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

Date: JUN 13 2000

Contact Person:

ID Number:

Telephone Number:
OP:E:EO:T2

Employer Identification Number:

UIL Nos.
4940.00-00
4940.02-01

LEGEND

M =
X =

Dear Applicant:

This letter responds to X's request dated Sept. 24, 1998 for a ruling that the tax on net investment income under section 4940 of the Internal Revenue Code will not apply to X's proposed foreign investment program, as described below.

Facts:

X is a private (non-operating) foundation described in sections 501(c)(3) and 509(a) of the Code. X proposes to conduct a program of investments (the "Investment Program") in order to promote economic development in M, a foreign country. The Investment Program will provide relief of poverty in M by producing jobs and thus will further charitable purposes. X's Investment Program will consist of two parts: a "Government Program" and a "Direct Loan or Investment Program." In a separate letter ruling (PLR 199943058, Aug. 6, 1999), the Service ruled that loans made under these programs will further exclusively charitable purposes and will be program-related investments under section 4944.

Government Program

The Government Program will involve three levels of loans. X will make loans of a certain amount in U.S. dollars to the government of M. The government of M, in turn, will make loans to privately owned local banks, which will make loans to businesses in M. Amounts repaid by borrowers may be reloaned by the government of M under the same procedures.

The loans between X and the government of M will be interest-free. The government's loans to the local banks will be at an interest rate well below the going market rate. The local banks may charge interest on their loans, up to a stated maximum (substantially below the going market rates). The government of M and the local banks may also charge a penalty for late payments, in order to encourage timely repayment. X will not receive any income from the program other than possible foreign currency gains.

Direct Loan or Investment Program

In X's Direct Loan or Investment Program, X will make direct loans (including below-market loans) to, or equity investments in, businesses in order to induce those businesses to operate in M. X will receive interest payments denominated in the currency of M instead of dollars.

Law:

Section 483(d) of the Code provides generally that section 483 does not apply to any debt instrument for which an issue price is determined under section 1273(b) or section 1274.

Section 985(b) of the Code generally defines a taxpayer's "functional currency" as the dollar.

Section 988 of the Code provides that foreign currency gain or loss attributable to a section 988 transaction is generally treated as ordinary income or loss, and that in certain cases such income or loss may be treated as capital gain or loss or as interest income or expense.

Section 988(c)(1)(A) of the Code defines certain transactions as a section 988 transaction if the amount that the taxpayer is entitled to receive (or is required to pay) by reason of such transaction is denominated in terms of a nonfunctional currency or is determined by reference to the value of one or more nonfunctional currencies.

Section 988(c)(1)(B)(i) of the Code defines one type of section 988 transaction as the acquisition of a debt instrument or becoming the obligor under a debt instrument.

Section 1272 of the Code generally requires a holder of a debt instrument with original issue discount to include the discount in gross income.

Section 1273(a)(1) of the Code defines "original issue discount" (OID) as the excess (if any) of a debt instrument's stated redemption price at maturity over its issue price.

Section 1273(b) of the Code defines the issue price of a debt instrument to which section 1273 applies.

Section 1274 of the Code determines the issue price of certain debt instruments given in consideration for the sale or exchange of property.

Section 4940 of the Code imposes an excise tax on private foundations based on their net investment income, consisting of items of gross investment income and capital gain net income, less certain deductions.

Section 4940(c)(2) of the Code defines "gross investment income" as the gross amount of income from interest, dividends, rents, payments with respect to securities loans (as defined in section 512(a)(5)), and royalties, but not including any such income to the extent included in computing the tax imposed by section 511.

Section 7872 of the Code recharacterizes certain below-market loans described in section 7872(c)(1) of the Code as two transactions: (1) a loan at the applicable Federal rate ("AFR"); and (2) a transfer from the lender to the borrower in an amount sufficient to fund the borrower's payments of interest at the AFR.

Section 1.988-3(c) of the Income Tax Regulations indicates that foreign currency gain is not characterized as interest income.

Section 53.4940-1(d) of the Foundations and Similar Excise Taxes Regulations provides that interest, dividends, rents, and royalties derived from assets devoted to charitable activities are includible in gross investment income. Therefore, for example, interest received on a student loan would be includible in the gross investment income of a private foundation making such loan.

Section 53.4940-1(f) of the regulations provides that sales or other dispositions of program-related investments (as defined in section 4944(c) of the Code) held by a private foundation are not taken into account in determining capital gain net income.

Section 1.7872-5T(b)(11) of the regulations exempts from section 7872 of the Code loans made by a private foundation or other organization described in section 170(c) with the primary purpose to accomplish one or more purposes described in section 170(c)(2)(B), unless one of the principal purposes of structuring the transaction as a loan is to avoid federal tax.

Rationale:

capital gains

Capital gains from the sale of program-related investments are excludible in determining net investment income under section 4940 of the Code.

gross investment income

Interest, dividends, and other items of gross investment income under section 4940(c)(1) of the Code arising from program-related investments are taxable under section 4940. While X anticipates receiving interest and dividends designated as such from the Direct Loan or Investment Program, X will receive only a return of capital from the Government Program, plus possible foreign currency gains. The question arises whether X will receive any return not designated as gross investment income, or any imputed income, that is properly characterized as gross investment income.

X will not receive any foreign currency gains under the Investment Program characterized as gross investment income under section 4940(c)(1) of the Code. X's interest-free loan to the government of M is not a section 988 transaction resulting in currency gain or loss, because the return of principal that X is entitled to receive is not denominated in terms of, or determined by reference to the value of, a nonfunctional currency such as the currency of M. Rather, the loan is denominated in and determined by reference to X's functional currency, the U.S. dollar. While loans under the Direct Loan or Investment Program may be section 988 transactions, any foreign currency gain from such loans will not be characterized under section 988 as interest or another item of gross investment income under section 4940(c)(1).

We also find that X will not receive any imputed income under sections 483, 1274, or 7872 of the Code. Because the loans made by X pursuant to the Investment Program will be issued for money, sections 483 and 1274 do not apply. Instead, the issue price of each loan is determined under section 1273(b). Thus, there is no interest imputed under section 1274 on the loans made by X. Section 7872 re-characterizes the repayment of certain below-market loans as interest in part. Since the Investment Program is a program-related investment, it is exempt under section 1.7872-5T(b)(11) of the regulations from such re-characterization.

Ruling:

Accordingly, we rule that interest or dividend income that is designated as such and derived from the Direct Loan or Investment Program will constitute gross investment income under section 4940(c)(1) of the Code. Otherwise, the tax on net investment income under section 4940 of the Code will not apply to X's Investment Program.

Except as we have ruled above, we express no opinion as to the tax consequences of the grant under the cited provisions of the Code or under any other provisions of the Code.

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

Because this letter could help resolve any future tax questions relating to X's activities, X should a copy of this ruling in X's permanent records.

We are providing our Ohio Tax Exempt & Government Entities office a copy of this ruling.

Sincerely yours,

(signed) Garland A. Carter

Garland A. Carter
Manager, Exempt Organizations
Technical Group 2