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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Date: MAY 9 2003

Contact Person:

Identification Number:

Telephone Number:

Uniform Issue List: 501.03-02
4942.03-05
4944.03-00
4945.04-06

T:EO:Br2

Legend:

M =
The City =
N =

Year E =
Date F =

Dear Sir or Madam:

We have considered your letter dated November 30, 2001, as supplemented by your letters of August 6, 2002, December 13, 2002, March 10, 2003, and May 2, 2003, in which you request rulings under sections 501, 4944, 4942, and 4945 of the Internal Revenue Code with respect to proposed loans to promote the development and construction of housing in the downtown area of the City ("Downtown") as described below.

Facts:

M is exempt from federal income taxation as an organization described in section 501(c)(3) of the Code, and is considered a private foundation within the meaning of section 509 of the Code. M provides significant grants to charitable organizations located in the greater City area. M has a particular commitment to economic development and an interest in assisting in the revitalization of the City. M has committed significant funds in the past to the activities of economic development organizations in the City region.

N is the governmental entity in the City that determines whether a particular area of the City is blighted. N has designated certain redevelopment areas in Downtown as blighted.

City officials recognized that Downtown is in dire need of economic development, and realized that a comprehensive development strategy was needed to address issues of Downtown decay and blight. The City, through its Department of City Planning, undertook a comprehensive study of Downtown, and in Year E published the City Downtown Plan (the "Plan"). Planning was undertaken by three oversight committees and six community task forces

composed of business leaders, administrators, design professionals, residents, clergy, and other concerned citizens and corresponding to the six focus areas of the study. The six areas were deemed to be interrelated, and success could not be achieved unless all areas were addressed.

One of the six focus areas of the Plan is housing. The Plan determined that without a significant resident population Downtown is not likely to thrive. The Plan concluded that housing was vital to the revitalization of the City because residents were needed to stabilize the other improvements planned for the City, such as the revitalization of the retail and entertainment sectors as well as encouragement of additional businesses in the City.

Downtown has relatively little housing. The residential population of Downtown is one of the smallest of the major cities. There is insufficient housing to provide the economic development momentum that housing is anticipated to provide. Furthermore, the City's economic condition hinders the development of new housing in Downtown. Because of low rental prices and high construction costs, developers are unable to undertake the major reconstruction necessary to convert Downtown buildings into residential buildings. Conventional financing is unavailable because conventional lenders do not believe that the cash flow from the projects will be sufficient to service the debt. To fill the financing "gap" occasioned by the unwillingness of conventional lenders to invest in downtown housing, the City is looking for alternative sources of funding, and has turned to organizations like M to provide funding for the development of the initial housing projects. The City anticipates that, once the initial projects are completed using the "gap" financing provided by non-conventional lenders, those projects will provide the critical mass of housing, and attendant economic momentum, that will attract the conventional lenders to invest in additional housing. Therefore, the Mayor of the City has approached M and requested its support of housing as part of M's support of other economic development initiatives Downtown.

M wishes to provide funding for the construction of new housing and renovation of existing buildings in Downtown. The housing is expected to be apartment units in multi-unit buildings, the majority of which will be rental units. The funding would be provided to organizations that are recognized as exempt under section 501(c)(3) of the Code and that are not private foundations as defined in section 509 of the Code. While those organizations would be permitted to lend some or all of the funds to for-profit developers, M represents that no for-profit developer or other individual receiving housing funds provided, directly or indirectly, by M will be a disqualified person with respect to M within the meaning of section 4946 of the Code.

M will provide funding for market rate housing only under certain conditions. Any grant agreement or loan agreement to fund housing would incorporate conditions that ensure the following:

1. The exempt organization recipient of funds from M must use the grants or loans to provide gap financing for residential projects in the City undertaken itself or, more usually, by a for-profit developer;

2. All residential housing supported by the funds must be located in an area

currently designated as blighted by N, with "currently" being determined as of the use of the funds, provided the area was also designated as blighted as of Date F;

3. There must be a representation that the housing projects will hire the unemployed, the underemployed, and minorities;

4. Any loans must be repaid to the extent of any proceeds from the housing projects, with an interest rate not to exceed the applicable federal rate under section 1274 at the time of the loan;

5. The exempt organization must represent that any dealings with a for-profit developer would be structured in a manner to ensure that any private benefit to the for-profit developer would be incidental to the public benefit emanating from the development of downtown housing in that all transactions with the developer must be on commercially reasonable terms as determined in the greater City market. For example, all gap financing would be structured as loans rather than grants, and it would be required that the loans be repaid in full with interest at a reasonable rated before the developer could receive a return on its investment in excess of a reasonable stated percentage (although the developer could receive reasonable compensation for services rendered);

6. The agreements with the exempt organization recipients of the funds for housing will include a provision precluding any for-profit developer or individual receiving such funds from being a disqualified person with respect to M within the meaning of section 4946 of the Code; and

7. With respect to loans, all requirements for program related investments under section 4944(c) must be satisfied.

Rulings Requested:

M has requested the following rulings:

1. Given the blighted state of the Downtown and the need for various integrated economic initiatives to assist in the revitalization of the Downtown, the proposed grants and loans for residential housing further charitable economic development purposes within the meaning of sections 501(c)(3) and 170(c)(2)(B) of the Code.

2. Given the blighted state of the Downtown and the need for various integrated economic initiatives to assist in the revitalization of the Downtown, the proposed grants and loans for residential housing qualify as economic development program-related investments within the meaning of section 4944(c) of the Code.

3. Given the blighted state of the Downtown and the need for various integrated economic initiatives to assist in the revitalization of the Downtown, the proposed grants and loans for

residential housing qualify as qualifying distributions under section 4942 of the Code to the extent and as paid to the exempt recipients.

4. M is not required to exercise expenditure responsibility under section 4945 of the Code with respect to the proposed grants or loans.

Law:

Section 170(c)(2)(B) of the Internal Revenue Code provides that, for purposes of section 170, the term "charitable contribution" means a contribution or gift to or for the use of a corporation, trust or community chest, fund, or foundation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals.

Section 501(a) of the Code exempts from federal income taxation organizations described in section 501(c).

Section 501(c)(3) of the Code describes corporations, trusts, and associations organized and operated exclusively for charitable and other exempt 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 Income Tax Regulations provides that the term "charitable" is used in section 501(c)(3) in its generally accepted legal sense, and includes relief of the poor and distressed or of the underprivileged and promotion of social welfare by organizations designed to lessen neighborhood tensions, to eliminate prejudice and discrimination, and to combat community deterioration and juvenile delinquency.

Rev. Rul. 70-585, 1970-2 C.B. 115, considers situations under which a nonprofit organization created to provide housing for low or moderate income families may qualify for exemption under section 501(c)(3) of the Code. In Situation 3, an organization is formed to formulate plans for the renewal and rehabilitation of a particular area in a city as a residential community. Studies of the area showed that the median income level in the area is lower than in other sections of the city and the housing located in the area is generally old and badly deteriorated. The organization's membership is composed of the residents, businesses, and community organizations in the area. The organization cooperates with the local redevelopment authority in providing residents of the area with decent, safe, and sanitary housing without relocating them outside the area. The organization has developed an overall plan for the rehabilitation of the area; it sponsors a renewal project in which the residents themselves take the initiative; and it arranges monthly meetings to involve residents in the planning for the renewal of the area. As part of the renewal project, it purchased an apartment house that it plans to rehabilitate and rent at cost to low and moderate income families with preference given to residents of the area. The organization is supported by federal funds, membership fees, and contributions. Since the organization's purposes and activities combat community deterioration by assisting in the rehabilitation of an old and run-down residential area, they are charitable within the meaning of section 501(c)(3) of the Code. Thus, it is held that the organization is exempt from Federal income tax under section 501(c)(3) of the Code.

Rev. Rul. 74-587, 1974-2 C.B. 162, describes an organization that devotes its resources to programs designed to stimulate economic development in high density urban areas inhabited mainly by low-income minority or other disadvantaged groups. The organization provides funds and working capital to corporations or individual proprietors who are not able to obtain funds from conventional commercial sources because of the poor financial risks involved in establishing and operating enterprises in these communities or because of their membership in minority or other disadvantaged groups. The program is designed to enable the recipient of funds or capital to start a new business or to acquire or improve an existing business. In selecting recipients for aid, the organization consults with other nonprofit and governmental organizations operating anti-poverty and anti-discrimination programs to identify particular undertakings that will fill a community need and offer the greatest potential community benefit. Preference is given to businesses that will provide training and employment opportunities for the unemployed or under-employed residents of the area. In selecting the recipient for financial assistance, the organization considers the applicant's motivation, education, experience, and prior participation in management and job training programs. The ruling finds that the organization is devoting its resources to uses that benefit the community in a way that the law regards as charitable. A program of aiding minority-owned businesses promotes the social welfare of the community since it helps to lessen prejudice and discrimination against minority groups by demonstrating that the disadvantaged residents of an impoverished area can operate businesses successfully if given the opportunity and proper guidance. It also helps to relieve poverty and lessen neighborhood tensions arising from the lack of employment opportunities by assisting local businesses that will provide a means of livelihood and expanded job opportunities for unemployed or underemployed area residents. Finally, it combats community deterioration by helping to establish businesses in the area and by rehabilitating existing businesses that have deteriorated. Although some of the individuals receiving financial assistance in their business endeavors may not themselves qualify for charitable assistance as such, they are nevertheless the instruments by which charitable purposes are sought to be accomplished. Accordingly, the organization is exempt under section 501(c)(3) of the Code.

Section 4944(a) of the Code imposes a tax on a private foundation that invests any amount in such 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 purpose 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 that a "program-related investment" shall not be classified as an investment which jeopardizes the carrying out of exempt purposes of a private foundation. 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) (that is, attempting to influence legislation, or participating or

intervening in any political campaign on behalf of any candidate for public office).

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. For purposes of section 4944, the term "purposes described in section 170(c)(2)(B)" shall be treated as including purposes described in section 170(c)(2)(B) whether or not carried out by organizations described in section 170(c).

Section 4942 of the Code requires that a private foundation make "qualifying distributions" in an amount sufficient to satisfy its minimum investment return.

Section 4942(g) defines "qualifying distribution" as any amount paid to accomplish a purpose described in section 170(c)(2)(B) other than a contribution to an organization controlled by the foundation or a disqualified person.

Section 53.4942(a)-3(a)(2) of the regulations provides that the term "qualifying distribution" means any amount (including program-related investments as defined in section 4944(c)) paid to accomplish one or more purposes described in section 170(c)(1) or (2)(B).

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

Section 4945(d) of the Code provides that the term "taxable expenditure" means any amount paid or incurred by a private foundation ... (4) as a grant to an organization unless (A) such organization is described in paragraph (1), (2), or (3) of section 509(a) or is an exempt operating foundation, or (B) the private foundation exercises expenditure responsibility with respect to such grant in accordance with subsection 4945(h), or (5) for any purpose other than one specified in section 170(c)(2)(B).

Section 53.4945-4(a)(2) of the regulations provides that, for purposes of section 4945, the term "grants" shall include loans for purposes described in section 170(c)(2)(B) and "program related investments" (such as investments in small businesses in central cities or in businesses which assist in neighborhood renovation).

Section 53.4945-5(a)(6)(i) of the regulations 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 subsection, 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 grants 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 53.4945-6(b)(v) of the regulations provides that any payment that constitutes a qualifying distribution under section 4942(g) of the Code will not be treated as a taxable expenditure under section 4945(d)(5).

Analysis:

Charitable Purpose

Under the law cited above, an organization will be considered to operate in furtherance of charitable purposes within the meaning of section 501(c)(3) if it engages in activities that promote social welfare by combating community deterioration. The loans and grants that M proposes to make for purposes of housing development in areas of Downtown that are designated as blighted by City government are activities that promote social welfare by combating community deterioration.

Like the organization described in Rev. Rul. 70-585, M proposes to engage in activities that further a community-designed plan for the renewal and rehabilitation of a particular area of a city by providing a residential component to that area. Also like the organization in the revenue ruling, M is working at the request of, and in cooperation with, the local redevelopment authorities. Like the area described in the revenue ruling, Downtown is old and badly deteriorated. M's proposed loans and grants would assist in the rehabilitation of blighted areas of Downtown as envisioned by the Plan.

Like the activities engaged in by the organization described in Rev. Rul. 74-587, M's proposed loans and grants are designed to stimulate economic growth in a depressed urban area. Like the organization in the revenue ruling, M will work with government agencies and nonprofit community organizations. M's funds will be provided to housing developers that are unable to obtain funds from conventional commercial sources because of the poor financial risks of developing housing in blighted areas of Downtown. M will structure the terms of its loans and grants so as to fill a community need and offer the greatest potential community benefit. Fund recipients will be required to develop housing in areas that are designated as blighted. Developers must represent that they will hire the unemployed, underemployed, and minorities in the area. Transactions with developers must be on commercially reasonable terms. Therefore, like the funds provided by the organization in the revenue ruling, M's loans and grants to housing organizations are designed to relieve poverty by providing expanded job opportunities to the area's unemployed and minorities, and to combat community deterioration by rehabilitating existing buildings and building new housing in blighted areas.

Therefore, under the reasoning of Rev. Rul. 70-585 and Rev. Rul. 74-587, M's proposed loans and grants made under the conditions represented above further charitable purposes within the meaning of section 501(c)(3) of the Code.

Program-Related Investments

Private foundations are subject to an excise tax on jeopardizing investments under section 4944 of the Code if they invest any amount in a manner that jeopardizes the ability of the foundation to carry out its exempt purposes. Under section 4944(c) of the Code, program-related investments are specifically excluded from jeopardizing investments. A program-related investment must significantly further the foundation's exempt activities, and it must not have been made but for the relationship between the investment and the accomplishment of the foundation's exempt purposes.

While M intends to make grants or loans solely to section 501(c)(3) organizations that are not private foundations within the meaning of section 509 of the Code, those organizations are permitted to lend some or all of the funds to for-profit developers as long as the requirements imposed by M with respect to loans to for-profit developers are met. However, as long as the requirements of section 53.4944-3(a)(1) of the regulations are met, a program-related investment may be made in a for-profit entity. For instance, section 53.4944-3(a)(2)(i) of the regulations provides that the term "purposes described in section 170(c)(2)(B)" shall be treated as including purposes described in section 170(c)(2)(B) whether or not carried out by organizations described in section 170(c).

The first requirement for a program-related investment is that the primary purpose of the investment must be to accomplish one or more of the purposes described in section 170(c)(2)(B). As discussed above, the primary purpose of the loans is to combat community deterioration in a manner that is considered charitable within the meaning of section 501(c)(3) of the Code. Thus, such loans accomplish a purpose described in section 170(c)(2)(B).

The second requirement for a program-related investment is that the investment must not have the production of income or the appreciation of property as a significant purpose. The funds invested by M will be used to provide gap financing for the development of housing in Downtown. Downtown has very little housing, and it is unclear whether the housing will successfully draw tenants. The investments have a significant risk because the housing must be located in blighted areas. In addition, although loans to for-profit developers will carry interest, the purpose of the interest is to minimize any private benefit to the for-profit developers. Therefore, the production of income and the appreciation of property is not a significant purpose of the proposed loans.

The third requirement for a program-related investment is that the funds not be used to carry on propaganda or otherwise influence legislation or to participate in any political campaign on behalf of or in opposition to any candidate for public office. No funds provided by M may be used for such purposes. The terms of the loans will specifically prohibit such use.

Thus, M's proposed loans qualify as a program-related investment within the meaning of section 4944(c) of the Code.

Qualifying Distribution

A private foundations is required under section 4942 of the Code to make qualifying distributions in an amount sufficient to satisfy the foundation's minimum investment return. The term "qualifying distributions" is defined in section 4942(g) of the Code as any amount paid to accomplish a purpose described in section 170(c)(2)(B) other than a contribution to an organization controlled by the foundation or a disqualified person. Section 53.4942(a)-3(a)(2) of the regulations provides that a qualifying distribution includes a program-related investment under section 4944(c) of the Code. As described above, M's proposed grants and loans further charitable purposes. In addition, the proposed loans qualify as a program-related investment, and M will not control any recipient organization. Under section 53.4942(a)-3(a)(1) of the regulations, qualifying distributions are determined on the cash receipts and disbursements method. Therefore, the proposed grants and loans should qualify as a qualifying distribution as and when the grants and loans are made by M.

Expenditure Responsibility

Private foundations are subject to an excise tax on taxable expenditures under section 4945 of the Code. Section 53.4945-6(b) of the regulations provides that any payment that constitutes a qualifying distribution under section 4942(g) of the Code, such as M's proposed grants and loans for residential housing, will not be treated as a taxable expenditure. Section 4945(d) of the Code provides, however, that a grant to an organization that is not described in paragraph (1), (2), or (3) of section 509(a) of the Code will be classified as a taxable expenditure unless the private foundation exercises expenditure responsibility. "Grant" for this purpose includes a program-related investment.

While the ultimate recipient of the proceeds of the M's proposed grants and loans may be for-profit developers, M will make the grants and loans solely to organizations described in paragraph (1), (2), or (3) of section 509(a) of the Code that have the discretion to determine the ultimate user of the funds. Since such recipient organization has discretion in choosing the entities that will benefit from the proceeds of M's grants and loans, M's grants and loans are not considered to be earmarked for a secondary grantee, and, therefore, M is not required to exercise expenditure responsibility with respect to the grants and loans.

Conclusion:

Accordingly, based on the facts represented, we rule as follows:

1. The proposed grants and loans to be used as gap financing for residential projects in areas of Downtown designated as blighted by N and provided under the terms and conditions described in the Request for Rulings and supplemental correspondence further charitable purposes within the meaning of section 501(c)(3) of the Code.

2. The proposed grants and loans to be used as gap financing for residential projects in areas of Downtown designated as blighted by N and provided under the terms and conditions described in the Request for Rulings and supplemental correspondence qualify as program-

related investments within the meaning of section 4944(c) of the Code.

3. The proposed grants and loans to be used as gap financing for residential projects in areas of Downtown designated as blighted by N and provided under the terms and conditions described in the Request for Rulings and supplemental correspondence qualify as qualifying distributions under section 4942 of the Code to the extent and as paid to the exempt recipients.

4. M is not required to exercise expenditure responsibility under section 4945 of the Code with respect to the proposed grants or loans to be used as gap financing for residential projects in areas of Downtown designated as blighted by the City Department of Planning or N and provided under the terms and conditions described in the Request for Rulings and supplemental correspondence.

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

Because this ruling letter could help resolve any questions about the application of the Code to your activities, you should keep a copy of this ruling 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,

(signed) Terrell M. Berkovsky

Terrell M. Berkovsky
Manager, Exempt Organizations
Technical Group 2