P. PUBLIC CHARITY CLASSIFICATION AND PRIVATE FOUNDATION ISSUES: RECENT EMERGING SIGNIFICANT DEVELOPMENTS

by
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"It was the best of times, it was the worst of times."

Charles Dickens, from A Tale of Two Cities, published in London, 1859.

1. Introduction

The healthy economy and rising stock market have produced good times for the charitable sector. According to the American Association of Fund-Raising Counsel, as reported in the New York Times on May 26, 1999, charitable giving by Americans climbed 11 percent to $175 billion in 1998. As reported in the Washington Post on April 18, 1999, private foundations distributed a record $20 billion in charitable grants last year, double the amounts in 1988. Private foundation assets grew even faster than private foundation largesse, to $282.6 billion, as the value of average holdings grew by 25 percent. As reported in Newsweek, March 22, 1999, private foundations have been hard pressed to meet their 5% minimum distribution requirement under IRC 4942. "Giving money away is harder than some feel it is," says Cole Williams, President of the David and Lucile Packard Foundation, a California based charity. The Packard Foundation was ranked the wealthiest American private foundation by the Chronicle of Philanthropy, with assets valued at 12.1 billion dollars as of June 1, 1999, according to USA Today, June 3, 1999.

Bad times are also at hand. Just as in the Star Wars Epic, and A Tale of Two Cities, there is a dark side in the Exempt Organizations Universe. The Service in recent years has been confronted with a number of aggressive tax avoidance schemes, such as certain donor directed funds and inappropriate uses of an IRC 509(a)(3) supporting organization (this topic); abusive trusts, gift funds, and deputized fund raising (see 1999 EO CPE Text, Topic O); aggressive tax exempt bond transactions (1999 EO CPE Text, Topic H); charitable split-dollar insurance schemes (this EO CPE Text, Topic R); accelerated charitable remainder trusts (1996 EO CPE Text, Topic G); and certain fund raising programs related to the tax deduction for charitable contributions (this EO CPE Text, Topic T; 1999 EO CPE Text, Topic M).

This article will discuss recent issues concerning public charity classification and private foundations, including:

(a) “Aggressive” interpretations of provisions applicable to donor advised or directed funds and IRC 509(a)(3) supporting organizations;

(b) Education Athletic Association, Inc. v. Commissioner;

(c) Supporting organizations that lose public charity status when the supported organization becomes a private foundation;

(d) The treatment under IRC 4940 of charitable lead trust distributions to private foundations;

(e) Implications under IRC 4941 of the final regulations under IRC 664 concerning charitable remainder unitrusts;

(f) IRC 4941 issues raised in several recent rulings and hypotheticals;

(g) A recent private letter ruling on IRC 4942 issues raised by private operating foundations with limited liability companies (LLC's);

(h) Implications under IRC 4943 of private foundation stock holdings in S corporations;

(i) Prudent investor standards under IRC 4944;

(j) New disclosure rules for exempt organizations; and

(k) User fee summary under Rev. Proc. 99-8, 1999 I.R.B. 289.

2. Public Charity Classification Developments

A. Pickle Cards Sour IRC 509(a)(2) Status

In Education Athletic Association, Inc. v. Commissioner, T.C. Memo 1999-75 (March 10, 1999), the Tax Court upheld the Service's determination that the organization was a private foundation.

Education Athletic Association (EAA) derived all its support in its 1993, 1994, and 1995 years from the sales of "pickle cards" to liquor establishments in Nebraska. Nebraska law permits nonprofit organizations to sell pickle cards. For the years in issue, EEA's gross receipts were $70,251; $57,944; and $26,675, respectively.

The court considered whether selling pickle cards was an unrelated trade or business within the meaning of IRC 513. The Service argued that income from the sale of pickle cards was UBTI. Because it was EEA's sole source of support, EEA was precluded from qualifying as a public charity under IRC 509(a)(2). EEA asserted that the sale of pickle cards was related because such a sale was a game of chance permitted by State law that did not compete with commercial enterprise activity. Based on prevailing case law, the Tax Court upheld the Service's positions by holding that pickle cards sales constituted unrelated trade or business and that EEA was a private foundation.

The decision was not appealed. Private foundation status will place EEA into an even more bitter brine, as the pickle card business would be a "business enterprise" under IRC 4943, subject to an initial 5 percent tax, and a subsequent 200 percent tax if not terminated.

B. Update on Donor Advised or Gift Funds

(1) Preface

The Service continues to contend with the issue of donor advised or gift funds, which were discussed in the 1996 EO CPE Text, Topic M, p. 328, titled "Donor Directed Funds," and the 1999 EO CPE Text, Topic O, Part I, titled "Gift Funds- A New Direction In Charity."

(2) Fund for Anonymous Gifts

As discussed in the 1999 EO CPE Text, cited above, the United States District Court for the District of Columbia, in The Fund for Anonymous Gifts, 97-2 U.S Tax Cases (CCH) P50, 710 (1997), held that a donor advised fund failed to qualify as a charitable organization within the meaning of IRC 501(c)(3). The court found that the Fund for Anonymous Gifts (Fund) has two purposes. The first purpose is to allow individuals to make anonymous charitable contributions that qualify for the tax deduction for charitable contributions. The second purpose is "to provide investment services to donors" by allowing conditions on donations requiring "that the donation be invested by the Trustee as directed by the donor, and that the income from the investment be donated on an anonymous basis at a later time specified by the donor." The court concluded that the control exercised by donors over the investment and distribution of contributions (both with respect to who receives a contribution and when a distribution is received) through "enforceable conditions subsequent" is not in furtherance of an exempt purpose under IRC 501(c)(3).

The decision of the District Court, on appeal before the United States Court of Appeals for the District of Columbia Circuit, was vacated and remanded in part. In Fund for Anonymous Gifts v. Internal Revenue Service, No. 97-5142, 1999 U.S. App. Lexis 8307, filed April 12, 1999, the Court explained as follows

> "at oral argument the organization expressed a willingness to amend its governing instrument to strike out the provision authorizing conditions subsequent on donations to the Fund."

The Government agreed to enter into settlement negotiations with the organization.

> "The Fund then amended its governing instrument, retroactive to the date the Fund was established, to eliminate the provision for conditions subsequent over donations. Over a year after settlement negotiations began, the parties still were unable to reach an agreement."

The Government argued that the amendment did not sufficiently address the inadequacies of the Fund's operations, contending that the administrative record showed that the Fund would not take complete control over the contributions. Instead, the Fund would adhere to the directions of its donors regarding the investment and the ultimate distribution of the contributed funds. The amendment would not prevent the Fund from providing investment services and acting as an administrative conduit for its donors' funds.

The Court of Appeals expressed that it was "baffled by the government's apparent intransigence" in refusing to settle the case given the fact that the objectionable control provision was eliminated. The Court of Appeals did not reverse because the lower court's decision was based on the Fund's document containing the objectionable control provision. Thus, the Court of Appeals vacated the decision and ordered the District Court to enter summary judgment for the Fund on the exemption issue. However, as the District Court did not decide the issue of the Fund's public charity status, the Court of Appeals remanded the case to the District Court for determination of whether the Fund is a publicly supported organization.

This decision is unpublished, and the Service will continue to review the issue of donor control in donor-advised funds.

(3) New Dynamics

In New Dynamics Foundation v. United States of America, No. 90-197T, an IRC 7428 action pending in the U.S. Court of Federal Claims, the complaint contained, in part, the following:

> The Foundation commenced business operations on or about June 17, 1996. As a part of its operations, the Foundation offered to contributors the ability to form individual foundations which would operate under the Foundation's guidance and control. These individual foundations were known as donor-advised foundations, whereby the contributors could make recommendations to the Foundation's board of directors how the contributions should be invested and how the those contributions should be disbursed in connection with the charitable purposes of the Foundation and/or the individual foundation created by the contributor. While the board of directors of the Foundation would consider the advice or recommendations given by the contributors and their advisors, the board of directors of the Foundation at all times had control of the ultimate decision of where to invest the donated assets for charitable purposes.

The outcome of this case may affect the future development of donor advised fund issues.

C. Favorable Donor Advised Fund Cases

The Service has approved IRC 501(c)(3)/public charity exemption applications of certain donor advised organizations in the past year. Common elements in these cases include representations by the applicant organizations that subject them to conditions similar to those imposed on private foundations under IRC 4942 and 4945:

i. The organization expects that its grant distributions for the year will equal or exceed 5 percent of its average net assets on a fiscal year rolling basis. If this level of grant activity is not attained, the organization will identify the named accounts from which grants over the same period totaled less than 5 percent of each account's average assets. The organization will then contact the donor-advisors of these accounts to request that they recommend grants of at least this amount. If a donor-advisor does not provide the qualified grant recommendations, the organization is authorized to transfer up to 5 percent of assets from the donor-advisor's named account to the charity selected by the organization.

ii. The organization will add language to its promotional materials which indicates that the organization will investigate allegations of improper use of grant funds for the private benefit of donor-advisors.

iii. The organization will add language to its grantee letters to the effect that grants are to be used by grantees exclusively in furtherance of charitable purposes, and cannot be used for the private benefit of donor-advisors.

These representations were critical factors in establishing exemption and public charity status, but do not by themselves assure exemption or public charity status in any particular case.

To qualify under IRC 501(c)(3), a donor-advised fund must have appropriate control over the donated assets. See, Fund for Anonymous Gifts v. IRS, supra, and National Foundation, Inc. v. United States, 13 Cl. Ct. 486 (1987). The Service applies the material restriction provisions (relating to the termination of private foundation status) in Reg. 1.507-2(a)(8) to measure the level of control. The criteria in this regulation are applied to donor-advised funds held in trust that seek to be treated as a component fund of a community trust that is a public charity. See Reg. 1.170A-9(e)(11).

D. Supporting Organizations: IRC 509(a)(3)

(1) Inappropriate Use of a Supporting Organization

The IRC 509(a)(3) public charity classification has recently been described as a kind of private foundation for the wealthy. An article in the May 29, 1998, Wall Street Journal, titled "**Gimme shelter** The SO Trend: How to Succeed in Charity Without Really Giving", discusses what it describes as a “growing” use of this technique to allow wealthy persons to obtain substantial charitable tax deductions while maintaining control of the property. At least this is the impression the Wall Street Journal article conveys. The supporting organization is described as "now supplanting the private foundation - the reigning giving technique for decades."

The article gives several examples of how a donor may transfer highly appreciated property to a newly-created “supporting organization,” and claim the maximum charitable deduction, but continue to exercise considerable control over the donated property by virtue of the donor's position or influence on or over the Board of Directors of the exempt supporting organization. In addition, the article says the technique allows the donor's charity to avoid the onerous Chapter 42 rules imposed on private foundations.

The alleged use of the supporting organization in this manner is not new. This technique was discussed in the 1997 EO CPE Text, Topic I, (Public Charity on the Razor's Edge), pages 116-121, and is of real concern.

Some commercial organizations may be promoting a kind of supporting organization that clearly does not meet the Code and Regulations. One promotion claims:

> Putting the money in the Supporting Organization creates a private credit facility, which is perfectly legal as a 509(a)(3) organization. . . . The family members can legally take loans from the Supporting Organization at very favorable rates. An example would be to borrow money at a cost of 6 percent, and invest it for a higher return, pocketing the difference. . . On the passing of the current generation, assets donated to the Supporting Organization can be managed in perpetuity for future generations.

In a subsequent paragraph, the promotional material suggests that a supporting organization may reduce taxes as well as operate as an intergenerational private lending institution.

This promotion is clearly erroneous. IRC 509(a)(3)(C) specifically provides that a supporting organization can not be controlled, directly or indirectly, by disqualified persons (as defined in IRC 4946) other than by foundation managers. This means that the donor or his family may not control the supporting organization, directly, or indirectly through, for example, employees or business agents. Manipulating the Board of Directors to the extent suggested in both the Wall Street Journal article and the promotional literature described above can jeopardize the tax status of the organization and subject the responsible individuals to excise taxes. A supporting organization never (or seldom) holding a Board of Directors meeting is likely to be found suspect. A donor or family member who receives a low interest loan or uses property donated to the supporting organization raises the issue of who controls the organization for purposes of IRC 509(a)(3)(C). If, in addition, the official Board of Directors never, or rarely meets, the supporting organization is likely to fail the control test. In addition to jeopardizing the control required under IRC 509(a)(3)(C), the kinds of transactions described above can jeopardize the organization's exempt status due to inurement or excessive private benefit or subject the recipients to excess benefit taxes under IRC 4958. See Topic B, this EO CPE text. In a particularly abusive situation, other penalties, such as those under IRC 6700 and IRC 6701, may be appropriate. See 1999 EO CPE Text, Topic M.

(2) Supporting Organizations of Public Charities Which Lose Public Charity Status- The Ripple Effect

An article in the August 1997 issue of the Exempt Organization Tax Review, by Christopher R. Hoyt, titled "Creating Supporting Organizations of Community Foundations From Nonprofit Hospital Sales", advanced the theory that a supporting organization could facilitate use of proceeds generated from the sale of Hospital assets. Mr. Hoyt's article explained that there have recently been a number of nonprofit hospital sales to for-profit businesses. He further explained that when any nonprofit exempt charitable organization converts to or is bought by a for-profit commercial business, all proceeds of the sale and any remaining assets of the exempt entity must be left to a tax exempt entity; either by donating the funds to an existing charity, or establishing a new charitable entity.

Mr. Hoyt proposes that the hospital sales proceeds be used by a supporting organization to support a community foundation, which is an exempt organization described in Regs. 1.170A-9(e)(10) and (11). (A discussion of community foundations is found in the 1994 CPE Text, Topic K). The article cites IRS approval of such arrangements in Private Letter Rulings 9538026 through 9538031. In PLR 9538026, the organization was exempt under IRC 501(c)(3) and other than a private foundation under IRC 509(a)(1) and IRC 170(b)(1)(A)(vi). The letter does not specifically describe the organization as a community trust as defined in section Reg. 1.170A-9(e)(10) and (11), although the description of the organization suggests a community trust. Nevertheless, the profits and assets of the former hospital are used by an organization qualifying as a supporting organization to carry out the charitable purposes for which the hospital was originally formed. This is a useful technique for exempt hospitals that contemplate selling the hospital assets.

However, the hospital undertaking a transition to a grantmaking foundation after the sale of its assets may experience difficulty in making the transition. PLR 9852023 illustrates the problems.

In PLR 9852023, **U**, the parent corporation of a hospital system, is contemplating selling its eight hospital centers. **U** is the sole member of each of these centers (each being corporations). **U** estimated that it will take 6 to 12 months or longer after the transfers of the facilities to wind down the activities of the eight corporations. The ruling states as follows:

> "The eight hospitals in addition to their sections 509(a)(1) and 170(b)(1)(a)(iii) of the Code classification are also entitled to additional classifications as organizations described in section 509(a)(2). Consequently, after they cease being hospitals, they will be able to continue to be treated as section 509(a)(2) organizations, subject to the applicable pubic support and investment/unrelated business income limitations. **U**, based on current revenues, anticipates that the eight hospital corporations would continue to remain publicly-supported organizations described in section 509(a)(2) for the Code for at least three to four years following the date of the transaction.

The ruling goes on to state that **U** will continue as the sole corporate member of each of the hospital corporations until each winds up its affairs. Accordingly, **U** will continue as a section 509(a)(3) organization until the complete wind up and dissolution of the corporations or the loss of their status under IRC 509(a)(2).

3. Private Foundation Issues

A. IRC 4940 - Definition of Net Investment Income: Distributions from Charitable Lead Trusts

The Service is considering an issue dealing with the definition of net investment income under IRC 4940(c)(1) raised by distributions from charitable lead trusts. Under the facts raised on examination, private foundation receives distributions from two charitable lead trusts. One person has effective control of the private foundation as director and also serves as one of three trustees in each of the two charitable lead trusts. The private foundation is not a named beneficiary of the lead trusts. Income distributions to charity are discretionary with lead trusts. The lead trusts have made distributions to charities other than the private foundation.

The distributions from the trusts consist of ordinary income, capital gain, and trust principal. The issue raised on examination concerned whether distributions from the trusts were ordinary income for purposes of net investment income as defined in IRC 4940. There was no issue raised regarding capital gain and principal distributions.

IRC 4940(c)(2) defines “gross investment income” as the gross amount of income from interest, dividends, rents, payments with respect to securities loans, and royalties.

Reg. 1.4940-1(d)(2) provides, in relevant part, that, with respect to distributions from a trust described in IRC 4947(a)(2), the income of such trust attributable to transfers in trust after May 26, 1969, shall retain its character in the hands of the distributee private foundation for purposes of IRC 4940.

There is different tax treatment under Reg. 53.4940-1(d)(2) and IRC 4947(a)(2). IRC 4947(a)(2) trusts are not subject to IRC 4940.

In Ann Jackson Family Foundation v. Commissioner, 97 T.C. 534 (1991), *aff"d* 15 F3d 917 (9th Cir. 1994), the Tax Court held Reg. 53.4942-2(b)(2) was invalid as inconsistent with a change in the statute which made the minimum investment return the exclusive base for IRC 4942 distribution purposes. As Reg. 53.4942-2(b)(2) is similar to Reg. 53.4940-1(d)(2), the holding in Ann Jackson Family Foundation raises the question of its validity as well. On the other hand, Ann Jackson Family Foundation may be distinguishable in that there has been no intervening statutory change in IRC 4940.

B. IRC 4941

(1) IRC 664: CRUTs and Reformations of CRUTs

In the 1999 EO CPE Text, Topic P, page 315, we discussed, at page 333, the proposed regulations under IRC 664 and focused, in particular on the "Flip" unitrust provisions. The final regulations T.D. 8791 were effective when published in the Federal Register, Vol. 63, No. 237 on December 10, 1998. See also 1999-5 I.R.B. 7.

The Explanation to the final regulations clarifies some issues related to the flip unitrusts. As discussed in the 1999 EO CPE Text, the proposed regulations provided specific rules when a trust converts from one of the income exception methods of computing the unitrust amount to the fixed percentage method (flip unitrust). The Explanation goes on to explain that some commentators to the proposed regulations requested flip unitrusts for all income exception CRUTS regardless of the marketability of the trust assets.

One notable change in the final regulations is the availability of the flip unitrust in additional situations consistent with the legislative history. The final regulations allow the governing instrument to provide that the CRUT will convert once from one of the income exception methods to the fixed percentage method for calculating the unitrust amount if the date or event triggering the conversion is outside the control of the trustees or any other persons. The examples given with respect to an individual include marriage, divorce, death, or birth of a child. Also, sale of unmarketable assets is a triggering event. A CRUT is not precluded from using a flip provision under the final regulations provided it is conditioned on an appropriate triggering event. Example 3 of Reg. 1.664-3(e) involves a CRUT holding liquid assets which is not permitted only because the flip is not subject to an appropriate triggering event. If the flip was subject to an appropriate triggering event, such as of the death of the donor's spouse and assuming that the governing instrument provides for such contingency, the flip is permitted.

The preamble to the final regulations also discusses the effective date and transitional rule. It states, in part, as follows:

> The final regulations allow income exception CRUTs to be reformed to add provisions allowing a conversion to the fixed percentage method provided the triggering event does not occur in a year prior to the year in which the court issues the order reforming the trust. Adding the conversion provisions will not cause the CRUT to fail to function exclusively as a CRT and will not be an act of self-dealing under section 4941 if the trustee initiates legal proceedings to reform

the trust by June 8, 1999.

Notice 99-31, 1999-23 I.R.B. 6 (June 7, 1999), informs taxpayers that the deadline for reformation of charitable remainder trusts will be extended from June 8, 1999, until June 30, 2000. The extension was granted to accommodate the concerns that state law impediments could prevent meeting the June 8, 1999, deadline. In addition, Notice 99-31 authorizes non-judicial reformations where such reformations are permitted under state law governing the reformation of trusts, provided that non-judicial legal proceedings meet the same June 30, 2000, deadline.

Thus, considering the length of time to conclude legal proceedings in certain parts of the country, it is possible, if not likely, that old CRUTs (those existing prior to December 10, 1998) may be processing a reformation action or other legal proceedings under state law for years into the future to take advantage of the transition rule. Thus, agents and tax law practitioners, when considering the Service's position on reformation of trusts for purposes of IRC 4941, will want to keep in mind the transition rule.

As stated in the 1999 EO CPE Text, Topic P, a CRUT having a governing instrument permitting the trust to "flip", that is, to convert from one of the income exception methods of computing the unitrust amount to the fixed percentage method, will not be deemed to be engaged in an act of self-dealing under IRC 4941 for the reasons set forth in the 1999 EO CPE Text, **provided that the governing instrument comes within the provisions set forth in the final Regulations - Reg. 1.664-3(c)**. Similarly, the trustee of a CRUT existing prior to December 10, 1998 may reform the trust document and convert from one of the income exception methods to the fixed percentage method without being treated as engaging in an act of self-dealing, **provided the reformation of the trust document and the conversion to the fixed percentage method meet the requirements of the transition rule provided under Reg. 1.664-(3)(f) and Notice 99-31**.

To add even greater complexity, the transition rule does not permit the pre-December 10, 1998, CRUT to qualify if the triggering event previously occurred before the date that the court allows for reformation of the trust document. However there is an exception. A pre-December 10, 1998, CRUT containing a flip provision in its trust document as of that date may still qualify for the transition rule even though the triggering event has already occurred prior to December 10, 1998.

The 1999 EO CPE Text, discussed conversion of an income-exception CRUT to a fixed CRUT, and explained that any income-exception CRUT that meets the requirements of the regulations in converting to a fixed percentage CRUT will not be engaged in an act of self-dealing. This continues to be the position of the Service under the final regulations and with respect to any conversion within the requirements of the transition rule. As mentioned above, Service personnel may see the transition conversion CRUTs for several years past the June 30, 2000, cut-off date.

The final regulations and the transition rule do not eliminate self-dealing issues relating to CRUTs that wish to reform the provisions of the governing trust document. Some conversions will fail to meet the requirements of the regulations or the transition rule. Some reformations will not relate to a conversion of an income exception CRUT to a fixed percentage CRUT. Some reformations may relate to an unrelated issue. In the past, the Service has determined that a reformation of a trust may constitute an act of self-dealing under IRC 4941.

The Service has issued a few rulings on reformation of a charitable remainder trust. In PLR 9522021 (March 1, 1995), commented on in the 1997 EO CPE, Topic K, page 148, the Service held that a NIMCRUT that had adopted a payout amount providing for the lesser of trust accounting income or a fixed payment percentage, could not be amended or reformed to provide merely for a fixed percentage payout amount, notwithstanding that the charitable deduction obtained by the grantor was the same in either case. The Service held that such a reformation would constitute an act of self-dealing under section 4941(d)(1)(E) of the Code. The PLR reasoned as follows:

> The provisions of section 4941 should be strictly enforced. Reforming the trust in the manner proposed will remove interests in the trust which were previously dedicated to charity and transfer them to the benefit of a disqualified person.

The issue in PLR 9522021 is now generally controlled by the final regulations and the transition rule discussed above.

Recently, in PLR 9804036 (October 24, 1997), the Service allowed the reformation of a NIMCRUT where the facts clearly indicated “scrivener's” error: a fixed payment CRUT was intended, but an error resulted in the drafting of a NIMCRUT instead. In this ruling, documentation and evidence submitted under penalty of perjury supported the conclusion of scrivener's error. As a result, the Service ruled that there was no self-dealing under IRC 4941.

In PLR 9816030 (January 22, 1998), the Service held that a charitable remainder annuity trust that returned all trust assets to the original grantor was not an act of self-dealing under 4941 because the trust was void *ab initio* in that fraud was exercised on the grantor to induce her to establish the trust. A court ordered the recision of the trust.

PLR 9833008 and PLR 9833010 were two rulings issued by Chief Counsel: (CC:DOM:P&SI) in which reformation was sought on scrivener's error. In these two cases, the trust document failed to allocate capital gain to income. The donor/income recipient was informed that income realized from capital gain would be allocated to income. The CRUT sought to have the trust reformed to provide that capital gain realized by the trust would be allocated to capital gain. Based on rather strong factual support of scrivener's error, these two rulings held that reformation would not violate IRC 664 and the regulations thereunder. No IRC 4941 ruling was requested as a part of these rulings.

Headquarters has also considered whether a CRUT would violate IRC 4941 if it sought reformation of a trust document that failed to provide that capital gain realized by the trust shall be allocated to income. In the absence of the assertion of scrivener's error, such issue is likely to be decided against permitting reformation with respect to IRC 4941.

In summary, the reformation of a CRUT's governing instrument may still require an analysis of self-dealing. Only in those cases where the CRUT qualifies under the FLIP provision of the regulations or the transition rule (including Notice 99-31), will self-dealing not be an issue.

(2) IRC 4941, 4945, 501(c)(3)- Historic Mansion Museum; Self-Dealing and Private Benefit

In relation to the preceding material [2.D.(1)] relating to the Wall Street Journal article, those persons who set up a supporting organization to hold the donor's donated real estate or tangible personal property that the donor continues to control should consider the Service's approach in somewhat similar circumstances in the private foundation area. A classic example is TAM 9646002, July 17, 1996.

The decedent willed a historic manor house to a private foundation. In 1986, the Service issued a private ruling (PLR 8651087) to the decedent/donor's son that the son and his family could continue to occupy the manor house rent free as resident curator of the property. The private letter ruling was conditioned on representations that the private foundation would erect a sign at the gate of the manor house informing the public that building and grounds were open to viewing by the public. The private foundation also represented that it would prepare a brochure with a history of the manor house and a map of the grounds that would be made available to visitors at the gate of the manor.

During an examination of the foundation, the Service discovered that there was no sign on the public road near the manor indicating the presence of a historic house. The sign was on the private road leading to the mansion out of eyesight from the public road. The brochure of the foundation contained no specific directions to the manor, no telephone number, and only a minimal map of the general area. The foundation never published any advertisement and did not work with a chamber of commerce or tourism groups to promote access to the property. There was only minimal public visits to the manor.

In TAM 9646002, the Service concluded that the foundation operated for the private benefit of the decedent's son and that payments made by the foundation for maintenance of the property were taxable expenditures under IRC 4945. The Service found self-dealing under IRC 4941 as the assets and income of the foundation were used by the disqualified person and his family. TAM 9646002 relied on Rev. Rul. 74-600, 1974-2 C.B. 385 and Manning Association v. Commissioner, 93 T.C. 596 (1989). Rev. Rul. 74-600 held that placement of paintings owned by a private foundation in the private residence of a disqualified person constituted self-dealing even though the paintings were occasionally made available to the public. In the Manning case, the court held that, despite the educational purposes promoted by the Association with the historic Manning homestead, the Association's operations were also conducted for the benefit of members of the Manning family, a substantial nonexempt purpose precluding exemption under IRC 501(c)(3).

The decedent's son described in TAM 9646002 was able to restructure the operations of the private foundation to eliminate the violations. In a new private letter ruling, PLR 9641033, the Service again allowed the decedent's son and his family to live in the manor house as a resident curator. However, the ruling imposed the conditions described below for the foundation to retain its IRC 501(c)(3) exemption and avoid the excise taxes under IRC 4941 and 4945. (The Assistant Commissioner EP/EO granted IRC 7805(b) retroactive relief after revoking PLR 8651087).

i. The manor house will be open to the public for regularly scheduled periods in addition to being open at other times by appointment to the general public.

ii. Visitors will be provided with detailed printed material describing the history, architecture, and furnishings of the house and a tour of the public rooms of the manor house.

iii. Voluntary contributions will be accepted.

iv. A permanent sign will be placed at the main entrance on the public road to the manor house with information about the manor house and times of pubic access to the manor house prominently visible.

v. The brochure will include detailed directions to the manor house with a listed telephone number and the times of operation along with the information contained in the present brochure.

vi. The museum's revised brochure will be distributed to a number of area tourism groups, such as chambers of commerce, for distribution and display at their visitor centers;

vii. The museum will advertise at least annually in an historical or antiquities periodical of wide circulation and more frequently in an appropriate periodical of regional circulation in locations frequented by area tourists. The advertisements will include an historical identification, as well as the information in (i) above, along with the telephone number and address.

viii. The museum will continue to manage the manor house's historical, architectural, art and wildlife refuge treasures, including maintaining a visitor register, as it has in the past in a manner not inconsistent with (i) through (vii) above.

The self-dealing and exemption issues were discussed in a similar context in GCM 39741. The GCM involved two situations where a private foundation’s sculptures were displayed outdoors at the residence or office of the donor/substantial contributor. In one, the GCM concluded that the limited public viewing of the sculptures resulted in an act of self-dealing much in the same manner as discussed in TAM 9646002 above. The donor's family continued to receive substantial enjoyment of the sculptures on display at the family residence while providing minimal benefit to the public.

In the other situation, the GCM concluded that the foundation failed to qualify for IRC 501(c)(3) exemption because the donor's continued interest in the sculptures was more than incidental. The sculptures were located on the grounds of the donor’s corporate headquarters. That arrangement resulted in private benefit to the donor. The donor also retained by license the right to exclude the public at will. Under the facts, private benefit to the donor was apparent and substantial.

(3) <u>IRC 4941 - A Compensatory Split-Dollar Insurance Arrangement</u>

PLR 9539016 addresses the issue of a split dollar life insurance plan as compensation for services for trustees of a private foundation. Topic R, in this EO CPE Text extracts Notice 99-36, 1999-26 I.R.B. 1, which discusses charitable split-dollar insurance plans. The split-dollar insurance plan addressed in PLR 9539016 is not a “charitable split-dollar insurance plan” but an employer-employee plan used to compensate employees for many years of service to the company.

In the context of PLR 9539016, the split-dollar insurance is used by the private foundation to compensate its trustees. The trustees duties consist of managing the foundation's investments, working with the foundation's investment advisors, and performing general management functions. The foundation owns the policy and will receive a portion of the proceeds equal to the greater of cash value or the premium it has paid. The trustees' heirs would receive the remainder of the death benefit.

Under IRC 4941(d)(1)(D), "self-dealing" includes any direct or indirect payment of compensation by a private foundation to a disqualified person.

IRC 4941(d)(2)(E) provides an exception from self-dealing for payment of compensation by a private foundation to a disqualified person for personal services which are reasonable and necessary to carrying out the exempt purpose of the private foundation.

Various published rulings cited in the PLR affect this issue. Rev. Rul. 74-591, 1974-2 C.B. 385 holds that a pension for past personal services paid by a private foundation to one of its directors, a disqualified person whose compensation is not excessive, does not constitute an act of self-dealing. Rev. Rul. 82-223, 1982-2 C.B. 301 holds that payment of premiums by a private foundation for an insurance policy providing liability insurance for the foundation manager would not constitute an act of self-dealing as long as the premium is treated as compensation, and the foundation manager's compensation is not excessive.

PLR 9539016 concluded that the payment of premiums on the split-dollar insurance as compensation to the foundation manager is an accepted form of compensation and the information submitted did not suggest that the compensation was excessive. See also the 1995 EO CPE Text, page 269 and the 1999 EO CPE Text, page 317 for additional discussions of the personal services exception.

(4) <u>Prohibited Payments to an IRC 4946 Government Official Under IRC 4945(d)(1)(F)</u>

Consider the following case study:

<u>A</u>, created under the will of S, has been recognized as exempt under section 501(c)(3) of the Code and classified as a private foundation. <u>A</u>'s purpose is to make distributions to other charitable organizations including organizations promoting education. The foundation expects to distribute a significant amount of support on certain educational projects since this was an area of great concern to S.

<u>A</u> is governed by a board of trustees, all of whom receive significant compensation each year. The trustees have nominated Mr. **G** to the probate court having jurisdiction of S's estate as an additional trustee and educational expert for <u>A</u>. Mr. **G** is employed with a government agency as the head of one of its departments. Mr. **G** has received approval from the agency to serve as a trustee for the foundation. Mr. **G** is paid a salary equal to or in excess of the GS-15, step 7 level. (See 1995 EO CPE Text, page 254). <u>A</u> will pay Mr. **G** a salary through the probate court for his services. Because of the amount of his pay and his employment with a government agency, Mr. **G** is a disqualified person within the meaning of IRC 4946(c)(3)(B).

Under the facts, payments to Mr. **G** by the probate court on <u>A</u>'s behalf, as compensation for services provided as <u>A</u>'s trustee and education expert, would constitute payments to a disqualified person and an act of self-dealing under IRC 4941. Although the payments would be made on <u>A</u>'s behalf by the probate court rather than directly by <u>A</u>, this arrangement would not remove the transaction from the prohibition against self-dealing described in IRC 4941(d)(1)(F).

The proposed compensation payments to Mr. **G** on A's behalf by the probate court would also be distinguishable from certain earmarked grants to government officials by intermediary organizations as described in Reg. 53.4941(d)-1(b)(2) and example (3) of Reg. 53.4941(d)-1 (b)(8). Although the payments to Mr. **G** would be made by the court as an intermediary organization, the court had not exercised control over the selection of Mr. G independent of A.

Mr. **G**'s services as A's trustee and education expert, while also continuing to serve as a government official, could affect the independence of both A and the Government, since Mr. **G** would be in a position to influence both entities. As stated in House Report 91-413 of the Tax Reform Act of 1969, 1969-3 C.B. 315:

> These provisions are not to interfere with legitimate activities by private foundations in connection with Government officials, while at the same time they minimize the possibility of improper influence of the attitude or conduct of such policy-making level officials.

See also PLR 9804040 for a ruling holding that a foundation director serving as a compensated chairperson of a government commission for a period not to exceed 130 days within any 365 day period is not a IRC 4946(c) government official.

(5) The Sale of Financial Products - - IRC 4941 Acts Between Related Entities and Private Foundations

One of the more intriguing self-dealing issues is the extent a bank or financial institution, serving as a foundation manager to private foundations, may invest the assets of the private foundation in its own financial products or the financial products of a financial institution with which the foundation manager has a historic and continuing business relationship. This matter was discussed in the 1999 EO CPE Text, Topic P, pages 324 through 326. The Service concluded under the situation discussed in Topic P, that the actions of TI and the Parent would constitute acts of self-dealing under IRC 4941.

Headquarters has been reviewing other examples along the lines of the 1999 EO CPE scenario.

In one case, the foundation manager, **X**, is a national banking institution, which serves as trustee of a number of private foundations. Corporate entities related to the parent corporation of **X** have created two business trusts (**BTs**) under state law to invest in large commercial investments not otherwise available to the public at large. Under the placement agreement between the parties, **X** is obligated to use its reasonable efforts to procure subscriptions for the purchase of beneficial interests in the **BTs** by eligible investors in accordance with the provisions of the agreement. For such services, **X** is contractually entitled to receive a percentage fee of the amounts procured for subscriptions to the **BTs**. Thus, the ability of **X** to procure subscriptions not only will entitle it to a fee for its efforts, but also establishes its business credibility with the customer and clients, and enables it to live up to its contract terms with the **BTs**.

X has invested a significant portion of the assets of one private foundation for which it is a foundation manager in one of the **BTs**.

X-Sub, as a wholly-owned subsidiary of **X**, is a disqualified person under IRC 4946(a)(1)(E), since **X** is conceded to be a foundation manager within the meaning of section 4946(a)(1)(B). **X-Sub** also has a business relationship with the **BTs** and provides sub-advisory services to the **BTs** for a fee. Pursuant to the agreement with the parties, **X-Sub**, the sub-advisor, has full authority to manage the assets of the **BTs**, allocate and reallocate the **BTs**' assets among the investment funds and monitor the performance in each investment fund. It also provides administrative and accounting services to the **BTs**, including bookkeeping and distribution of quarterly reports, and the preparation of financial statements and tax information reports for investors. In return for these services, the **BTs** pay **X-Sub** a fee equal to a percentage of the **BTs**' net assets per annum.

It may be argued that the benefit to **X** of providing subscriptions to the **BTs** is magnified. Not only does **X** receive a fee directly for the subscriptions secured and not only do such subscriptions build its business credibility and goodwill with the customers (the trusts), but subscriptions also further the business interests of its subsidiary, **X-Sub**, the sub-advisor, a disqualified person, by providing it fees for its services.

The **BTs** are not merely investment vehicles to serve **X**'s charitable or trust department fiduciary clients with needed investment opportunities. Rather, they are a complete investment business endeavor serving existing general bank customers and non-bank customers alike. Admission as an investor to the **BTs** is open to all individual and institutional investors that meet the qualifications for investment under the terms of the private placement agreement. Thus, the **BTs** are conducting an investment business endeavor in which **X** and its subsidiary have a substantial economic interest by virtue of the contractual relationships with the **BTs**. Procuring subscriptions to the **BTs** furthers the establishment of these endeavors, lends credibility to them, and generates fees for the disqualified persons.

Accordingly, it could be argued that **X**'s actions constitute acts of self-dealing within the meaning of IRC 4941(d)(1)(E) as use by a disqualified person of the income or assets of **X**'s private foundation accounts for **X**'s own financial and/or business benefit. In both GCM 39107 and 39632, self dealing was held to exist merely on the basis that the use of the private foundation assets by the foundation manager to make a loan to a business customer (at the going interest rate) was self-dealing simply because the use of the assets enhanced the goodwill of the foundation manager with his customer. This is the same argument advanced in the 1999 EO CPE Text, Topic P, pages 324 to 326 as noted above.

Consider the facts of another scenario. **M** and **N** are national banking associations. Each is a wholly owned subsidiary of **O**. **M** offers a full range of banking, trust and investment services. **M** acts as trustee for a number of trusts and private foundations. In the past, **M** has contributed the assets of the private foundations to common trust funds which are maintained exclusively for the collective investment of monies of trusts and private foundations for which it acts in a fiduciary, agency, or custodial capacity.

M is the investment adviser to **P**, a family of open-end management investment companies. It has been represented that each distinct portfolio of assets of **P** (or mutual fund), qualifies as a regulated investment company under IRC 851. **M** also serves as sub-administrator to **P** and receives a fee for such services. **N** serves as custodian to **P** and receives a fee for such services. In the future, **M** will take the place of **N** as custodian. It is also possible that in the future **M** may serve as underwriter as well as principal administrator to **P** for which it will receive an appropriate fee. **M** receives a reasonable fee for serving as investment adviser to **P**. Apparently, **O** and **P** are unrelated entities to each other.

M has determined, in its capacity as fiduciary of the private foundations participating in the common trust funds, that such investments be converted to investments in **P**'s funds. There would be no charges for such conversion. The issue under consideration is whether the investments in **P** are acts of self-dealing under IRC 4941.

One view of this proposed conversion is that the investments in **P** are similar to general banking services. It is arguably a typical investment activity which is a permissible use of foundation assets entered into for the purpose of obtaining funds to be used to further the exempt purposes of the private foundations. Therefore, such services are excluded from the definition of self-dealing by reason of the provision of Reg. 53.4941(d)-2(c)(4)(iii) referring to example (3) of 53.4941(d)-3(c)(2). This type of investment may fall within the meaning of Reg. 53.4941(d)-2(c)(4), a self-dealing exception, which provides that a bank or trust company that provides "trust functions" to a foundation, with respect to which the bank or trust company is a disqualified person, if the services are reasonable and necessary to carry out the exempt functions of the private foundation.

The view outlined above with respect to the **M - P** scenario is supported by GCM 39547. In addition to the rationale expressed in the preceding paragraph which is derived from the text of GCM 39547, the GCM goes on to distinguish the holding in Rev. Rul. 77-259, 1977-2 C.B. 387. That ruling holds that the purchase by a private foundation of a mortgage note from a bank (a disqualified person with respect to the private foundation) which in the normal course of its business acquires and sells mortgages, does not fall within Reg. 53.4941(d)-2(c)(4) and constitutes an act of self-dealing. That regulation does not specifically exclude "trust functions" from permissible general banking services excepted from self-dealing transactions under IRC 4941.

In summary, then, there may be a fine line between the two scenarios described in the preceding material. Perhaps the case of **X** can be distinguished from the case involving **M** and **P** on the facts. There are some obvious factual differences that come to mind, including the fact that **P** is an unrelated party to **M** unlike the case with **X**. On the other hand, there may not be that great a difference in facts to rule favorably under IRC 4941. The Service will continue to study these scenarios before forging future positions.

(6) <u>IRC 4941, 4942, 4945, and 501(c)(3) - Employer Related Disaster Relief and Emergency Hardship Organizations</u>

The 1999 EO CPE Text, Topic K, beginning on page 232, discussed IRC 501(c)(3) exemption issues as well as private foundation issues raised by employer related disaster relief and emergency hardship organizations. The Topic concluded that such programs were not exempt under IRC 501(c)(3) in that the organizations served a private as well as public interests, and thus are in conflict with the private benefit prohibition. Further, the article concluded that tax exemption was also precluded because of the substantial private benefit to the employer/creator of the private foundation, which constitutes inurement in violation of IRC 501(c)(3) and IRC 170(c)(2)(B).

The 1999 Topic also addressed private foundation issues, because the employer-related disaster relief and emergency hardship organizations that the Service had considered were each supported primarily by one corporation and its related entities. The Topic explained that the employer-related disaster relief and emergency hardship private foundations engaged in acts of self-dealing under IRC 4941 if they made grants to employees of the sponsoring employer, and provided grants that were taxable expenditures under IRC 4945(d), and that were not qualifying distributions under IRC 4942(g).

The positions explained in the Topic were reconsiderations of earlier Service positions. After reconsidering the issue, various PLRs were issued in 1999 (PLRs 199914040; 199917077; 199917079) that revoked PLRs 9314058, 9544022, and 9516047. The AC(EP/EO) granted retroactive relief for up to six months from the dates of the letters for the organizations to wrap up any outstanding payments or obligations.

C. IRC 4942-Private Operating Foundations and Limited Liability Companies (LLCs)

PLR 9834033 ruled that the disbursements made by a LLC (hereafter, "D") to operate a family service support center may be treated by a private operating foundation (POF), within the meaning of IRC 4942(j)(3), as qualifying distributions within the meaning of IRC 4942(g)(1) and (2), for the active conduct of the POF's activities. The POF and a separate public charity had created D to operate the family service support center. The POF and the public charity each held a 50 percent interest in D, which under state law is treated as a corporation, but for federal tax purposes is treated as a partnership.

Reg. 53.4942(b)-1(b)(1) provides that, except as provided in subparagraph (2) or (3), qualifying distributions are not made by a foundation "directly for the active conduct of activities constituting it charitable, educational, or other similar exempt purpose" unless such qualifying distributions are used by the foundation itself, rather than by or through one or more grantee organizations which receive such qualifying distributions directly or indirectly from such foundation. Thus, grants made to other organizations to assist them in conducting activities which help to accomplish their charitable, educational, or other similar exempt purpose are considered indirect, rather than direct, means of carrying out activities constituting the charitable, educational, or other similar exempt purpose of the grantor foundation, regardless of the fact that the exempt activities of the grantee organizations may assist the grantor foundation in carrying out its own exempt activities.

The only published precedential material to shed any light on this issue is Rev. Rul. 78-315, 1978-2 C.B. 271. In that ruling, a private operating foundation under IRC 4942(j) operated a cultural center. The managing trustees of the organization formed a separate corporation to act only in a fiduciary capacity on behalf of the organization in conducting the operations of the cultural center. The corporation receives property from the organization only to the extent necessary to carry out its fiduciary duties and holds such property in a fiduciary capacity on behalf of the organization rather than as an absolute owner. It contracts for goods and services in a fiduciary capacity on behalf of the organization. Rev. Rul. 78-315 concludes that because the corporation acts only in a fiduciary capacity on behalf of the trust, it is not a grantee organization that receives qualifying distributions from the organization. Rather it is the trustee of the organization (a trust). Accordingly, the Ruling holds that the corporation, in its capacity as trustee, makes qualifying distributions directly for the active conduct of activities constituting the purpose of its function for which the organization is operated as required by IRC 4942(j)(3)(A).

Returning to PLR 9834033, the Service held that since the POF made a grant to D, in which it maintains a significant involvement in the active conduct of the program, the distributions will be considered as having been made directly for the active conduct of its exempt operating purposes, and the foundation will be considered a private operating foundation under Reg. 53.4942-1(b)(2).

As an alternative, the rationale of Rev. Rul. 78-315 might be applied to find that D was acting as a fiduciary for the POF in the operation of the POF's program. Thus, one could view D, the LLC, as in no different position that the corporation in Rev. Rul. 78-315. For a further discussion on LLCs, see Topic H, this Text.

D. IRC 4943-Impact on Private Foundation Holding S Corp Stock

The Small Business Job Protection Act of 1996, P.L. 104-188, permits IRC 501(c)(3) organizations and IRC 401(a) pension plans to hold stock in S corporations beginning January 1, 1998. See IRC 1361(c)(6). A charitable remainder trust described under IRC 664 and 4947(a)(2) is not a permitted shareholder of an S corporation.

IRC 512(e) provides that a shareholder of an S corporation will recognize tax on unrelated business taxable income on its ownership of S corporation stock regardless of whether the S corporation income is generated from active or passive interests. However, questions arise under IRC 4943 if the subject organization is a private foundation.

IRC 4943(a)(1) imposes a tax on the excess business holdings of a private foundation. Under IRC 4943(c), a private foundation is permitted to hold 20 percent of the stock of a corporation reduced by the percentage of voting stock owned by disqualified persons to such private foundation. Where the S corporation is engaged in the active conduct of a trade or business identified as a "business enterprise," there is little doubt that any private foundation owning more than 20 percent of such stock (alone or in combination with disqualified persons) will be subject to the tax imposed under IRC 4943. The gray area relates to private foundation holding in an S corporation whose income is generated from passive sources within the meaning of IRC 4943(d)(3)(B).

IRC 4943(d)(3)(B) defines "business enterprise" for purposes of IRC 4943 to exclude a trade or business at least 95 percent of the gross income of which is derived from passive sources. Gross income from passive sources includes items excluded by IRC 512(b)(1), (2), (3), (5), and certain other defined income. In the case of a "C" corporation, it is clear that a corporation having 95 percent or more of passive income as defined in IRC 4943(d)(3)(B) does not subject the private foundation owner of the C corporation stock to the IRC 4943 tax regardless of the amount of stock held. Does the same hold true with a private foundation holding stock in a S corporation which has 95 percent passive source income but which is subject to UBIT?

There are three examples specifically provided for in the regulations wherein private foundations engaged in activities that may be subject to UBIT are not subject to IRC 4943 taxes. Reg. 53.4943-10(c)(2) provides that income classified as passive [excluded by IRC

512(b)(1),(2), (3), and (5)] does not lose its passive character because it is debt financed within the meaning of IRC 514. In addition, for purposes of IRC 4943, income from passive sources includes income from the sale of goods if the seller private foundation does not manufacture, produce, physically receive or deliver, negotiate sales of, or maintain inventories in such goods. Also, under IRC 4943(d)(3)(A) and Reg. 53.4943-10(b), a "business enterprise" does not include a functionally related business as defined in IRC 4942(j)(4) and Reg. 53.4942(a)-2(c)(3)(iii). The latter provides that a functionally related business includes an activity that is carried on within a larger complex of endeavors which is related to the charitable purposes of the organization. Examples (1) and (2) of Reg. 53.4942(a)-2(c)(3)(iii)(b) provide, in turn, that a "functionally related business" includes hotel and restaurant activities within an historical museum community and the selling of advertising space in educational journals to commercial entities even though such private foundation activities may be subject to UBIT. In the case of passive source S corporation holdings of private foundations, which is subject to UBIT, there is no specific exception in the regulations. The Service is reviewing this matter.

E. IRC 4944- Prudent Man/Prudent Investor Rule; "Close Scrutiny" Investments

Nonprofit sector periodicals have devoted attention in recent years to new legal standards for fiduciaries who invest trust or endowment assets. See, for example, Investing in US Securities is a Violation of Your Fiduciary Duty and Let Go of Your Own Investment Assumptions by John A. Edie and Lowell S. Smith, Foundation News, November/December 1993 and January/February 1994.

The "Prudent Man Rule" standard has evolved. The Prudent Investor Rule of the American Law Institute's Restatement of the Law Third, Trusts, adopted in 1992, changed the standard of care to one applied to investments in the context of the trust portfolio and as a part of an overall investment "strategy" rather than to each investment. The Uniform Management of Institutional Funds Act (UMIFA), which has been adopted in various forms by a majority of the states, similarly emphasizes the concept of total return compared to inflation, and that no investment is per se imprudent.

An overriding concern of many commentators is that foundation fiduciaries must do more than merely invest in "safe" products to meet expenses (including IRC 4940 taxes and required IRC 4942 payouts) and fund grant programs. They must also consider inflation adjustments that will otherwise cut into "real values" and result in losses of purchasing power.

In light of these developments and critiques, commentators have questioned whether the "prudent trustee" approach of IRC 4944 should be allowed to lapse. IRC 4944 was enacted in 1969 with regulations first promulgated in 1972.

Reg. 53.4944-1(a)(2)(i) provides in part that:

> the foundation managers must exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment, in providing for the long- and short term financial needs of the foundation to carry out its exempt purposes. Foundation managers may take into account the expected return (including both income and appreciation of capital), the risks of rising and falling price levels, and the need for diversification within the investment portfolio. The determination whether the investment of a particular amount jeopardizes the carrying out the exempt purposes of a foundation shall be made on an investment by investment basis, in each case taking into account the foundation's portfolio as a whole. No category of investments shall be treated as a per se violation of section 4944.

The "prudent trustee" approach of the regulations could be viewed as neither entirely consistent with nor entirely inconsistent with the Prudent Investor Rule and the UMIFA. Further, a view of IRC 4944 must take into account statutory and policy considerations that may differ from those behind the Prudent Investor Rule evolving in the ALI Restatement and UMIFA. For example, IRC 4944(c) describes a "program related investment," which is made primarily for charitable purposes, rather than to produce income or create property appreciation. Reg. 53.4944-1(a)(2)(i) also provides that IRC 4944 and its Regulations shall not exempt or relieve any person from compliance with any federal or state law imposing any obligation, duty, responsibility, or other standard of conduct or with respect to the operation or administration or a trust to which section 4944 applies. Nor shall any State law exempt or relieve any person from any obligation, duty, responsibility, or other standard of conduct provided in section 4944 and the regulations thereunder. For foundation managers, this regulation may be difficult to follow considering that federal tax and state laws may not be entirely consistent.

In regard to Reg. 53.4944-1(a)(2)(i)'s promulgation that "no category of investments shall be treated as a per se violation of IRC 4944", the regulations do provide that certain types or methods will be closely scrutinized. These closely scrutinized investments include: trading in securities on margin; trading in commodity futures; investments in working interests in oil and gas wells; purchase of "puts", "calls", and "straddles;" the purchase of warrants; and selling short. In the new Internal Revenue Manual Private Foundation Handbook (IRM 7.8.3) chapter on IRC 4944, at 16.2.3(3), the following recent investment strategies are listed that also deserve close scrutiny:

> investment in "junk" bonds; risk arbitrage; hedge funds; derivatives; distressed real estate; and international equities in third world countries.

Service private letter rulings through the years have been both favorable and adverse on close scrutiny investments. Recent PLRs that have found investments were not jeopardizing investments under particular facts and circumstances include PLR 9723045 (small-cap equities; international capital; distressed securities; oil and gas; real estate; risk arbitrage; and timberland); PLR 9237035 (commodity futures); PLR 9451067 (hedge funds; market neutral funds; and oil and gas interests); and PLR 8718006 (gold mining stock).

In contrast, the Service held adversely in cases with the following facts and circumstances: PLR 8631004 (heavily leveraged investments); G.C.M. 39632 (loans with inadequate collateral); TAM 9627001 (collateralizing margin requirements - - see 1999 EO CPE Text, Topic P, page 338).

F. IRC 4945 - Private Foundation Taxable Expenditures: Expenditure Responsibility Over Foreign Grantee Regrants

PLR 9717024, January 23, 1997, discussed the expenditure responsibility required of a private foundation where the initial foreign grantee of the private foundation grant “regrants” the funds to an individual or another organization to carry out the former's charitable purposes. PLR 9717024 describes how the private foundation, **X**, makes grants to organizations (Initial Grantees) to further **X**'s charitable goals. In some cases, the initial grantee is neither a public charity nor an exempt operating foundation under IRC 4940(d)(2) or one that can meet the good faith determination rules under Reg. 53.4945-5(a)(5) and Rev. Proc. 92-94, 1994-2 C.B. 507. **X**, must, and does, exercise expenditure responsibility with respect to such grants to initial grantees.

PLR 9717024 illustrates that the initial foreign grantees may pursue the charitable goals of **X**'s grants by making grants ("re-grants") to other organizations or individuals ("secondary grantees"). **X**'s expenditure responsibility over re-grants to secondary grantees is satisfied as long as the regrants to secondary grantees have not been earmarked by **X** for any named secondary grantees. Reg. 53.4945-5(a)(6) establishes that a non-earmarked grant is, in effect, made by **X** to the initial grantee and not to the secondary grantee.

A follow up letter to **X**, dated March 20, 1998, held that **X**'s procedures in awarding grants complied with the requirements of IRC 4945(g)(1) and 4945(g)(3), and that regrants made according to these procedures would not result in "taxable expenditures" within the meaning of IRC 4945(d)(3). The point of this letter is that the approval of the grant-making procedures is a one-time approval of **X**'s system of standards and procedures for selecting recipients of grants that meet the requirements of IRC 4945(g)(1). Approval will apply to succeeding grant programs provided that the standards and procedures under which they are conducted do not differ materially from those described in **X**'s ruling request. Thus, under the circumstances, **X** does not have to ask for additional advance approvals on similar succeeding grant programs.

G. IRC 6104(d) - New Disclosure Rules for Exempt Organizations

New regulations (T.D. 8818, 1999-17 I.R.B. 3), effective June 8, 1999, now require exempt organizations other than private foundations to furnish requesters with copies of exempt applications and annual information returns. Congress added private foundations to the IRC 6104(d) disclosure law through the Tax and Trade Relief Extension Act of 1998 (P.L. 105-277, 112 stat. 2681, Title 1, section D, subsection 2).

However, this inclusion does not take effect until the 60th day after final regulations have been issued that apply to private foundations. Private foundations continue to be subject to the public disclosure requirements under IRC 6104(d) and (e), as in effect prior to the Tax and Trade Relief Extension Act of 1998. As of this writing, July 8, 1999, there have been no proposed regulations published on the private foundation inclusion under IRC 6104(d). The proposed regulations will be published in the near future. See also Topic O, this CPE Text, Final Regulations on Disclosure Requirements for Annual Information Returns and Applications for Exemption.

4. Headquarters Rulings and Key District Determinations in Public Charity Classification and Private Foundation Matters

In Rev. Proc. 99-8, 1998-1 I.R.B. 229, the Service has spelled out the offices of jurisdiction of various types of exempt organization issues that are presented in ruling or determination requests. Some of the associated user fees have been eliminated depending on the issue area of the request. We have extracted section 6.14 of Rev. Proc. 99-8 for the convenience of the reader.

SUMMARY OF EXEMPT ORGANIZATION FEES

This table summarizes the various types of exempt organization issues, indicates the office of jurisdiction for each type, and lists the applicable user fee. Reduced fees may be applicable in certain instances.

Issue	Location	Fee
Accounting period and method changes	Nat. Office	$130
Advance approval after recognition of exemption	Ohio KDO	none
Advance ruling period inquiries	Ohio KDO	none
Amendments, reorganizations, name changes	Ohio KDO	none
Application for recognition of exemption	Ohio KDO	$500
Confirmation of exemption	Ohio KDO	none
Qualified subsidiaries of section 501(c)(25)	Nat. Office	$500

Organizations Regulation 301.9100 relief in connection with applications for recognition of exemption	Ohio KDO	none
Section 507 terminations		
(a) Notice under section 507(b)(1) or (2)	Ohio KDO	none
(b) Advance ruling under 507(b)(1) or (2)	Nat. Office	$2100
Section 514(b)(3) Neighborhood Land Use Rule	Nat. Office	none
Section 4940(d) exempt operating foundation Status	Ohio KDO	none
Section 4942(g)(2) set-asides notification	Nat. Office	none
Section 4943(c)(7) extensions of disposal period	Nat. Office	$2100
Section 4945 advance approval of organization's grant making procedures with applications for recognition of exemption	Ohio KDO	none
Section 4945(f) advance approval voter registration activities	Ohio KDO	none
Section 6033 annual information return filing requirements		
(a) requested with original application	Ohio KDO	none
(b) requested after recognition of exemption	Nat. Office	$200
Unusual grants to certain organizations under sections 170(b)(1)(A)(vi) and 509(a)(2)	Ohio KDO	none

The Ohio KDO also issues determinations for no user fees on IRC 4945(f) advance approval requests of foundation grant making procedures that are separate from exemption applications. See section 7.04(5) of Rev. Proc. 99-4, 1999-1 I.R.B. 127.