Internal Revenue Service

Department of the Treasury
199943044
Washington, DC 20224

Contact Person:

Telephone Number:

In Reference to:
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Significant Index Nos.
4942.00-00
4943.00-00
4944.00-00
4945.00-00

Legend:
M=
N=
O=
x=
y=

Dear Sir or Madam:

This is in response to M's request for certain rulings under sections 501(c)(3), 4942, 4943, 4944, and 4945 of the Internal Revenue Code of 1986 (hereafter "Code") submitted on M's behalf by M's authorized representative. M has requested the following rulings:

1. M's acquisition of stock in O is a program-related investment for purposes of section 4944(c) of the Code.

2. M's acquisition of stock in O is not a jeopardizing investment for purposes of section 4944 of the Code.

3. The O stock acquired by M qualifies as an asset used directly in carrying out M's exempt purposes for purposes of calculating undistributed income and is a qualifying distribution for purposes of section 4942 of the Code.

4. M's ownership of O stock does not constitute excess business holdings for purposes under section 4943 of the Code

5. M's investment in O stock will not be a taxable expenditure within the meaning of section 4945(a) of the Code.

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6. M's ownership of the O stock will have no effect on M's status as an organization described in section 501(c)(3) and exempt from tax under section 501(a) of the Code.

M has been recognized as exempt under section 501(c)(3) of the Code and classified as a private foundation under section 509(a). M's primary purpose is to promote economic development in underdeveloped and disadvantaged areas of N. M states that it accomplishes its stated purposes by investing a substantial portion of its assets in new and existing for-profit business enterprises located in N. M states that these investments create jobs for the unemployed and underemployed and alleviate general economic depression throughout N.

M states that M provides seed money to establish or start-up businesses and operate much like a venture capital organization. M states that it has engaged business consultants in N to investigate start-up and struggling businesses for purposes of investment. M states that it has established the following criteria for investments in N businesses:

(1) The project is unable to raise investment capital, probably because private investors viewed the risk versus return ratio as too high.

(2) The project is based in a depressed economic area in N with high unemployment.

(3) The project has potential for creating quality employment for underemployed and unemployed individuals.

O is a for-profit business enterprise conducting its operations in N. O's business operations are conducted in a national priority development region. These regions are designated by the government of N as economically depressed. This designation is caused by high rates of unemployment and underemployment, particularly among recently arrived immigrants. M states that companies choosing to locate within these regions qualify for various types of economic assistance in the form of government supported low-interest loans, tax incentives, and government grants.

M proposes to make certain loans and grants to O, totaling x dollars. M states that the loans and grants to O are intended to be an equity investment for purposes of encouraging the creation of jobs and economic development in a region targeted for this purpose by the N government.

Under a written agreement with M, at least y percent of O's employees must be members of the previously unemployed or underemployed targeted group. The agreement also prohibits O from engaging in lobbying and political activities. O is also required to maintain certain recordkeeping and reporting information for purposes of M's compliance with the exercise of expenditure responsibility described in section 4945(h) of the Code. M states that it will dispose of its investment in O if O is successful, offers its shares in a public offering, and M determines that its charitable purposes have been accomplished.

Section 501(c)(3) of the Code provides, in part, for the exemption from federal income tax of organizations that are organized and operated exclusively for charitable, scientific or educational purposes no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(d)(2) of the regulations defines the term 'charitable' as including the promotion of social welfare by organizations designed to relieve the poor and distressed or the underprivileged, to lessen neighborhood tensions, to eliminate prejudice and discrimination, or to combat community deterioration.

Section 4942(a) of the Code imposes an excise tax on the undistributed income (as defined in paragraph (a) of Sec. 53.4942(a)-2) of a private foundation for any taxable year which has not been distributed before the first day of the second (or any succeeding) taxable year following such taxable year (if such first day falls within the taxable period as defined in paragraph (c)(1) of this section). For purposes of section 4942 the term "distributed" means distributed as qualifying distributions under section 4942(g).

Section 4943(a)(1) of the Code imposes an excise tax on the excess business holdings of a private foundation in a business enterprise.

Section 4943(c)(1) of the Code states that "excess business holdings" means, with respect to the holdings of any private foundation in any business enterprise, the amount of stock or other interest in the enterprise which the foundation would have to dispose of to a person other than a disqualified person in order for its remaining holdings in the enterprise to be permitted holdings.

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

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organization is described in paragraph (1), (2), or (3) of section 509(a) or is an exempt operating foundation, or the private foundation exercises expenditure responsibility with respect to such grant.

Section 4945(h) of the Code provides that the expenditure responsibility referred to in subsection (d)(4) means that the private foundation is responsible to exert all reasonable efforts and to establish adequate procedures to see that the grant is spent solely for the purpose for which made, to obtain full and complete reports from the grantee on how the funds are spent, and to make full and detailed reports with respect to such expenditures to the Secretary.

Section 4945(d)(5) of the Code provides that for purposes of this section, the term "taxable expenditure" means any amount paid or incurred by a private foundation for any purpose other than one specified in section 170(c)(2)(B).

Section 53.4942(a)-3(a)(2) of the Foundation and Excise Taxes Regulations provides that the term "qualifying distribution" means--

(i) Any amount (including program-related investments, as defined in section 4944(c), and reasonable and necessary administrative expenses) paid to accomplish one or more purposes described in section 170(c)(1) or (2)(B), other than any contribution to--

(a) A private foundation which is not an operating foundation (as defined in section 4942(j)(3)), except as provided in paragraph (c) of this section, or

(b) An organization controlled (directly or indirectly) by the contributing private foundation or one or more disqualified persons with respect to such foundation, except as provided in paragraph (c) of this section;

(ii) Any amount paid to acquire an asset used (or held for use) directly in carrying out one or more purposes described in section 170(c)(1) or (2)(B). See paragraph (c)(3) of Sec. 53.4942(a)-2 for the definition of 'used (or held for use)'; or

(iii) Any amount set aside within the meaning of paragraph (b) of this section.

Section 4944 provides for the imposition of a tax on investments that jeopardize the carrying out of any of the exempt purposes of a private foundation. Section 4944(c), however,

provides an exception from the tax for program-related investments.

Section 53.4943-10(b) of the regulations provides that for purposes of section 4943(d)(4) the term 'business enterprise' does not include a functionally related business as defined in section 4942(j)(5). See Sec. 53.4942(a)-2(c)(3)(iii). In addition, business holdings do not include program-related investments (such as investments in small businesses in central cities or in corporations to assist in neighborhood renovation) as defined in section 4944(c) and the regulations thereunder.

'Program-related investment' is defined in section 53.4944-3(a)(1) of the regulations as an investment having the following three characteristics:

(i) The primary purpose of the investment is to accomplish one or more of the purposes described in section 170(c)(2)(B);

(ii) No significant purpose of the investment is the production of income or the appreciation of property; and

(iii) 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.

Under section 53.4944-3(a)(2)(i) of the regulations, an investment is considered to satisfy the 'primary purpose' characteristic if it significantly furthers the accomplishment of the private foundation's exempt activities and if the investment would not have been made but for the relationship between the investment and the accomplishment of the foundation's exempt activities.

Under section 53.4944-3(a)(2)(iii) of the regulations, in determining whether an investment satisfies the 'no significant purpose' characteristic, it shall be relevant whether investors who are solely engaged in the investment for profit would be likely to make the investment on the same terms as the private foundation.

Section 53.4944-3(a)(2)(iii) of the regulations also emphasizes that the fact that an investment produces significant income or capital appreciation shall not, in the absence of other factors, be conclusive evidence of a significant purpose involving the production of income or the appreciation of property.

Example (3) under section 53.4944-3(b) of the regulations describes a situation in which a private foundation purchases stock in a small business enterprise located in a deteriorated urban area. Conventional sources of funds are unwilling to provide funds to the corporation at reasonable interest rates unless it increases the amount of its equity capital. The example states that the private foundation's investment in the corporation is a program-related investment even though the foundation may realize a profit if the corporation is successful and the common stock appreciates in value.

Rev. Rul. 74-587, 1974-2 C.B. 162, provides that a nonprofit organization formed to relieve poverty, eliminate prejudice, reduce neighborhood tensions, and combat community deterioration through a program of financial assistance in the form of low-cost or long-term loans to, or the purchase of equity interests in, various business enterprises in economically depressed areas is exempt under section 501(c)(3) of the Code.

M's proposed investment in O is designed to create jobs, enhance living conditions in a depressed community designated by the government of N, and help combat community deterioration by building a sound economic base in N. This activity constitutes a charitable purpose within the meaning of section 170(c)(2)(B). In addition, M's investment strategy is designed to achieve this goal. Therefore, the proposed investment satisfies the first characteristic of a program-related investment (the 'primary purpose' characteristic), set forth in sections 53.4944-3(a)(1)(i) and 53.4944-3(a)(2)(i) of the regulations.

O's business operations will be conducted in an area designated as economically depressed by the N government. O is required to employ individuals who are members of the targeted class of unemployed or underemployed workers in the region. Further, M states that the investment in O will be liquidated when it appears that O's operations are sufficiently developed and independent. Therefore, M's investment in O meets the second characteristic of a program-related investment (the 'no significant purpose' characteristic), set forth in section 53.4944-3(a)(1)(ii) of the regulations. Because of the economic condition of the targeted depressed area and corresponding likely limited return on the investment in O, no significant purpose of M's proposed investment in O is the production of income or the appreciation of property. It is clear that the economically depressed condition of the target area indicates that investors solely interested in making a profit would not be likely to invest in O. Moreover, the mere possibility that the target area investments will be profitable will not taint the investment, as

indicated in section 53.4944-3(a)(2)(iii) and Example (3) under section 53.4944-3(b) of the regulations.

Because of the restrictions against O's use of funds to attempt to influence legislation or the outcome of any election, the M's proposed investment in O also satisfies the third characteristic of a program-related investment (the 'no purpose' characteristic), set forth in section 53.4944-3(a)(1)(iii) of the regulations.

Because M's acquisition of O stock meets the requirements of a program-related investment under section 4944(c) of the Code, the O stock qualifies as an asset used directly in carrying out M's economic development purpose pursuant to section 501(c)(3) of the Code. Therefore, the amounts paid to acquire M's equity interest in O constitute a qualifying distribution for purposes of section 4942 of the Code. In addition, the O stock acquired by M is not a business holding for purposes of section 4943 pursuant to section 53.4943-10(b) of the regulations.

The loans and grants provided by M to O are intended to promote economic development, create jobs, and otherwise combat community deterioration much the same as the activities conducted by the organization described in Rev. Rul. 75-487 pursuant to section 1.501(c)(3)-1(d)(2) of the regulations. O will maintain records and provide information required by M to exercise the responsibility described in section 4945(h) of the Code.

Based on the above we rule as follows:

1. M's acquisition of stock in O is a program-related investment for purposes of section 4944(c) of the Code.

2. M's acquisition of stock in O is not a jeopardizing investment for purposes of section 4944 of the Code.

3. The O stock acquired by M qualifies as an asset used directly in carrying out M's exempt purposes for purposes of calculating undistributed income and is a qualifying distribution for purposes of section 4942 of the Code.

4. M's ownership of O stock does not constitute excess business holdings for purposes of section 4943 of the Code.

5. M's investment in O stock will not be a taxable expenditure within the meaning of section 4945(a) of the Code.

6. M's ownership of the O stock will have no effect on M's status as an organization described in section 501(c)(3) and exempt from tax under section 501(a) of the Code.

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

This ruling does not purport to rule under any other section of the Code.

Sincerely yours,

(signed) Robert C Harper, Jr.
Robert C. Harper, Jr.
Chief, Exempt Organizations
Technical Branch 3

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