Private Letter Ruling 8923071,, IRC Section 42

March 16, 1989

This is in response to the ruling requests contained in your letter of November 29, 1988, in which you request rulings as to the federal income and excise tax consequences of a loan you have proposed to make.

You are recognized as exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code and as a private foundation within the meaning of section 509(a) of the Code.

You are governed by a board of seven directors and have a fair market value of approximately $175,000x.

M is recognized as exempt from federal income taxation under section 501(c)(3) of the Code and is a community trust within the meaning of sections 1.170A-9(e)(10)-(13) of the Income Tax Regulations. M has a board of directors consisting of 24 persons of which two are also members of your board.

In May, 1986, P, an organization dedicated to the relief of the homeless, prepared both a short-term and a long-term strategy for meeting the needs of the homeless persons in the U metropolitan area. The major recommendation of the long-term strategy was the establishment of a large-scale program to create 500 units of affordable housing for the "working poor".

While formulating its strategy and recommendations, P approached N, an organization recognized as exempt from federal income tax under section 501(c)(3) of the Code, who was also attempting to provide affordable low cost housing to the poor in the U area. Given the similarity of the goals between P and N, an agreement was reached to merge the two efforts. Such agreement provided that P would spearhead the local fund-raising campaign for the program.

To facilitate and accomplish this local fund-raising, M has established a fund ("Fund"). All contributions to Fund will be used to assist in providing low-income housing in the program described below.

It is now contemplated that proposed projects for housing will be presented to M and N by existing not-for-profit community development corporations. Each proposed project will be reviewed by N which will then recommend to M those projects which it believes most appropriate and deserving. M will then decide whether it wants to participate through its Fund.

Once a project is accepted by both M and N, it will be implemented and the construction and ownership accomplished through a for-profit limited partnership, hereinafter referred to as "Partnership(s)". The general partner of each Partnership may be a not-for-profit

community development corporation; however, in certain Partnerships, a for-profit developer may be an additional general partner, and, in some instances, the sole general partner of a Partnership may be a for-profit developer or other for-profit corporation or business.

Each building to be owned by any Partnership must meet the requirements of Section 42 of the Code to enable the Partnerships and its partners to obtain the "low-income housing credit" afforded under that section.

Financing of the Partnerships will come from M's Fund and other sources. It is presently contemplated that Q limited partnerships will provide all of the equity for each Partnership. Q limited partnerships are for-profit partnerships, the partners of which are for-profit corporations. The managing general partner of each of the Q limited partnerships will be R, a not-for-profit corporation, whose board of directors is elected by S as sole voting member of that corporation. S is a non-profit corporation created in 1980 to provide financial and capacity-building assistance to community development corporations. R was incorporated in 1987 and capitalized with a grant of $ 880,000 from S.

T, a "disqualified person" with respect to you, will be a partner in each Partnership through its investment in Q limited partnerships. T will hold less than a 35% interest in Q limited partnerships.

First mortgage financing for the Partnerships, at market rates, will be sought from local banks and other lending institutions. It is presently hoped that these first mortgage loans and the interest rates thereon will be written down through funds provided to the Partnerships by the state housing development commission. Second mortgage financing may be provided by the City of U. Additional "soft loans", such as your proposed loan described herein, plus outright contributions, will also be sought by each Partnership.

Financing for each Partnership may well vary in material respects from that presently contemplated and described above, depending on the circumstances surrounding each Partnership. It is now contemplated that the housing will be constructed over the next five years through the use of a series of Partnerships.

M is approaching U businesses, foundations, and other charities for either outright contributions to or loans to its Fund. M has approached you and you are now contemplating making the loan hereinafter described to M's Fund.

You propose to loan $ 500x to M. The proceeds of the loan will become part of M's Fund and will be evidenced by a promissory note from M to you. There will be no interest payable on your loan.

M has advised you that the proceeds of your loan will be loaned by M to Partnerships. Principal payments on your loan must be made by M only when and as M receives principal payments from the Partnerships on monies loaned by M to the Partnerships.

In connection with the foregoing paragraph, you are imposing upon M only one restriction respecting the terms on which M loans money to the Partnerships. That restriction is that each M loan (involving your loan proceeds) to a Partnership must require the Partnership to pay certain principal payments on the loan at any time any property of the Partnership is sold or refinanced. If Partnership property is sold or refinanced, the cash proceeds from such sale or refinancing may first be used by the Partnership to repay debt which is secured by the property which is sold or refinanced and certain other indebtedness. The partners, both general and limited, of the Partnership may then receive a sufficient amount of cash to enable the partners to pay the income tax which is due from each partner because of the sale or refinancing. To the extent cash then remains from such sale or refinancing, the same must be used to repay, to the extent then owing, the M loan to the Partnership before further distributions of such monies may be made to the partners of the Partnership. Unless the M requires otherwise, the cash flow generated each year by a Partnership through operations in the normal course may be distributed to the partners of the Partnership without any repayment being required with respect to the M loan.

All other decisions respecting the terms of the loan by M to a Partnership are in the sole discretion and judgment of M. Accordingly, M in each instance has the right to require that interest be paid on any loans by M to a Partnership. M has the right to require a more stringent schedule for repayment of principal than just upon a sale or refinancing. To the extent that M does require principal payments at times other than upon a sale or refinancing, an amount equal to such additional principal payments must be then paid by M to you as repayment of principal on your loan to M. It is also within the discretion of M as to whether a loan made to a Partnership is secured in any manner.

If a Partnership defaults on a loan from M, M alone will determine what response will be made in that situation, i.e., waiver, forgiveness, lawsuit, foreclosure, etc... .

If all of the property of a Partnership is sold and the Partnership is unable to repay the principal of the loan from M because the properties did not generate sufficient sales proceeds, you must forgive a corresponding portion of the principal which is then due you by M.

It is presently contemplated that your loan proceeds will be advanced to M at the rate of $ 100x per year beginning in 1988.

If M so decides, a M loan to a Partnership may be "without recourse" to the general partners of the Partnership.

M may not restrict in any way the manner in which the Partnership may spend the loan proceeds received from M. The Partnership may be able to spend the loan proceeds received in any manner or for any purpose which the Partnership deems necessary or appropriate. Such purposes may include, but are not limited to, construction costs, professional fees, interest, syndication fees, developer fees, and other fees, allowances,

and expenses. The proceeds of the M loan to a Partnership will be commingled by the Partnership with other monies and funds available to the Partnerships.

You will not dictate to M what, if any, periodic reports M must receive from each Partnership concerning the use of the loan proceeds from M. You will require that M notify you in writing no later than the end of each year of the following:

(i) The Partnerships to which M has loaned money during the year in question, and

(ii) The sales or refinancings which have occurred during the year in question with respect to any Partnership to which M has loaned monies, and the amount of principal repayments received by M from the Partnerships.

You have requested the following rulings:

(1) Your loan of approximately $ 500x to M constitutes a "program-related investment" under section 4944(c) of the Code, and, therefore, such loan will not be considered an investment which jeopardizes the carrying out of your exempt purposes.

(2) Neither the making of the loan by you to M, any loan by M to a Partnership, nor the repayment of any such loan, whether in the normal course or otherwise, nor any other transaction described herein, shall constitute a prohibited act of "self-dealing" under section 4941 of the Code. In particular, the fact that the your loan proceeds will be loaned by M to partnerships in which T, a disqualified person, is a partner, will not constitute an act of self-dealing under section 4941 of the Code.

(3) The loan of approximately $ 500x by you to M will constitute a qualifying distribution for you for purposes of section 4942 of the Code in the year in which the proceeds of the your loan are advanced to M.

(4) The loan by you to M will not constitute "excess business holdings" for purposes of section 4943 of the Code.

(5) The loan by you to M will not jeopardize, or cause you to lose, your tax-exempt status under section 501(c)(3) of the Code, even given the fact that M will be loaning the proceeds to for-profit partnerships in which T, a disqualified person, is a partner.

(6) You are not required to exercise expenditure responsibility under section 4945 of the

Code with respect to your loan, and such failure shall not result in the loan being a taxable expenditure under section 4945.

(7) Your loan will not constitute a taxable expenditure under any provision of section 4945 of the Code.

Sections 501(a) and 501(c)(3) of the Code provide for the exemption from federal income tax of those organizations which are organized and operated exclusively for charitable purposes.

Section 1.501(c)(3)-1(d)(2) of the Income Tax Regulations provides that the term "charitable" is used in section 501(c)(3) of the Code in its generally accepted legal sense and includes the relief of the poor and distressed or of the underprivileged.

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

Section 4946(a)(1) of the Code defines a disqualified person as a substantial contributor, a foundation manager, or an owner of 20% of the profits of a partnership which is a substantial contributor to the foundation. Further, a partnership is a disqualified person if a person described in the foregoing categories owns 35% of the profits interest.

Section 53.4941(d)-1(a) of the Foundation and Similar Excise Taxes Regulations provides that any direct or indirect transaction described in section 53.4941(d)-2 is an act of self-dealing.

Section 53.4941(d)-2(c) of the regulations provides that the lending of money or other extension of credit between a private foundation and a disqualified person is an act of self-dealing.

Section 53.4941(d)-1(b)(4) of the regulations provides that transactions between a private foundation and an organization in which disqualified persons described in section 4946(a)(1) of the Code own no more than 35 percent of the organization, shall not be treated as an indirect act of self-dealing between the foundation and the disqualified persons solely because of the ownership interest of such persons in such organization.

Section 4942(g) of the Code defines "qualifying distribution" as any amount paid to accomplish a purpose described in section 170(c)(2)(B) other than a contribution to an organization controlled by the foundation or a disqualified person.

Section 53.4942(a)-3(a)(2) of the regulations provides that a qualifying distribution includes program-related investments as defined in section 4944(c) of the Code. However, a contribution to a controlled organization is not a qualifying distribution.

Section 53.4942(a)-3(a)(3) of the regulations provides that "control" means the ability of a disqualified person to cause the donee organization to make an expenditure or fail to make an expenditure by use of aggregating votes or a position of authority.

Section 4943(c)(1) of the Code provides that the term "excess business holdings" means, with respect to the holdings of any private foundation in any business enterprise, the amount of stock or other interest in the enterprise which the foundation would have to

dispose of to a person other than a disqualified person in order for the remaining holdings of the foundation in such enterprise to be permitted holdings.

Section 53.4943-10(a)(2) of the regulations provides that a bond or other evidence of indebtedness is not a holding in a business enterprise unless such bond or evidence of indebtedness is otherwise determined to be an equitable interest in such enterprise.

Section 53.4943-10(b) of the regulations provides that business holdings do not include program-related investments as defined in section 4944(c) of the Code, e.g., investments in corporations to assist neighborhood renovation.

Section 4944(a) of the Code imposes a five- percent tax on private foundations and foundation managers for making investments which would jeopardize the carrying out of any of its exempt purposes.

Section 53.4944-1(a)(2) of the regulations provides that a jeopardizing investment is one in which the foundation manager fails to exercise ordinary business care and prudence in making such investment.

Section 4944(c) of the Code provides that program-related investments, i.e., those which accomplish one or more of the purposes described in section 170(c)(2)(B) of the Code, and have no significant purpose to produce income or appreciate property, shall not be considered a jeopardy investment.

Section 53.4944-3(a)(1) of the regulations provides in part that the primary purpose of a program-related investment is to accomplish a purpose described in section 170(c)(2)(B) of the Code but not one described in section 170(c)(2)(D). Nor may it have a significant purpose to produce income or appreciate property.

Section 53.4944-3(a)(2)(i) of the regulations provides that an investment shall be considered to be made primarily to accomplish a purpose described in section 170(c)(2)(B) of the Code if it furthers the exempt activities of the foundation, and the investment would not have been made but for the relationship between the investment and the exempt activities of the foundation. Moreover, purposes described in section 170(c)(2)(B) need not be carried out by an organization described in section 170(c) for the investment to be characterized as program-related.

Section 170(c)(2)(B) of the Code refers to the following purposes: religious, charitable, scientific, literary and educational.

Section 170(c)(2)(D) of the Code refers to the influencing of legislation and participating in a political campaign.

Section 53.4944-3(a)(3)(i) of the regulations provides that once an investment is determined to be program-related, it will not lose this characterization due to any changes

in the terms or form of the investment if such changes are made primarily for exempt purposes and not for any significant purpose to produce income or appreciate property.

Section 53.4944-3(b), Example (5), of the regulations, involves a loan by a private foundation to a large, financially secure business enterprise, so as to induce the business to establish a new plant in a deteriorated urban area. The loan was made at a below-market rate and significantly furthered the accomplishment of the organization's exempt status.

Section 4945(a) of the Code imposes a tax on each taxable expenditure, as defined in subsection (d), a tax equal to 10 percent of the amount thereof.

Section 4945(d)(4) of the Code provides that the term "taxable expenditure" means any amount paid or incurred by a private foundation as a grant to an organization unless such organization is described in section 509(a)(1), (2), or (3), or the private foundation exercises expenditure responsibility with respect to such grant in accordance with section 4945(h).

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

Your proposed loan possesses the requisite characteristics of a program-related investment under section 53.4944-3(a) of the regulations. The primary purpose of the loan is to provide relief for the poor and distressed by assisting in the construction of low-income housing. Such a purpose is a charitable purpose within the meaning of section 1.501(c)(3)-1(d)(2) of the regulations and section 501(c)(3) of the Code, and, therefore, is a purpose described in section 170(c)(2)(B). Because of the existing risk and the zero rate of interest, it is apparent that no significant purpose of the investment is the production of income or the appreciation of property. The terms of the proposed loan indicate that no purpose of the investment is to accomplish the purpose of attempting to influence legislation or to attempt to participate in, or intervene in, any political campaign on behalf of any candidate for public office. As such, your proposed loan is similar in relevant respects to Example (5) of section 53.4944-3(b) of the regulations.

Because the proposed loan will not be made to a disqualified person, or a partnership in which a disqualified person with respect to you owns more than 35% of the profits

interest, the loan is described in section 53.4941(d)-1(b)(4) of the regulations, and will not be considered an indirect act of self-dealing within the meaning of section 4941(d)(1)(B) of the Code.

Because your proposed loan will be a program-related investment, and because the proposed loan will not be made to an organization controlled by you or one or more disqualified persons with respect to you, nor to a private foundation, the loan will meet the requirements under section 53.4942(a)-3(a)(2)(i) of the regulations and will not be treated as an indirect act of self-dealing between the foundation and the disqualified person solely because of the ownership interest of such person in the limited partnerships.

Because you will not be entitled to any additional return from the loan other than the payments of principal, the proposed loan will not constitute an equitable interest in the borrowers. Thus, the proposed loan is described in section 53.4943-10(a)(2) of the regulations and, therefore, is not a holding in a business enterprise. Further, because the proposed loan will be a program-related investment, it is described in section 53.4943-10(b) and is not an excess business holding.

Section 53.4945-6(i) of the regulations provides that a grant by a private foundation to a grantee organization which the grantee organization uses to make payments to another organization will not be viewed as a grant by the private foundation to the secondary grantee if the foundation does not earmark the use of the grant for any named secondary grantee. The section further provides that the above grant will not be regarded as a grant by the foundation to the secondary grantee even though such foundation has reason to believe that certain organizations would derive benefits from such grant so long as the original grantee organization exercises control over the selection process and actually makes the selection completely independently of the private foundation. The loans you propose to make to M are not earmarked for any secondary grantee. The identity of the for-profit organizations, which will ultimately be the recipients of the monies, is not now known. In addition, M has complete discretion as to whom receives the funds once they are collected. Therefore, you have not earmarked your grant for the benefit of any secondary grantee and the grant will be considered as made to M, an organization described in section 509(a)(1) of the Code.

Section 4945(d)(4)(A) provides that a grant to an organization described in section 509(a)(1) of the Code will not constitute a taxable expenditure within the meaning of section 4945(a); therefore, because your proposed loan is a grant to an organization described in section 509(a)(1) of the Code, it will not constitute a taxable expenditure.

Based on the foregoing, we rule as follows:

(1) Your loan of approximately $ 500x to M constitutes a program- related investment under section 4944(c) of the Code, and will not be considered an investment which jeopardizes the carrying out of your exempt purposes.

(2) Neither the making of the loan by you to M, any loan by M to a Partnership, nor the repayment of any such loan, whether in the normal course or otherwise, shall constitute a prohibited act of self-dealing under section 4941 of the Code.

(3) Your loan of approximately $ 500x to M will constitute a qualifying distribution for you for purposes of section 4942 of the Code in the year in which the proceeds of your loan are advanced to M.

(4) Your loan to M will not constitute excess business holdings for purposes of section 4943 of the Code.

(5) Your loan to M will not jeopardize or cause you to lose your tax-exempt status under section 501(c)(3) of the Code.

(6) You are not required to exercise expenditure responsibility under section 4945 of the Code with respect to the your loan, and such failure shall not result in the loan being a taxable expenditure under section 4945.

(7) Your loan will not constitute a taxable expenditure under section 4945 of the Code.

A copy of this ruling will be forwarded to your {sic} key District Director for exempt organization matters. Please keep this ruling with your permanent records. Please continue to use your employer identification number on all returns which you file and in all correspondence with the Internal Revenue Service.

If you have any question regarding this ruling, please contact the person whose name appears in the heading of this letter.

This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than the sections described above. This ruling is directed only to the organization that requested it. Section 6110(j) of the Code provides that it may not be used or cited as precedent.