section 511 tax. All of the returns included gross receipts from the sale of pull-tabs, the cost of goods sold, and the deductions related to the production of the pull-tab income. Subsequently, the taxpayer filed amended returns claiming an additional deduction for the amounts transferred from its gaming account to its own charitable program and subsequently spent. These amended returns constitute timely filed claims for refund.

During the tax years under examination, the taxpayer commingled its bingo and pull-tab receipts in a gambling account, as allowed by Washington law. No other types of revenues were deposited in this account. Amounts were transferred from this account to the organization's general account. You have indicated that all amounts claimed as section 162 deductions were subsequently paid out as functional expenses from the general account. It does not appear that you have made an allocation between the bingo and pull-tab receipts for these years.

The taxpayer is operating its gaming activities under rules set forth in the 1973 Gambling Act for the State of Washington. Under this Act, only bona fide charitable or nonprofit organizations may conduct gaming. These are defined in RCW 9.46.0209 as organizations having charitable, benevolent, eleemosynary, educational, civic, patriotic, political, social, fraternal, athletic or agricultural purposes when found by the Commission to be organized and operated solely for those purposes rather than for the purpose of carrying on gambling activities. Under this section, if contributions are not deductible or the organization is not exempt from federal income taxes, the organization is not considered a bona fide charitable or nonprofit organization. The Act also creates the Washington State Gambling Commission, Chapter 230-WAC, to implement the statutory scheme.

WAC 230-12-076 sets forth licensing requirements for organizations participating in gaming activities. Organizations are assigned a regulatory group based upon the authorized gambling receipts as follows:

(1) *Group 1* — gambling activities with combined annual gross receipts up to $300,000.

(2) *Group 2* — gambling activities with combined annual gross receipts up to $1,000,000.

(3) *Group 3* — gambling activities with combined annual gross receipts up to $3,000,000.

(4) *Group 4* — gambling activities with combined annual gross receipts up to $5,000,000.

(5) *Group 5* — gambling activities with combined annual gross receipts that exceed $5,000,000.

WAC 230-08-255 states that as a requirement of obtaining a gambling license and to maintain it, a charitable or nonprofit organization must demonstrate that it has made significant progress toward meeting its stated purposes during the period under review. "Significant progress" means that an organization has complied with requirements set forth in its by-laws and charter; has actively engaged in providing services to the public or its members during the entire period under consideration; and the services provided directly relate to the stated purposes of the organization. Such activities are deemed to be significant when an organization uses a substantial portion of its resources, including net gambling income, for providing such services. Organization in Groups 3,4, and 5, are subject to the following additional requirements:

(1) Elections to select officers must be held at least once every two years;

(2) A general membership meeting must be held at least once every two years;

(3) At least 60 percent of the net gambling income earned in the most recently completed fiscal year must be used in the same period as functional expenses to provide services to members or the public; [There are several exceptions to the timing of the required payout.]

(4) No more than 35 percent of the functional expenses may be spent for supporting service expenses. If more than 50 percent of the functional expenses are provided through indirect methods such as contributions, scholarships, services, then not more than 20 percent of functional expenses can be spent for supporting services.

Functional expenses are essentially program service expenses. [WAC 230-02-162] Supporting service expenses are administrative costs. [WAC 230-02-279]

WAC 230-12-110 provides that an organization shall not "fail to devote the entire net income of any gambling activity exclusively to the lawful purpose of the organization."

WAC 230-12-280 provides further that an organization's gambling license may be voided for failure to comply with these requirements.

Issues

Based on these facts you have asked the following questions:

1. Are the requirements under the Revised Code of Washington State (RCW) and the Washington Administrative Code (WAC) that require an organization to make significant progress toward meeting its stated purpose as

a condition for a gaming license so broad that they do not constitute a requirement of lawful purpose expenditures?

2. Is the distribution of net gambling income by the taxpayer in accordance with Washington law, subject to the limitations of section 512(b)(10) as a charitable contribution under section 170, or are the payments deductible under section 162 as ordinary and necessary business expenses?

3. If the payments are deductible under section 162, is the excess of the payments over sixty percent subject to the charitable limitation under section 170?

4. If a licensee is a Group I or II licensee, do the requirements of the RCW and WAC constitute a lawful purpose expenditure?

5. Is a licensee that is exempt under section 501 (c)(3) or (4) entitled to a lawful purpose expenditure deduction under section 162, even though the functional expenses required under the RCW and WAC for a charitable gaming license are not charitable payments as defined in section 170?

6. Are amounts relating to bingo proceeds (as defined at section 513(f)(2)), as distinguished from pull-tabs, that are transferred from the gambling account to the general account and ultimately expended for functional services, deductible under either section 162 or 170 of the code.

Law

Section 511 of the code imposes a tax on the unrelated business taxable income of an organization described in section 501(c)(3), that is derived from any unrelated trade or business regularly carried on by it.

Section 512(a)(1) defines the term "unrelated business taxable income" as the gross income derived by any organization from any unrelated trade or business 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 512(b)(10) permits organizations subject to the section 511 tax the deductions allowed by section 170 but not to exceed 10 percent of the unrelated business taxable income computed without the benefit of this paragraph.

Section 162(a) allows a deduction for all the ordinary and necessary expenses paid or incurred during the tax year in carrying on any trade or business. Section 1.162-15(a) of the Income Tax Regulations, provides that no deduction is allowable for a charitable contribution or gift by a corporation if any part of that contribution is deductible under section 170.

Section 513(f) states that the term "unrelated trade or business" does not include any trade or business which consists of conducting bingo games. "Bingo game" is defined in section 513(f)(2) to mean any game of bingo where wagers are placed, the winners are determined and the distribution of prizes or other property is made in the presence of all persons placing wagers in such game.

In *South End Italian Independent Club, Inc. v. Commissioner*, 87 T.C. No 11 (7/22/86), the Tax Court held that a section 501(c)(7) social club that distributes its net proceeds from the operation of beano games in accordance with Massachusetts law, was not subject to the limitations imposed by section 512(b)(10) because the proceeds were ordinary and necessary business expenses deductible under section 162 rather than charitable contributions subject to section 170. The Massachusetts gaming law required that the entire net proceeds of the beano games be used for charitable purposes and not be distributed to the members of the organization. The court decision did not rest on the purpose to which the net proceeds were dedicated. The court was persuaded that because the payments were compelled as a condition for maintaining a gaming license that the payout was not a voluntary charitable contribution, it was an ordinary and necessary business expense and deductible in fall.

Similarly, in *Women of the Motion Picture Industry, et al. v. Commissioner*, T.C. Memo 1997-518, the Tax Court held that the Texas gaming statute required that the net proceeds of both bingo and "instant bingo", a form of pull-tab, be paid out for lawful purposes within specified time limits as a condition of maintaining a gaming license. Although the statute permitted leeway as to the timing of the payout, all funds had to eventually be paid out for charitable purposes or the organization risked revocation of its gaming license. The court concluded that the payments made for lawful purposes under this statute were ordinary and necessary business expenses deductible under section 162. In this case, the amount of income and expenses attributable to the instant bingo activities was stipulated by the parties. No deductions were allowed for expenses attributable to the section 513(f) bingo.

Discussion

All of the issues raised hinge on whether the Washington State law requires that the net proceeds of the gaming activity be used for lawful purposes under the statute as a requirement for obtaining and maintaining a gaming license. To make this determination, an examination of the 1973 Gambling Act for the state of Washington, as implemented by the Washington State Gambling Commission in Chapter 230-WAC, is necessary.

WAC 230-12-110 states clearly that *an organization shall not fail to devote the entire net income of any gambling activity exclusively to the lawful purpose of the organization*. An organization's gambling license is subject to revocation under WAC 230-12-280 if it fails to use any part of the net gaming income for lawful purposes.

WAC 230-12-076 and WAC 230-08-255 impose additional requirements for organizations holding gambling licenses. These focus on the organization's operational success in making "significant progress" towards the goals that are the basis for its tax exempt status. Organizations that hold Group 3, 4, or 5 gaming licenses are subject to additional requirements regarding the timing of distributions to be made and limitations on certain administrative expenses.

The Washington State statutory scheme is similar to both the Texas statute discussed in *Women of the Motion Picture*

Industry, et al v. Commissioner, *supra*, and the Massachusetts statute discussed in *South End Italian Independent Club, Inc. v. Commissioner*, *supra*. It is the fact that the state law requires that funds be expended in a certain manner as a condition of maintaining a license, and the fact of possible license revocation if the funds are not expended in that manner, that renders these payments ordinary and necessary business expenses deductible under section 162. They are not charitable contributions under section 170 as they are not "voluntary," they are mandated as a condition of continued operations. This is not changed by the fact that the state may impose further restrictions on the timing and distribution of the funds.

An organization is not entitled to a deduction under section 162 until an expenditure is made. The court in *Women of the Motion Picture Industry, et al. v. Commissioner*, *supra*, noted that a transfer of funds from the gaming account to the organization's general account is not an expenditure. When the funds are spent by the organization for a lawful purpose under the statute, however, the expense is deductible under section 162. Program service expenditures are lawful purpose expenditures under the Washington State statutory scheme and deductible from the gaming receipts at the time the funds are spent.

The question of deductibility only arises in the context of unrelated business taxable income. An exempt organization is not taxed on its income from exempt activities such as bingo defined in section 513(f). This is considered support from a related activity under section 509(a)(2). Accordingly, an organization must allocate its gambling income between related and unrelated sources even when permitted by the state to commingle the funds in one restricted gaming account. Only expenditures that are directly connected to the unrelated business income portion may be deducted under section 162. This issue was present in *Women of the Motion Picture Industry, et al. v. Commissioner*, *supra*. The parties had stipulated the amount of income and expenses attributable to the instant bingo activities and no deductions were allowed for expenses attributable to the section 513(f) bingo.

Conclusions

1. The requirements under the Revised Code of Washington State and the Washington Administrative Code that require an organization to make significant progress toward meeting its exempt purposes as a condition for a gaming license are not too broad to constitute a lawful purpose expenditure. The purposes of an organization exempt under section 501(c)(3) are, by definition, charitable. This law is requiring licensed organizations to spend the gambling proceeds for charitable purposes in addition to continuing an ongoing charitable program conducted with proceeds generated from sources that are not unrelated business taxable income. RCW 9.46.0209 specifically requires that an organization not be operated solely for the purpose of carrying on gambling activities and that it be an organization to which contributions are deductible or exempt from federal income taxes. WAC 230-08-255 also requires an independent charitable program as a condition for holding a gambling license. Only then may the gaming proceeds be spent for additional program services.

2. Washington State law requires the distribution of net gambling income for lawful purposes as a requirement of obtaining and maintaining a gaming license. Expenses incurred to maintain the gaming license are ordinary and necessary business expenses deductible under section 162. Thus, the limitations of section 512(b)(10) of the code do not apply.

3. WAC 230-12-110 requires that the entire net gambling proceeds be used for lawful purposes. The additional requirement of WAC 230-08-255 that certain licensees spend 60 percent of the net gaming income within the current year does not change the requirement that 100 percent of the net gambling proceeds be used for lawful purposes though it may change the timing of the deduction. A deduction can only be taken in the year the funds are actually spent.

4. RCW 9.46.0209 and WAC 230-12-110 apply to all gambling licensees.

5. A licensee exempt under sections 501(c)(3) or 501(c)(4) is entitled to a lawful purpose expenditure deduction under section 162 for expenses incurred as a condition of holding a gambling license. Lawful purposes are loosely defined in RCW 9.46.0209. The list of permissible purposes for which gaming income may be spent must be tempered by the further requirement that the organization be exempt from federal tax and use the funds in furtherance of its own stated purposes whether as an adjunct to its own program or by a program of targeted grants. A 501(c)(3) or 501(c)(4) organization incurring expenditures for non-exempt purposes jeopardizes its exempt status, whether those funds are generated by an unrelated trade or business or not.

6. Expenditures from 513(f) bingo proceeds are not deductible. An allocation must be made between the 513(f) bingo and the pull-tab income in the gaming account. If there are no records on which to base an allocation, all the funds may be considered from an unrelated trade or business. Expenditures from bingo proceeds that are not described in section 513(f) that are made as a condition of holding a gambling license are deductible under section 162 as ordinary and necessary business expenditures.

Full Text LTRs

Foundations' Investment Partnership Won't Result in Excise Taxes

LTR 199939046

The Service has ruled that the participation in an investment partnership by 15 related private foundations will not result in foundation excise taxes.

U.I.L. Nos. 4941.04-00, 4943.04-03, 4945.04-00

Date: July 6, 1999

Employer Identification Number: * * *

LEGEND:
A = * * *
J = * * *
K = * * *
L = * * *
M = * * *
N = * * *
O = * * *
P = * * *
Q = * * *
R = * * *
S = * * *
T = * * *
U = * * *
V = * * *
W = * * *
X = * * *
Y = * * *
Z = * * *

Dear Applicant:

This letter responds to *L*'s request dated January 12, 1999 for a ruling whether its participation in an investment partnership will result in excise tax under sections 4941, 4943, or 4945 of the Internal Revenue Code.

Facts

L, M, N, O, P, Q, R, S, T, U, V, W, X, Y, and *Z* are 15 private foundations described in sections 501(c)(3) and 509(a). Each foundation is a disqualified person with respect to the others under section 4946(a)(1)(H).

Investment management is provided to the foundations by *J*, a family-owned company controlled by *A*. *J* provides its services to *L* for a fee and to the other foundations free of charge.

The 15 foundations plan to form *K*, a general partnership, to make certain investments together. The 15 foundations will be the only partners, and the partnership agreement will prohibit the admission of partners that are not private foundations. *L* will serve as the managing general partner. *J* will provide investment management and administrative services to *K* at no charge.

Upon formation of *K*, each foundation will make a maximum dollar commitment to *K* after analysis of its particular investment portfolio and projected cash flow. *K*'s capital calls will be funded by each foundation in proportion to (but not in excess of) its commitment as investments are made. Participation in distributions and allocation of profits and losses will likewise be in the ratio of the foundations' respective capital investments in *K*. Funding of capital calls will be mandatory upon the request of the managing general partner.

Each foundation will invest a relatively small percentage of its investment portfolio in the proposed partnerships; it is anticipated that each foundation's investment in and capital commitment to the partnerships will not exceed 20 percent of the value of its investment portfolio at the time that any partnership capital commitment is made. Each foundation's other investments will generally consist of cash and cash equivalents, U.S. government obligations, corporate debt securities, equity mutual funds, and publicly traded corporate stock.

It is contemplated that a new investment partnership may be formed each year. This arrangement will permit each foundation to review its particular investment portfolio and needs annually and to vary its investment commitment relative to the other foundations without complicating the administration of a single partnership.

The purpose of *K* (and the subsequent partnerships) is to enable each foundation to invest in equity interests in private businesses and private equity funds not otherwise available to them, and to achieve greater diversification in investments. The investments generally will be made in other (lower-tier) limited partnerships *W* will not manage the lower-tier partnerships), to which *K* will subscribe as a limited partner. With the possible exceptions of *L* and *M*, none of the foundations could participate individually in such investments due to requirements (for reasons of administrative convenience and securities laws) as to the maximum number and minimum financial size and dollar commitments of investors.

The partnership agreement prohibits *K* from:

1. making any investments that would cause any of the foundations to be subject to an excise tax under section 4944;

2. directly engaging in an operating business; and

3. making any investment that would cause the combined interests of any partner and all disqualified persons with respect to such partner in any business enterprise to exceed the permitted holdings of the partner under section 4943 and the regulations thereunder.

The other limited partnerships in which *K* (and subsequent partnerships) invest may be engaged in active trades or businesses. *K*'s gross income from non-passive sources (e.g.,

income from partnerships engaged in an active trade or business) may exceed 5 percent in any given year. The foundations will treat their proportionate shares of such income as unrelated business income and pay tax accordingly under section 512(c).

In compliance with section 4941(d)(1)(A), *K* will not buy property from, sell property to, exchange property with, or lease property to or from a disqualified person with respect to any of the foundation partners (other than as permitted under section 53.4941(a)-1(a)(1) of the regulations).

In compliance with section 4941(d)(1)(B), *K* will not receive credit from, or extend credit to, a disqualified person with respect to any of the foundation partners.

In compliance with section 53.4941(d)-2(f)(1) of the regulations, *K* will not purchase or sell investments in an attempt to manipulate the price of the investments to the advantage of a disqualified person.

Rulings Requested

Rulings are requested that the formation and operation of *K* will not:

(1) constitute an act of self-dealing under section 4941;

(2) result in excess business holdings under section 4943; and

(3) constitute a taxable expenditure under section 4945.

Law

Section 512(c)(1) provides that if a trade or business regularly carried on by a partnership of which an organization is a member is an unrelated trade or business with respect to such organization, such organization in computing its unrelated business taxable income shall, subject to the exceptions, additions, and limitations contained in section 512(b), include its share (whether or not distributed) of the gross income of the partnership from such unrelated trade or business and its share of the partnership deductions directly connected with such gross income.

Section 513(c) provides that the term "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.

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

Section 4941(d)(1) defines self-dealing as including 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.

Section 4941(d)(2)(C) provides that the furnishing of goods, services, or facilities by a disqualified person to a private foundation shall not be an act of self-dealing if the furnishing is without charge and if the goods, services, or facilities so furnished are used exclusively for purposes specified in section 501(c)(3).

Section 4941(d)(2)(E) provides generally that the payment of compensation by a private foundation to a disqualified person for personal services which are reasonable and necessary to carrying out the exempt purpose of the private foundation shall not be an act of self-dealing if the compensation is not excessive.

Section 4943(a)(1) imposes an excise tax on a private foundation's excess business holdings in a business enterprise during any tax year.

Section 4943(c)(1) defines excess business holdings as a private foundation's holdings of interests in business enterprises in excess of permitted holdings.

Section 4943(c)(2)(A) generally defines the permitted holdings of a private foundation in an incorporated business enterprise as 20 percent of the voting stock, reduced by the percentage of voting stock owned by all disqualified persons. If all disqualified persons together own no more than 20 percent of the voting stock, nonvoting stock held by the foundation is also a permitted holding.

Section 4943(c)(2)(B) provides that where the foundation and all disqualified persons together own no more than 35 percent of the voting stock, and it is established to the Service's satisfaction that effective control of the corporation is in one or more non-disqualified persons, then the private foundation's holding is a permitted holding.

Section 4943(c)(2)(C) provides that a foundation is not treated as having excess business holdings in a corporation in which it (together with all other foundations described in section 4946(a)(1)(H)) owns no more than 2 percent of the voting stock and no more than 2 percent in value of all outstanding shares of all classes of stock.

Section 4943(c)(3) provides that the permitted holdings of a private foundation in a business enterprise that is not incorporated is determined under regulations consistent in principle with section 4943(c)(2), except that —

(a) in the case of a partnership or joint venture, "profits interest" is substituted for "voting stock," and "capital interest" is substituted for "nonvoting stock,"

(b) in the case of a proprietorship, there are no permitted holdings, and

(c) in any other case, "beneficial interest" is substituted for "voting stock."

Section 4943(d)(1) provides generally that in computing the holdings of a private foundation or a disqualified person in any business enterprise, any stock or other interest owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries.

Section 4943(d)(3) provides that a "business enterprise" does not include —

(a) a functionally related business (as defined in section 4942(j)(4)), or

(b) a trade or business at least 95 percent of the gross income of which is derived from passive sources (including income described in sections 512(b)(1), (2), (3), and (5), and income from the sale of goods if the seller does not manufacture, produce, physically receive or deliver, negotiate sales of, or maintain inventories in such goods).

Section 4945 imposes an excise tax on taxable expenditures by a private foundation.

Section 4945(d) defines a "taxable expenditure" as including any amount paid or incurred by a private foundation for any purpose other than one specified in section 170(c)(2)(B).

Section 4946(a)(1)(H) provides that for purposes of section 4943 only, a disqualified person with respect to a private foundation includes a private foundation

(i) which is effectively controlled (directly or indirectly) by the same person or persons who control the private foundation in question, or

(ii) substantially all of the contributions to which were made (directly or indirectly) by the same person or persons described in sections 4946(a)(1)(A), (B), or (C), or members of their families (within the meaning of section 4941(d)), who made (directly or indirectly) substantially all of the contributions to the private foundation in question.

Section 1.513-1(b) of the Income Tax Regulations provides that the term "unrelated 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. Thus, the term "trade or business" in section 513 is not limited to integrated aggregates of assets, activities and good will which comprise businesses for the purposes of certain other provisions of the Internal Revenue Code.

In section 53.4941(d)-3(c)(2), Example (2) of the Foundations and Similar Excise Taxes Regulations, *C*, a manager of private foundation *X*, owns an investment counseling business. Acting in his capacity as an investment counselor, *C* manages *X*'s investment portfolio for which he receives an amount which is determined to be not excessive. The payment of such compensation to *C* shall not constitute an act of self-dealing.

Section 53.4943-8(c)(1) of the regulations provides generally that any interest (whether or not in a separate entity) owned by a corporation that is actively engaged in a trade or business is not deemed constructively owned by its shareholders.

Section 53.4943-8(c)(2) of the regulations provides that for purposes of section 53.4943-8(c)(1) —

(i) A corporation is not considered actively engaged in a trade or business if the corporation is not a business enterprise by reason of sections 4943(d)(3)(A) or (B);

(ii) In the case of a corporation which owns passive holdings and is actively engaged in a trade or business, such corporation is not considered actively engaged in a trade or business if the net assets used in such trade or business are insubstantial compared to passive holdings.

Section 53.4943-8(d) of the regulations provides that any interest in a business enterprise which is owned by a partnership shall be deemed to be constructively owned by the partners in such partnerships.

Section 53.4943-10(a)(1) of the regulations provides that except as provided in sections 53.4943-10(b) or (c), the term "business enterprise" includes the active conduct of a trade or business, including any activity regularly carried on for the production of income from the sale of goods or the performance of services and which constitutes an unrelated trade or business under section 513.

Section 53.4943-10(a)(2) of the regulations provides that a bond or other evidence of indebtedness does not constitute a holding in a business enterprise unless such bond or evidence of indebtedness is otherwise determined to be an equitable interest in such enterprise. Similarly, a leasehold interest in real property does not constitute an interest in a business enterprise, even though rent payable under such lease is dependent, in whole or in part, upon the income or profits derived by another from such property, unless such leasehold interest constitutes an interest in the income or profits of an unrelated trade or business under section 513.

Section 53.4943-10(b) of the regulations provides that the term "business enterprise" does not include a functionally related business, and that business holdings do not include program-related investments.

Section 53.4943-10(c)(1) of the regulations provides that the term "business enterprise" does not include a trade or business at least 95 percent of the gross income of which is derived from passive sources; except that if in the taxable year in question less than 95 percent of the income of a trade or business is from passive sources, the foundation may, in applying this 95 percent test, substitute for the passive source gross income in such taxable year the average gross income from passive sources for the 10 taxable years immediately preceding the taxable year in question (or for such shorter period as the entity has been in existence). Thus, stock in a passive holding company is not to be considered a holding in a business enterprise even if the company is controlled by the foundation. Instead, the foundation is treated as owning

its proportionate share of any interests in a business enterprise held by such company under section 4943(d)(1).

Section 53.4945-6(b)(1) of the regulations provides that expenditures to acquire investments entered into for the purpose of obtaining income or funds to be used in furtherance of purposes described in section 170(c)(2)(B), and reasonable expenses with respect to such investments, ordinarily will not be treated as taxable expenditures under section 4945(d)(5).

Section 53.4945-6(b)(2) of the regulations provides that, conversely, any expenditures for unreasonable administrative expenses, including compensation, consultant fees, and other fees for services rendered, will ordinarily be taxable expenditures under section 4945(d)(5) unless the foundation can demonstrate that such expenses were paid or incurred in the good faith belief that they were reasonable and that the payment or incurrence of such expenses in such amounts was consistent with ordinary business care and prudence. The determination whether an expenditure is unreasonable shall depend upon the facts and circumstances of the particular case.

Section 53.4946-1(a)(8) of the regulations provides that for purposes of section 4941 only, an organization described in section 501(c)(3) (other than an organization described in section 509(a)(4)) is not a disqualified person.

In H.R. Rep. No. 413 (Part 1), 91st Cong., 1st Sess. 27 (1969), and S. Rep. No. 552, 91st Cong., 1st Sess. 38-39 (1969), The House Ways & Means Committee and Senate Finance Committee stated the following concerns underlying the enactment of section 4943:

1. the increased use of foundations to maintain control of businesses, and a corresponding decrease in concern about producing income for charitable purposes

2. uncertainty in the law at what point business involvement or noncharitable purposes become sufficiently great to disqualify a foundation from exempt status, and the harshness of revocation of 501(c)(3) exemption as a penalty

3. diversion of most of the interest and attention of the foundation managers away from their charitable duties to the maintenance and improvement of the business

4. where the charitable ownership predominates, the running of a business in a way that unfairly competes with businesses whose owners must pay tax on the income derived from their businesses.

In S. Rep. No. 552, 91st Cong., 1st Sess. 38-39 (1969), the Senate Finance Committee cited the following examples in the Treasury Department's 1965 study of private foundations where business rather than charitable purposes appeared to predominate in foundation activities:

> *Example 1.* The *A* foundation holds controlling interests in 26 separate corporations, 18 of which operate going businesses. One of the businesses is a large and aggressively competitive metropolitan newspaper, with assets reported at a book value of approximately $10,500,000 at the end of 1962 and with gross receipts of more than $ 17 million for that year. Another of the corporations operates the largest radio broadcasting station in the state. A third, sold to a national concern as of the beginning of 1965, carried on a life insurance business whose total assets had a reported book value of more than $20 million at the end of 1962. Among the other businesses controlled by the foundation are a lumber company, several banks, three large hotels, a garage, and a variety of office buildings. Concentrated largely in one city, these properties present an economic empire of substantial power and influence.
>
> *Example 2.* The *B* foundation controls 45 business corporations. Fifteen of the corporations are clothing manufacturers; seven conduct real estate businesses; six operate retail stores; one owns and manages a hotel; others carry on printing, hardware, and jewelry businesses.
>
> *Example 3.* The *C* foundation has acquired the operating assets of 18 different businesses, including dairies, foundries, a lumber mill, and a window manufacturing establishment. At the present time it owns the properties of seven of these businesses. Its practice has been to lease its commercial assets by short-term arrangements under which its rent consists of a share of the profits of the leased enterprise. By means of frequent reports and inspections, it maintains close check upon its lessees' operations.

In S. Rep. No. 552, 91st Cong., 1st Sess. 41 (1969), the Senate Finance Committee stated the following regarding the meaning of "business holding" under section 4943:

> The committee also provided that stock in a passive holding company is not to be considered a business holding, even if the holding company is controlled by the foundation. Instead, the foundation is to be treated as owning its proportionate share of the underlying assets of the holding company. The committee also made it clear that passive investments generally are not to be considered business holdings. For example, the holding of a bond issue is not a business holding, nor is the holding of stock of a company which itself derives income in the nature of a royalty to be treated as a business holding.

Rev. Rul. 78-144, 1978-1 C.B. 168, held that a 501(c)(3) organization's leasing of heavy machinery under long-term lease agreements requiring the lessee to provide insurance, pay the applicable taxes, and make and pay for most repairs, with the functions of securing leases and processing rental payments performed for the organization without compensation, was not excepted from the term "unrelated trade or business" by reason of the volunteer labor exception under section 513(a)(1). Once the organization found a lessee and leased the property, the only remaining requirement generally was to receive, record, and deposit the rents. The work in connection with finding a lessee, negotiating a lease, and processing the rental payments was performed for the organization without compensation. The Service reasoned that the rental of personal property is a trade or business, and that the volunteer labor exception applies only where the performance

of services is a material income-producing factor in carrying on the business, and there was no significant amount of labor regularly required or involved in the kind of business carried on by the organization.

Rationale

Section 4941 Issues

For purposes of section 4941, none of the 15 foundations is a disqualified person with respect to any other, under section 53.4946-1(a)(8) of the regulations. Therefore, *K* is not a disqualified person with respect to any of the foundations either.

The formation and operation of *K* will not involve a sale or exchange or an extension of credit between a private foundation and a disqualified person, and will not involve a transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation.

The formation and operation of *K* as set forth above will not involve the furnishing of goods, services, or facilities between a private foundation and a disqualified person, other than *J*'s provision of services to *K* (and indirectly to the foundation partners). However, under section 4941(d)(2)(C), this provision of services will not result in self-dealing, as *J*'s services will be provided without charge. Moreover, *J*'s services are investment management services, which are permissible personal services for which a foundation may pay reasonable compensation under section 4941(d)(2)(E) and section 53.4941(d)-3(c)(2), Example (2) of the regulations. For the same reasons, the formation and operation of *K* as set forth above will not involve the impermissible payment of compensation or expenses by a private foundation to a disqualified person.

Section 4943 Issues

The main question presented is whether *K* itself is a business enterprise for purposes of section 4943. If not, then none of the foundations' holdings in *K* will result in an excess business holding, given the representation that *K* will not make any investment that would cause the interest of any foundation (together with the interests of all disqualified persons with respect to such foundation) in any business enterprise to exceed the permitted holdings of the foundation under section 4943, and assuming that none of the foundations or disqualified persons subsequently acquire an interest (directly or indirectly) in such business enterprise.

If *K* were a business enterprise, then *L*'s investment in *K*, along with the investments of the other foundations, would be an excess business holding, since the combined profit interests of *L* and the other foundation disqualified persons in *K* would be in excess of 20 percent, and the 2 percent *de minimis* rule of section 4943(c)(2)(C) would not apply. *K* would not meet the business enterprise exception under section 4943(d)(3)(B), since it is contemplated that less than 95 percent of *K*'s income will be derived from the listed passive sources. *J*'s volunteer services for *K* would not, in our view, serve to exclude *K* from the definition of an unrelated trade or business, since *J*'s services would not appear to be a material income-producing factor, under the reasoning of Rev. Rul. 78-144.

The taxpayer argues that *K* is not a business enterprise in the first place and therefore does not need the exception set forth in section 4943(d)(3)(B), and cites rulings such as Rev. Rul. 75-223 and to the definition of "trade or business" in other sections. We do not necessarily agree with the taxpayer's view that *K*, as described, will not be engaged in a trade or business for purposes of section 513. Moreover, a strict reading of section 53.4943-10(c)(1) of the regulations would limit the term "passive holding company" to organizations receiving at least 95 percent of their gross income from the passive sources listed exclusively in section 4943(d)(3).

However, the term "business enterprise" for the purposes of section 4943 may not encompass certain partnerships that engage solely in investment activities. The taxpayer represents that *K*'s activities will consist of investing in private businesses, mainly as a limited partner in other limited partnerships. Furthermore, the taxpayer represents that *K* will not manage the business of the lower tier partnerships. Because limited partnership interests may represent passive investments (comparable to stock and securities), *K*, based on the specific facts represented in this case, will not be treated as a business enterprise under section 4943.

The policies underlying section 4943 support our conclusion. The legislative history of the Tax Reform Act of 1969, P.L. 91-172, made it clear that Congress only sought to prevent private foundations from engaging in active businesses. Specifically, the Senate Finance Committee stated "that stock in a passive holding company is not to be considered a business holding, even if the holding company is controlled by the foundation. Instead, the foundation is to be treated as owning its proportionate share of the underlying assets of the holding company. The committee also made it clear that passive investments generally are not to be considered business holdings." See S. Rep. No. 91-552, 91st Cong. 1st Sess., reprinted in 1969 U.S. Code Cong. Serv. 2027, 2068.

K will not engage directly in any sale of goods or performance of services, but will merely hold interests in other business enterprises. The purpose of *K* is not to maintain family control of a business. The operation of *K* may actually result in less business involvement or diversion of attention of foundation managers toward investment activities than would otherwise be the case, except perhaps for the managers of the managing partner, *L*.

A contrary conclusion in this case would prevent the taxpayer from indirectly investing in limited partnership interests, through *K*, even though it could invest in such interests directly. The taxpayer has represented that *K* would not acquire more than a 20 percent interest in any limited partnership. The taxpayer and disqualified persons are allowed to directly hold up to a 20 percent interest in a business enterprise without violating the excess business holdings provision of section 4943. The mere interposition of *K* should not produce a different result.

We think this is a situation that calls for the application of the constructive ownership rules. Under the constructive ownership rule of section 4943(d)(1), *K* will not hold an impermissible interest in any business enterprise that would result in an indirect excess business holding for any of its foundation partners. Given that the foundation partners could directly hold such interests in business enterprises, and that *K* is formed for valid business reasons, we believe that the foundations should be allowed to form and hold interests in *K* to achieve the same result indirectly.

We emphasize that our ruling in this case applies solely to the facts as described and solely for purposes of section 4943 and not section 513 or other code sections. The foundation partners of *K* will pay unrelated business income tax on their unrelated business taxable income in accordance with section 512(c).

Section 4945 Issues

The formation and operation of *K* as set forth above will not result in any expenditures by any foundation partners for noncharitable purposes if *K*'s expenditures, and administrative payments from *L* to *K*, are reasonable. See sections 53.4945-6(b)(1) and (2) of the regulations.

Rulings

Accordingly, we rule that the formation and operation of *K* will not:

(1) constitute an act of self-dealing under section 4941;

(2) result in excess business holdings under section 4943; and

(3) constitute a taxable expenditure under section 4945 (assuming that *K*'s expenditures, and administrative payments from *L* to *K*, are reasonable).

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.

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

Because this letter could help resolve any future questions about the application of Chapter 42 to its activities, *L* should keep a copy of this ruling in its permanent records.

We are providing the Key District Director a copy of this ruling.

Sincerely yours,

Garland A. Carter
Chief, Exempt Organizations
Technical Branch 2

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