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

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Contact Person:

Uniform Issue List: 501.03-13
4941.04-00
4942.05-00
4945.04-00

Contact Number:

OP:E:ED:T2

LEGEND:

M =
N =

A =
B =

Dear Sir or Madam:

This is in response to letters dated November 11 and 12, 1999, and previous correspondence from your authorized legal representatives, who have requested certain rulings on your behalf.

M is an organization exempt from federal income tax under section 501(a) of the Internal Revenue Code as an organization described in section 501(c)(3). M has been classified as a private foundation under section 509(a). M's articles of incorporation provide that it is organized and operated exclusively for charitable and educational purposes to beautify and enrich its geographical area with works of art. M receives donations to acquire, display and exhibit works of art, and to donate and convey works of art consistent with the requirements under section 501(c)(3). M makes gifts of significant pieces of contemporary art to governmental and charitable organizations for public display and appreciation.

M's governing board consists of A and B , their four children and an unrelated person, all of whom are disqualified persons with respect to M under section 4946 of the Code.

M has expanded its activities by establishing and operating a small art gallery, which initially was devoted primarily to the study of art by graduate level students, qualified public museum groups and individual artists. The gallery's major resources are works of art on loan from private collectors and the artists who create the pieces on exhibition. A and B own an extensive collection of art which will be loaned to M from time to time for study in the gallery.

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In order to facilitate the establishment of the gallery, A and B purchased a warehouse building which was converted to a condominium consisting of five units. A and B will donate to M for use as a gallery the largest of the condominium units without mortgage, lien, encumbrance or any reversionary interest plus an undivided interest in the common areas and an adjoining parking lot. A and B will donate sufficient resources to meet the costs of remodeling the largest unit for use as a gallery, and to cover the gallery's operating expenses. A and B will also donate to M another of the condominium units, which will be available for commercial leasing to unrelated occupants that will pay rent to M.

The remaining three condominium units in the aggregate amount to 15% of the total square footage of the condominium. These units will be retained by A and B as their personal offices with a permanent secretary who will serve as a receptionist and as M's secretary, without cost to M. A and B will not use their offices for business purposes, but their occasional use will be limited to their activities on behalf of M and other tax-exempt organizations, of which they are officers and trustees. A and B's offices are available for use at all times by M and its staff, which in fact make use of these offices on a daily basis.

As owners of the five condominium units, A and B, and M will participate in a condominium ownership association that addresses common operational, maintenance and repair items. Common costs will be allocated among the unit owners on an objective basis according to the respective square footage of each owner's unit. As owner of the two largest units, M will have a majority of the building's square footage and, thus, voting control of the association.

Financial information provided by M indicates that upon completion of the proposed transaction, substantially more than one-half of M's assets will be devoted directly to the operation of the gallery. All of the rental income from the commercial condominium unit plus other investment income will be used to meet the operating expenses and maintenance costs of the gallery unit and M's share of the commonly owned condominium expenses. A and B will donate to M the anticipated shortfall of amounts needed to defray such expenses.

In a recent submission, M's representatives stated that the gallery has been open to scholars, museum groups and the general public, and more than one thousand persons have viewed the works of art exhibited therein. The gallery has had a joint exhibition with a large museum, N, which attracted the general public to important works of art that were jointly displayed. Public exhibitions featuring other noted artists have been scheduled. The gallery is open for visits by the general public for not less than two and usually four days per week, and at all other times by appointment to outside scholars and groups. M employs an administrator, who is not related to A and B, and who helps to arrange for the exhibitors and greet and direct persons who might be studying or viewing pieces at the gallery. Because of the increase in frequency of use of the gallery, additional staff have been hired to assist visitors.

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M issues press releases for new shows and exhibitions at the gallery to two daily newspapers, weekly newspapers and specialized periodical publications. The gallery is listed in the local telephone book, and callers reach either the receptionist, or a menu selection describing current exhibits, gallery hours, location and transportation directions. M has an affiliation with N, the large museum mentioned above, which has its own key to the building and an open invitation to access the gallery at any time. N frequently brings visiting museum groups and other interested persons through the gallery. M has registered a domain name and is in the process of constructing a web site describing the gallery. The web site will afford the public, worldwide, access to the gallery. The gallery is listed in a hotel art/news packet placed in hotel rooms and is described in various magazines. Handouts describing current pieces on display are available for each visitor, and a brochure is under consideration. The gallery's parking spaces for the general public and scheduled groups are marked for visitors.

Section 501(c)(3) of the Code provides, in part, for the exemption from federal income tax of organizations organized and operated exclusively for 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(c)(1) of the Income Tax Regulations provides the following:

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

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations provides the following:

> An organization is not organized or operated exclusively for one or more of the purposes specified in subdivision (i) of this subparagraph unless it serves a public rather than a private interest. Thus, to meet the requirement of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

Section 509(a) of the Code states that the term "private foundation" means a domestic or foreign organization described in section 501(c)(3) other than an organization described in section 509(a)(1), (2), (3), or (4).

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

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Section 4941(d)(1) of the Code lists various acts of self-dealing, including any direct or indirect (A) sale or exchange, or leasing, of property between a private foundation and a disqualified person, (C) furnishing of goods, services, or facilities between a private foundation and a disqualified person, and (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)(A) of the Code provides that the transfer of real or personal property by a disqualified person to a private foundation shall be treated as a sale or exchange if the property is subject to a mortgage or similar lien which the foundation assumes, or if it is subject to a mortgage or similar lien which a disqualified person placed on the property within the ten-year period ending on the date of the transfer.

Section 4941(d)(2)(C) of the Code 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)(D) of the Code provides that the furnishing of goods, services, or facilities by a private foundation to a disqualified person shall not be an act of self-dealing if such furnishing is made on a basis no more favorable than that on which such goods, services, or facilities are made available to the general public.

Section 4942(a) of the Code imposes an excise tax in the amount of 15% on the undistributed income 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.

Section 4942(a)(1) of the Code provides that the tax under section 4942 shall not apply to the undistributed income of a private foundation for any taxable year for which it is an operating foundation under section 4942(j)(3).

Section 4942(j)(3) of the Code provides, in part, that the term "operating foundation" means any organization which makes qualifying distributions directly for the active conduct of the activities constituting the purpose or function for which it is organized or operated equal to a certain specified amount.

Sections 53.4942(b)-1 and -2 of the Foundation and Similar Excise Tax Regulations, in part, provide that an operating foundation must meet the "income" test, and one of the so-called alternative tests, including the "assets" test and the "endowment" test, all of which are described in detail in the regulations.

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Section 4945 of the Code imposes a tax of 10% on each taxable expenditure of a private foundation; section 4945(d)(5) provides that 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).

By establishing and operating an art gallery in the manner described, M will continue to further its exempt educational purposes within the meaning of section 501(c)(3) of the Code. Although initially the gallery's operations were expected to be somewhat limited, recently submitted information indicates that students, museum groups, artists and the general public have regular access to the gallery. A and B's purchase of the warehouse, donation of the condominium units to M, and donations of resources for payment of remodeling expenses and other expenses enable M to carry out its exempt function through the operation of the gallery. Under these circumstances, M will continue to be operated exclusively for exempt purposes as required by section 1.501(c)(3)-1(c)(1) of the regulations. Any possible benefit derived by A and B from donating property and resources and lending their artworks to M, retaining office condominiums, and participating in the condominium association is merely incidental to the accomplishment of an exempt purpose under section 501(c)(3). Thus, the establishment and operation of the gallery will not result in M's furthering the private interests of A and B. See section 1.501(c)(3)-1(d)(1)(ii).

In connection with the operation of the art gallery, M will make qualifying distributions in appropriate amounts directly for the active conduct of activities constituting the purpose or function for which it is organized or operated. The financial information presented indicates that M will meet the applicable tests set forth in sections 53.4942(b)-1 and -2 of the regulations, and has met such tests since July 1, 1998. Thus, as of that date, M's foundation classification has changed from that of private foundation under section 509(a) of the Code to that of private operating foundation under section 4942(j)(3).

With regard to the question of self-dealing under section 4941 of the Code, as noted previously, A and B are disqualified persons under section 4946 with respect to M. Because of this relationship, the following transactions between the parties must be carefully considered:

(1) Donations by A and B to M. Under section 4941(d)(1)(A) of the Code, an act of self-dealing includes the sale or exchange, or leasing of property between a private foundation and a disqualified person. However, in accordance with section 4941(d)(2)(A), A and B's donation of the two condominium units will not be treated as a sale or exchange, as the property is not subject to a mortgage or similar lien assumed by M. Likewise, A and B's donations of resources to defray remodeling expenses and other expenses will not constitute acts of self-dealing under section 4941(d)(1).

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(2) Lending of works of art by A and B to M. Under section 4941(d)(1)(C) of the Code, the furnishing of goods, services or facilities between a private foundation and a disqualified person is an act of self-dealing. However, in accordance with section 4941(d)(2)(C), A and B's lending of works of art will not be an act of self-dealing because such lending is without charge, and the works of art are used exclusively for exempt purposes under section 501(c)(3).

(3) Participation in the condominium association by A, B, and M. Under section 4941(d)(1)(E) of the Code, self-dealing includes the transfer of a private foundation's income or assets to, or use by or for the benefit of, a disqualified person. Here, although A and B, and M will be owners in the same condominium association, their condominium units are legally separate, and M clearly has majority voting control of the association based on square footage. Under these circumstances, M's income or assets will not be used by A and B within the meaning of section 4941(d)(1)(E). Thus, such participation in the condominium association will not constitute an act of self-dealing under section 4941, where costs are shared based on square footage.

For purposes of section 4945 of the Code a taxable expenditure includes amounts paid or incurred for purposes other than those listed in section 170(c)(2)(B). Here, amounts attributable to M's remodeling of the condominium units, operation and maintenance of the gallery, and payment of its share of maintaining the common areas are not taxable expenditures because they are paid or incurred in furtherance of educational purposes under section 170(c)(2)(B). As discussed above, M's establishment and operation of the gallery furthers its educational purposes under section 501(c)(3).

Based on the foregoing, we rule as follows:

(1) The proposed expansion of its activities will not jeopardize M's continued qualification for recognition of exemption as an organization described in section 501(c)(3) of the Code;

(2) M's proposed activities will result in a change of its foundation classification from that of a private foundation under section 509(a) of the Code to that of a private operating foundation under section 4942(j)(3), effective July 1, 1998;

(3) The proposed transaction, including A and B's donation to M of (a) the two condominium units, (b) the resources necessary to remodel one of the units into a gallery and the other into commercial space, and (c) the resources necessary to meet the operating expenses of M's expanded activities will not constitute acts of self-dealing within the meaning of section 4941(d) of the Code;

(4) The loan from time to time to M of works of art owned by A and B under the circumstances described above will not constitute acts of self-dealing within the meaning of section 4941(d) of the Code;

(5) The participation of A and B, and M in the condominium association and their sharing of costs of maintenance of the common areas based on square footage will not constitute acts of self-dealing within the meaning of section 4941(d) of the Code; and,

(6) The proposed transaction and the following expenditures to be made as described above will not constitute taxable expenditures and will not subject M to the tax on taxable expenditures under section 4945 of the Code: (a) for remodeling the condominium units for use as a gallery, (b) for the operation and maintenance of the gallery, and (c) for M's fair share of maintaining the common areas of the condominium building.

Except as specifically ruled upon above, no opinion is expressed concerning the federal income tax consequences of the transactions described above under any other provision of the Code.

Pursuant to a Power of Attorney on file in this office, a copy of this letter is being sent to M's authorized representatives.

We are providing the Area Manager- Pacific Coast with a copy of this ruling. You should keep a copy of this letter in your permanent records.

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

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If you have any questions, please contact the person whose name and telephone number appear in the heading of this letter.

Sincerely,

(signed) Garland A. Carter

Garland A. Carter
Manager, Exempt Organizations
Technical Group 2

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