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

200045033

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.0509.01-02

Date: AUG 15 2000

NO THIRD PARTY CONTACTS

Contact Person:

ID Number:

Telephone Number:

T:EO:RA:T4

Employer Identification Number:

Legend:
M =
N =.
O =.
a =
b =

Dear Sir or Madam:

This is in response to your request of February 12, 2000, for a ruling on the proper treatment of excess contributions and the calculation of net investment income for a supporting organization exempt under section 509(a)(3) of the Internal Revenue Code.

M is exempt under section 501(c)(3) of the Code and is classified as a supporting organization under section 509(a)(3). M is organized and operated exclusively for charitable, religious and educational purposes, by conducting and supporting activities for the benefit of, to perform the function of, and/or carry out the purposes of several named public charities. To date, M has accomplished its exempt purpose by supporting N, a tax exempt private school.

M was formed in 1996 and was initially funded by a gift from a and b, husband and wife, of stock in O, a publicly traded corporation. In its first fiscal year, M contributed a percentage of its O stock to N to satisfy its pledge to the school to aid in the construction and renovation of a school building. M pledged an additional matching grant to N to be paid when the school had received sufficient matching funds from other donors. When the school reached this goal during M's second fiscal year, M contributed additional O stock in accordance with its pledge.

During its first fiscal year, M had no income or receipts other than the original contribution of O stock; additionally, M had no expenses other than the contribution paid to N. In its second fiscal year, M's income included not only additional contributions received, but also interest and dividends from securities and capital gains. M incurred expenses for investment management fees, accounting fees, and miscellaneous expenses. In its third

140

fiscal year, M again had income from contributions, interest and dividends on securities and capital gains and expenses for investment management fees, other professional fees and miscellaneous expenses.

Based on the above, you have requested that we rule that M continues to be described in section 509(a)(3) of the Code and is in compliance with the "substantially all" requirement of section 1.509(a)-4(i)(3)(iii)(a) of the Income Tax Regulations for any year in which its charitable distributions made prior to the end of the succeeding year, plus unused carryovers, equal or exceed 85% of its income reduced by related expenses, with income being defined as excluding contributions received and long term capital gains. The unused carryover will be computed in accordance with the procedures described in section 53.4942(a)-(3)(e) of the Foundation and Similar Excise Taxes Regulations.

Section 509(a)(3) of the Code provides that the term "private foundation" means a domestic or foreign organization described in section 501(c)(3) other than an organization which:

(A) is organized, and at all times thereafter is operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more organizations described in section 509(a)(1) or (2),

(B) is organized, supervised, or controlled by or in connection with one or more organizations described in section 509(a)(1) or (2), and,

(C) is not controlled directly or indirectly by one or more disqualified persons classified in section 4946 other than foundation managers and other than one or more organizations described in section 509(a)(1) or (2).

Section 1.509(a)-4(i)(1)(i) of the regulations provides, in part, that a supporting organization will be considered as being operated in connection with one or more publicly supported organizations only if it meets the "responsiveness test" and the "integral part test."

Section 1.509(a)-4(i)(3)(i) of the regulations provides, in part, that a supporting organization will meet the "integral part test" if it maintains a significant involvement in the operations of one or more publicly supported organizations and such publicly supported organizations are, in turn, dependent upon the supporting organization for the type of support which it provides.

Section 1.509(a)-4(i)(3)(ii) of the regulations requires that the activities engaged in for or on behalf of the publicly supported organizations are activities to perform the functions of, or to carry out the purposes of, such organizations, and, but for the involvement of the

supporting organization, would normally be engaged in by the publicly supported organizations themselves.

Section 1.509(a)-4(i)(3)(iii)(a) of the regulations requires that the supporting organization make payment of substantially all of its income to or for the use of one or more publicly supported organizations, and the amount of support received by one or more of such publicly supported organizations is sufficient to insure the attentiveness of such organizations to the operations of the supporting organization. In addition, a substantial amount of the total support of the supporting organization must go to those publicly supported organizations which meet the attentiveness requirement with respect to such supporting organization. Except as provided in section 1.509(a)-4(i)(3)((iii)(b), the amount of support received by a publicly supported organization must represent a sufficient part of the organization's total support so as to insure such attentiveness.

Section 4942 of the Code generally imposes a tax on the undistributed income of a private foundation. For purposes of the definition of "operating foundation" under section 4942(j)(3), section 4942(f)(1) defines "adjusted net income," as the excess of the gross income for the taxable year (with certain modifications, including taking capital gains and losses into account only in an amount equal to any net short-term capital gain for the taxable year), over the sum of the deductions (with certain modifications) which would be allowed to a corporation subject to tax under section 11 for the taxable year.

Section 53.4942(b)-1(c) of the regulations provides that for purposes of section 4942(j)(3)(A) of the Code (relating to qualifying distributions by private operating foundations), the term "substantially all" means 85 percent or more.

Section 53.4942(a)-3(d) of the regulations provides, in part, that a qualifying distribution made during a taxable year shall be treated as made (i) first out of undistributed income ... of the immediately preceding taxable year ... to the extent thereof; (ii) second out of the undistributed income from the taxable year to the extent thereof; and (iii) then out of corpus.

Section 53.4942(a)-3(e) of the regulations provides, in part, that if in any taxable year for which an organization is subject to the initial excise tax there is created an excess of qualifying distributions, such excess may be used to reduce distributable amounts in any taxable year of the adjustment period. The distributable amount for a taxable year in the adjustment period shall be reduced to the extent of the lessor of (i) the excess of qualifying distributions made in prior taxable years to which such adjustment period applies or (ii) the remaining undistributed income at the close of such taxable year after applying any qualifying distributions made in such taxable year to the distributable amount for such taxable year.

Rev. Rul. 76-208, 1976-1 C.B. 161, held that a section 501(c)(3) trust did not satisfy the "substantially all" requirement of the integral part test set forth in section 1.509(a)-4(i)(3)(iii)(a) of the regulations and was therefore not a section 509(a)(3) supporting organization. The trust instrument designated a bank as sole trustee and provided that 75 percent of the trust income was to be distributed annually to a specified church with the remaining 25 percent to accumulate until the original corpus doubled, at which time the entire annual income was to be distributed to the church. The Service reasoned that although the term "substantially all" is not defined in the section 509 regulations, it is defined in the Foundation Excise Tax Regulations issued under sections of the Code which were promulgated under the Tax Reform Act of 1969 as was section 509. The Service adopted the 85 percent definition set forth in section 53.4942(b)-1(c) of those regulations.

The term "income" (or "annual net income") in section 1.509(a)-4(i)(3)(iii) of the regulations, like the term "substantially all," is not further defined in that section of the regulations, but is defined in section 4942 of the Code and the regulations thereunder. For the reasons stated in Rev. Rul. 76-206, the term "adjusted net income" under section 4942(f)(1) of the Code should be used as the definition of "income" for purposes of section 1.509(a)-4(i)(3)(iii)(a) of the regulations. "Adjusted net income" under that section includes net short-term capital gain.

As you point out, neither the section 509(a)(3) regulations or Rev. Rul, 76-208 discuss or define the time period that an organization has to distribute "substantially all" of its income. However, since it references section 4942, it is reasonable to consider the distribution periods set forth in that section as a reasonable standard for determining whether a supported organization has satisfied the substantially all" rule set forth in section 1.509(a)-4(i)(3)(iii)(a) of the regulations as well. Thus, in accordance with section 53.4942(a)-3(d) of the regulations, any payments to N during M's third fiscal year would be to satisfy the substantially all requirement for its second fiscal year. You have indicated that M had a net loss in its second fiscal year, however, and was not required to make any distribution. In its third fiscal year, M distributed the rest of the matching grant which you indicate far exceeded 85 percent of its adjusted net income as defined in section 4942(f)(1). As permitted by section 53.4942(a)-3(e)(3) of the regulations, M may carryover the excess contribution for five tax years following the year in which the excess contribution was made.

Based on the above, we conclude that M continues to be described in section 509(a)(3) of the Code and is in compliance with the "substantially all" requirement of section 1.509(a)-4(i)(3)(iii)(a) of the Income Tax Regulations. M will continue to satisfy the "substantially all" requirement of section 1.509(a)-4(i)(3)(iii)(a) for any year in which its charitable distributions made prior to the end of the succeeding year, plus unused carryovers, equal or exceed 85% of its income reduced by related expenses, with income being defined as excluding contributions received and long term capital gains. The unused

carryover should be computed in accordance with the procedures described in section 53.4942(a)-(3)(e) of the Foundation and Similar Excise Taxes Regulations.

This ruling is based on the understanding that there will be no material changes in the facts upon which it is based.

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.

We are informing your Area Manager of this ruling. Please keep a copy of it in your permanent records. If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Gerald V. Sack

Gerald V. Sack
Manager, Exempt Organizations
Technical Group 4