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

JUL 25 2000

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Contact Person:

ID Number:

Telephone Number:

OP:E:ED:T 3

Employer Identification Number:

LEGEND:

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Dear Sir or Madam:

This is in response to a ruling request dated June 15, 1999, submitted on your behalf by your authorized representatives. You are seeking rulings on whether certain investments are program-related investments under section 4944(c) of the Internal revenue Code and your obligations to exercise expenditure responsibility under section 4945(h) in connection with certain grants and program-related investments.

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X is an organization that has been recognized as exempt from federal income tax under section 501(c)(3) of the Code, and as a private foundation described in section 509(a).

X's principal activity has, since its inception, been to make grants to various charitable organizations. Nearly all of X's grants (both in terms of number of grants and dollar volume of grants) are made directly to organizations that have received determination letters from the Internal Revenue Service that they are public charities described in sections 501(c)(3) and 509(a)(1), (2) or (3).

While a number of X's grants are general support grants to public charities that may be used by the grantees for any charitable purpose, most of X's grants are designated to be used for a specific purpose, project, or program (for example, to construct a building on a university campus, to support a specific research project being conducted by the grantee, to purchase specific property for conservation, to start a new youth program, etc.). Normally, in such cases, the grant would not be made but for the fact that the grantee requested a grant for a specific purpose, project, or program, and the request was approved. Sometimes X issues a request for proposals to a group of organizations, such as to public school districts for reading programs or to community colleges to strengthen their educational programs. X then awards grants in stated amounts for specified purposes that could be designated either for general support or for particular projects or programs.

Each grant award letter describes the purpose of the grant and limits use of the grant funds to that purpose, unless the grantee receives X's consent to use the grant for a different purpose. The grantee is required to submit a report on the use of the grant funds and a description of the progress made toward achieving the purpose of the grant. Further, if a grantee were to use grant funds for any purpose other than the purpose for which the grant was made, X would consider requesting a refund of the grant, withholding future payments (if any), and not making any additional grants to that grantee.

Program-related investments, generally. More than 10 years ago, X determined that it could, in addition to making direct charitable grants, leverage the use of its endowment to make program-related investments ("PRIs") described in section 4944(c) of the Code.

As of March 5, 1999, X had an outstanding portfolio of a$ in PRIs, consisting of approximately b$ in a social deposit, c$ in direct loans for charitable purposes, and d$ in loan guaranties. If loans and loan guaranties being considered as of that date are added, the outstanding total PRIs in loan form would increase to e$ and PRIs in the form of guaranties will increase to f$.

X has expanded its PRIs into new areas and forms of investments different from the direct investments in entities that help to achieve the charitable goals of X. Rather, the new type of investment is in a business enterprise which is financially secure and the stock of which is listed and traded on a national exchange, such as a commercial bank, where the investment is to induce the other entity (the bank) to take action that it otherwise would not take.

One of X's major emphases is upon a Program that seeks to promote the health, development, and economic security of vulnerable children; to protect them from violence; and to strengthen the capacity of families, communities, and the nation to care for all of America's children. The Program places children at the center of its efforts, but views children in the context of their families, their communities, and the broader state and national policy environment. The Program's grant-making approach and strategic investments focus on access to quality health care, the development of children and youth, the economic security of families, the reduction of violence in homes and communities, the transformation of local communities, and the building of a national capacity and will to support children.

The Program places a high priority on investing resources as strategically as possible to achieve and sustain long-term change. The Program's grant-making is guided by the realization that such change requires multiple and overlapping strategies.

A Program Subdivision has a 1999 grant-making budget of about g$. The Program Subdivision staff spends much of its time on efforts to improve the quantity and quality of care and education for children ages 0-5. While parents and other family members have traditionally supplied most of this nurturing for children, either by themselves or through family-based child care, center-based care is the only option for many today's working parents. Affordability and accessibility are real issues for many working parents. The nonprofit public charity child care providers meet this need for families of modest means throughout the country.

Experts have told the Program Subdivision staff that the need for center-based child care in this state alone is such that it could take billions of investment dollars to meet the need for facilities, personnel and training, and much of that need is currently met by the nonprofit child care providers. Welfare-to-work requirements are increasing this demand daily. Since X's grant funds available to this program are only a small fraction of this money, the Program Subdivision staff has been forced to seek innovative approaches to involve the commercial sector in closing the gap. These approaches have begun to manifest themselves through program related investments that seek to maximize the leverage that could be obtained by X's resources. These PRIs use commercial banks and banking tools to assist with the financing of child care facilities for use by nonprofit, public charity child care providers.

Guaranties: Under these arrangements, a public charity borrows money, in the form of either an installment loan or a line of credit, from a commercial bank, and, depending upon the circumstances, pays interest at either a market or below-market rate. The loan proceeds are used for exclusively charitable purposes, and X either wholly or partially guarantees repayment. X does not give guaranties solely to reduce the interest rate paid by borrowers, even though a lower rate often is the result. Instead, X's policy is that its guaranty must be required-that is, but for X's guaranty, a borrower would not qualify for the loan or line of credit. This is the rule and not the exception for nonprofit child care providers, which generally lack the amount of assets or cash flow to secure loans for capital projects under commercial underwriting norms. Pursuant to written agreements between X or the lending financial intermediary and the charitable borrower, borrowed funds may be used solely to achieve the stated charitable purposes.

X does not give guaranties expecting that they will called, although obviously that might happen. If it does, and depending upon the circumstances, a Reimbursement Agreement between the public charity and X, or the loan agreement between the charity and the bank, will require the charity to reimburse X. Similar default provisions cover prohibited uses of the funds, such as use for a non-charitable purpose or taxable expenditure. In all guaranty arrangements, the charity is obligated to monitor the charitable use of the funds and report the use to the bank at least annually.

X traditionally has given guaranties either by simple signature alone on a contract or by purchasing a letter of credit from its bank to back its promise. But the annual cost (at least 0.75 percent of the amount of the loan) and paperwork associated with letters of credit make them too costly and cumbersome for use in the nonprofit child care facilities program. X's signature on a partial or full guaranty agreement by and of itself makes these borrowers creditworthy, but does not in all cases lower the cost of funds to the point of affordability for them or actually get them into the commercial credit market. Because of these factors, X's Child Development program staff has decided to utilize compensating balances or encumbered deposits to bridge the gap and get the most bank capital into the sector.

In some cases, as part of the guaranty arrangement, or as an alternative to a signature guaranty, X may be required to deposit funds with the bank in an account in the name of X. If this is required, the bank bars X from withdrawing funds below the level of X's liabilities on the guaranties. The banks require that these funds be invested in very high quality, highly liquid fixed income instruments, currently yielding approximately five percent, or less. The rate of return, thus, does not reflect the added risk arising from the real possibility that some or all of such a deposit may be forfeited if a charity borrower fails to make its required payments to the bank. X would insist upon a substantially higher return on a portfolio investment with similar default risks.

Single purpose deposit guaranty program: The encumbered deposit guaranty strategy has resulted in two variations that X is considering as models for the foreseeable future. One variation is exemplified by a deposit of approximately h$ to be made to induce a commercial bank to lend an identical amount to a commercial sector developer in the form of a construction loan. This developer will use all the funds to build a dedicated child care center for use by Y, a public charity child care center operator, on land owned by Y in a shopping center being built, in a neighborhood that is home to about 25 percent of the welfare recipients in the county. X's guaranty is required for the bank to make the construction loan on this project.

Y has a strong operational record but insufficient credit to support the financing of the h$ needed for the construction of the new facility. The construction financing is being used by the developer to build the facility pursuant to a purchase contract with Y and under Y's supervision. Y has provided detailed specifications for the construction project and has retained engineering consultants to supervise the work in progress, including the processing and approval of progress payment requests and the periodic inspections to assure compliance with the intent of the construction plans. The developer was unwilling to undertake the project without assurances that it would not be left with construction debt in the event Y failed to purchase the building. Therefore, X has agreed to guarantee the construction financing to enable Y to contract with the developer to build a facility that meet its specific needs.

To provide collateral in support of the construction financing, X has agreed to keep h$ on deposit with the lending bank for the one-year term of the loan. X will earn interest at a rate of 2 percent on the restricted deposit, which is substantially less than it otherwise could earn on this sum of money if it were free to invest it elsewhere. In addition to the loan guarantee, X also has agreed to provide an interest rate subsidy to the developer by applying its earnings on the collateral deposit against the 4 percent interest the developer will owe on the construction loan. X also has made related grants to Y to retain consultants to assist Y with fundraising, and to retain a technical assistance provider to assist Y with analysis of financing alternatives. In addition, X has agreed to participate in arranging permanent financing for Y after the new facility is built, effectively guaranteeing that Y will be able to purchase the building that meets its specifications. The loan guarantee is specifically earmarked for such use in building Y's facility and was designed to enable Y to undertake a construction that otherwise would not have been possible.

The loan agreement between the bank and the developer requires that the funds are to be used only for this project, and X's guaranty agreement with the bank requires the bank to monitor this restriction. The development agreement between the developer and Y also restricts the use of the funds to the construction specified by Y, as does X's reimbursement agreement with Y. Under this reimbursement agreement, Y has the duty to confirm that the funds are used to build the facility to Y's charitable purpose specifications.

Loan guaranty and interest rate subsidy program: As an alternative to a single-purpose deposit guaranty (or, possibly, in combination with such a guaranty), X is making deposits in one or more for-profit, commercial banks to induce the banks to lend money to one or more public charities. Depending on the

circumstances, a deposit may bear interest as described above, or at a lower rate. Either way, X will not be permitted to withdraw any portion of the deposit subject to liability on the guaranties.

One form of such a loan guaranty and interest rate subsidy arrangement is a program whereby X has agreed to provide guarantees of up to j$ to cover a loan pool that will assist child care providers in certain counties with financing for construction and tenant improvements on child care facilities, and purchase of equipment. Guarantees will cover between 50% and 80% of each loan. The investment account supports the signature guarantees that X will provide on individual loans. In certain instances, in addition to the guaranty, X will provide an interest rate subsidy to the public charity whereby X applies its earnings on the collateral deposit against the interest the borrower has to pay on the loan. Z will administer the program.

Borrowers must be section 501(c)(3) public charities and will be eligible for the program only if they would not qualify for the loans they are seeking without a guarantee or similar credit enhancement. X has the right to approve each borrower, the percentage of the loan being guaranteed, and any interest rate subsidy being provided, before providing a guarantee. Z or X will find third parties to offer technical assistance to borrowers and to monitor the quality of the services they are providing.

To meet the [lending] bank's requirements, X had to set aside j$ in an investment account with a third-party bank, a member of the same banking family as the lending bank. Although the investment account is encumbered with the restrictions on withdrawal of funds that are used to support the loan guarantees, the earnings are no higher than the earnings X receives on its unrestricted investment accounts with the bank (which X uses for its overnight cash needs). X retains title to the investment account.

Under the Z program, the bank will identify public charity borrowers and process the loan applications. Because X's guaranty of any particular loan will be for an amount less than the 100 percent of the amount borrowed (generally in the 50 percent to 80 percent range), it is expected that X's j$ deposit will generate k$ in loans to be used by public charities for charitable purposes.

In the Z program, the contract between Z and the borrower will limit the borrower's use of the borrowed funds to the specific charitable purposes for which they were borrowed and will require periodic reports from the charitable borrower on the use of the funds, as normally required for commercial loans, copies of which will be supplied to X. There will be no reimbursement agreements between X and the borrowers, nor will there be any reports by the borrowers to X aside from the copies of the reports to Z. However, pending receipt of the response to this request for rulings, X is taking all necessary steps to ensure, on an interim basis, that these loans to the borrowers satisfy all of the formal section 4945(h) expenditure responsibility requirements, including reporting the required information on X's annual Form 990-PF. After receipt of favorable rulings, it is expected that Z will use its standard loan agreements with the charitable borrowers without the extra expenditure responsibility commitments or reporting. As a practical matter, this program, especially if it has the potential to grow significantly to cover loans to hundreds of small public charities, will not be administrable from X's perspective if X must exercise full expenditure responsibility with each loan, in addition to the bank's normal oversight of the loans. X would not try to bring the program to scale if expenditure responsibility were to be required.

Section 170(c)(2)(B) of the Code refers to organizations which are organized and operated exclusively for religious, charitable, scientific, literary and educational purposes.

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

Section 4944 of the Code provides generally that for the imposition of tax on the amount a private foundation invests in a manner as to jeopardize the carrying out of any of its exempt purposes.

Section 4944(c) of the Code provides that investments, the primary purpose of which is to accomplish one or more of the purposes described in section 170(c)(2)(B) and no significant purposes of which is the production of income or the appreciation of property, shall not be considered as investments which jeopardize the carrying out of exempt purposes.

Section 53.4944-3(a)(1) of the Foundation and Similar Excise Taxes Regulations provides in part that a "program-related investment" is an investment which possesses the following 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 one or more of the purposes described in section 170(c)(2)(D).

Section 53.4944-3(a)(2)(i) of the regulations provides that an investment shall be considered as made primarily to accomplish one or more of the purposes described in section 170(c)(2)(B) if it significantly furthers the accomplishment of the private foundation's exempt activities and if the investment would not have been made but for such relationship between the investment and the accomplishment of the foundation's exempt activities.

Section 53.4944-3(a)(2)(iii) of the regulations provides that in determining whether a significant purpose of an investment is the production of income or the appreciation of property, it shall be relevant whether investors solely engaged in the investment for profit would be likely to make the investment on the same terms as the private foundation. However, 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.

Section 53.4944-3(a)(3)(i) of the regulations provides that once it has been determined that an investment is "program-related" it shall not cease to qualify as a "program-related investment" provided that changes, if any, in the form or terms of the investment are made primarily for exempt purposes and not for any significant purpose involving the production of income or the appreciation of property. A change made in the form or terms of a program-related investment for the prudent protection of the foundation's investment shall not ordinarily cause the investment to cease to qualify as program-related. Under certain conditions, a program-related investment may cease to be program-related because of a critical change in circumstances, as, for example, where it is serving an illegal purpose or the private purpose of the foundation or its managers. For purposes of the preceding sentence, an investment which ceases to be program-related because of a critical change in circumstances shall in no event subject the foundation making the investment to the tax imposed by section 4944(a)(1) before the 30th day after the date on which such foundation (or any of its managers) has actual knowledge of such critical change in circumstances.

Example (5) of section 53.4944-3(b) of the regulations provides as follows:

X is a business enterprise which is financially secure and the stock of which is listed and traded on a

national exchange. Y, a private foundation, makes a loan to X at an interest rate below the market rate in order to induce X to establish a new plant in a deteriorated urban area which, because of the high risks involved, X would be unwilling to establish absent such inducement. The loan is made pursuant to a program run by Y to enhance the economic development of the area by, for example, providing employment opportunities for low-income persons at the new plant, and no significant purpose involves the production of income or the appreciation of property. The loan significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, even though X is large and established, the investment is program-related.

Section 4945 of the Code imposes a tax on each taxable expenditure of a private foundation.

Section 4945(d)(4) of the Code, provides that a private foundation must exercise expenditure responsibility in connection with any grant to an organization, unless the grantee organization is described in section 509(a)(1), (2), or (3). Failure to comply with this requirement will cause the grant to be a taxable expenditure within the meaning of section 4945(d)(4).

Section 4945(h) of the Code provides that expenditure responsibility referred to in section 4945(d)(4) means that a private foundation is responsible to exert all reasonable efforts, and to establish adequate procedures-

(1) to see that the grant is spent solely for the purpose for which made,

(2) to obtain full and complete reports from the grantee on how the funds are spent, and

(3) to make full and detailed reports with respect to such expenditures to the Secretary.

Section 53.4945-5(a)(1) of the regulations generally provides that under section 4945(d)(4) the term "taxable expenditure" includes any amount paid or incurred by a private foundation as a grant to an organization (other than an organization described in section 509(a)(1), (2) or (3)), unless the private foundation exercises expenditure responsibility with respect to such grant in accordance with section 4945(h).

Section 53.4945-5(a)(4) of the regulations provides that, for purposes of section 4945(d)(4) of the Code, an organization will be treated as a section 509(a)(1) organization if it is an organization described in section 170(c)(1), even if it is not described in section 501(c)(3); or if it is a foreign government or any agency or instrumentality thereof, even if it is not described in section 501(c)(3). However, any grant to such organizations must be made exclusively for charitable purposes as described in section 170(c)(2)(B).

Section 53.4945-5(a)(6)(i) of the regulations (Certain earmarked grants) 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 the grant. For purposes of this subdivision, 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.

Section 53.4945-5(b)(1) of the regulations (Expenditure responsibility) provides that a private foundation is not an insurer of the activity of the organization to which it makes a grant. Thus, satisfaction of the requirements of sections 4945(d)(4) and (h) and of subparagraph (3) or (4) of this paragraph, will ordinarily mean that the grantor foundation will not have violated section 4945(d)(1) or (2). A private foundation will be considered to be exercising "expenditure responsibility" under section 4945(h) as long as it exerts all reasonable efforts and establishes adequate procedures-

(i) To see that the grant is spent solely for the purpose for which made,

(ii) To obtain full and complete reports from the grantee on how the funds are spent, and

(iii) To make full and detailed reports with respect to such expenditures to the Commissioner.

In cases in which pursuant to paragraph (a)(6) of this section a grant is considered made to a secondary grantee rather than the primary grantee, the grantor foundation's obligation to obtain reports from the grantee pursuant to section 4945(h)(2) and this section will be satisfied if appropriate reports are obtained from the secondary grantee. For rules relating to expenditure responsibility with respect to transfers of assets described in section 507(b)(2), see section 507(b)(2) and the regulations thereunder.

Section 53.4945-5(b)(4) of the regulations provides that in order to meet the expenditure responsibility requirements of section 4945(h), with regard to the making of a program-related investment (as defined in section 4944 and the regulations thereunder), a private foundation must require that each such investment with respect to which expenditure responsibility must be exercised under section 4945(d)(4) and (h) and this section be made subject to a written commitment signed by an appropriate officer, director, or trustee of the recipient organization. Such commitment must specify the purpose of the investment and must include an agreement by the organization-

(i) To use all the funds received from the private foundation (as determined under paragraph (c)(3) of this section) only for the purposes of the investment and to repay any portion not used for such purposes, provided that, with respect to equity investments, such repayment shall be made only to the extent permitted by applicable law concerning distributions to holders of equity interests,

(ii) At least once a year during the existence of the program-related investment, to submit full and complete financial reports of the type ordinarily required by commercial investors under similar circumstances and a statement that it has complied with the terms of the investment,

(iii) To maintain books and records adequate to provide information ordinarily required by commercial investors under similar circumstances and to make such books and records available to the private foundation at reasonable times, and

(iv) Not to use any of the funds

(a) To carry on propaganda, or otherwise to attempt, to influence legislation (within the meaning of section 4945(d)(1)),

(b) To influence the outcome of any specific public election, or to carry on directly or indirectly, and voter registration drive (within the meaning of section 4945(d)(2)), or

(c) With respect to any recipient which is a private foundation (as defined in section 509(a)), to make any grant which does not comply with the requirements of section 4945 (d)(3) or (4).

X's general support grants to public charities described in sections 501(c)(3) and 509(a)(1), (2) or (3) of the Code which are used by those public charities in furtherance of their charitable goals are not taxable expenditures because such grants are described in section 4945(d)(4)(A) to which the expenditure responsibility requirements of section 4945(h) are not applicable.

In order for X's deposit guaranty program to qualify as a program related investment, the primary purpose of the program must be to accomplish one or more of the purposes described in section 170(c)(2)(B) with no significant purpose which is the production of income or the appreciation of property. The limitation on borrowers to organizations described in section 501(c)(3) and limitation on the use of borrowed funds to exclusively for charitable purposes satisfies the first part of this test. Ordinary investors for profit would be highly unlikely to invest or make deposits on terms similar to those agreed to by X under the guaranty program whereby the deposits will bear interest below risk-adjusted market rate interest, and, the deposited funds are exposed to a greater risk and illiquidity created by the restrictions on withdrawal and investment direction. These conditions demonstrate that no significant purpose of the guaranty deposits is the production of income or the appreciation of property. Therefore, X's guaranty program qualifies as a program-related investment within the meaning of section 4944(c) of the Code.

Similarly, X's loan guaranty and interest rate subsidy program also qualifies as a program-related investment. The primary purpose of the program is to induce the bank to make low interest loans to certain child care organizations who are section 501(c)(3) public charities that would not qualify for the loans they are seeking without X's guarantee or similar credit enhancement. The deposits with the bank will bear interest below the risk-adjusted market rate indicating the lack of a significant purpose which is the production of income, and presents no indication that the investment has a purpose which is to accomplish one or more of the purposes described in section 170(c)(2)(D) (i.e. lobbying and political activities).

In the event that under the guaranty program or the loan guaranty and interest rate subsidy program, a borrower should not be a governmental unit or a public charity described in section 509(a)(1), (2), or (3), where X, through a pre-grant inquiry, identifies the specific borrower before the loan is made and will not offer a guarantee unless it is satisfied that it is making an investment for exclusively charitable purposes, then X's agreements with the secondary grantee/borrowers and the reports provided to X by such borrowers can be deemed to be reasonable efforts by X to establish adequate procedures to meet the expenditure responsibility requirements of section 4945(h).

Based on the information submitted and the representations made therein, we rule as follows:

(1) Grants to public charities for specific charitable purposes or projects. Grants by X to public charities described in sections 501(c)(3) and 509(a)(1), (2) or (3) to be used by the grantees for specific charitable purposes or projects are described in section 4945(d)(4)(A) and the expenditure responsibility requirements of section 4945(h) do not apply.

(2) Deposit guaranties as program-related investments. The deposits with a commercial bank, bearing interest below the risk-adjusted market rate, made or to be made by X under the guaranty program, are "program-related investments" described in section 4944(c) and the expenditure responsibility requirements of section 4945(h) do not apply if the borrowers are governmental units or charities described in section 509(a)(1), (2) or (3).

(3) Loan guaranty and interest rate subsidy program as program-related investments. The deposits with a commercial bank, bearing interest below the risk-adjusted market rate, made or to be made by X under the loan guaranty and interest rate subsidy program, are "program-related investments" described in section 4944(c), and the expenditure responsibility requirements of section 4945(h) do not apply if the borrowers are governmental units or charities described in section 509(a)(1), (2) or (3).

(4) Non-public charity borrowers. If under either the guaranty program or the loan guaranty and interest rate subsidy program, a borrower should not be a governmental unit or a public charity described in section 509(a)(1), (2) or (3), the expenditure responsibility requirements of section 4945(h) may be satisfied by agreement between X and the borrower and reports provided to X by the borrower, rather than by agreements with and reports from the bank.

These rulings are based on the understanding that there will be no material changes in the facts upon which they are based.

These rulings are directed only to the organization that requested them. Section 6110(k)(3) of the Internal Revenue Code provides that they may not be used or cited by others as precedent.

Please keep a copy of this ruling letter in your permanent records.

Sincerely,

Robert C. Harper, Jr.

Robert C. Harper, Jr.
Manager, Exempt Organizations
Technical Group 3