



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

TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

Number: **201152021**  
Date: 12/30/2011

Date: October 5, 2011

Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

UIL:

501.03-03 Trusts  
509.01-01 Private Foundation  
4942.00-00 Taxes on Failure to Distribute Income  
4942.03-07 Set-Asides

Legend:

Additional Set-Aside Amount =  
Initial Set-Aside Amount =  
Set-Aside Amounts =  
State =  
Year 1 =  
Year 2 =  
Year 3 =  
Year 4 =  
Year 5 =  
Year 8 =  
Year 9 =

Dear \_\_\_\_\_ :

We have considered your ruling request dated December 7, 2010 requesting a ruling that the use of debt to fund all or part of certain set-aside amounts will not cause those amounts to fail to be treated as qualifying distributions under section 4942 of the Internal Revenue Code (the "Code").

## Facts

You are a tax-exempt organization described in section 501(c)(3) of the Code and classified as a private foundation under section 509(a) and as a private operating foundation under section 4942(j)(3). Your charitable mission is to serve orphan and destitute children in State. You own and use a multiple building facility to serve those children in furtherance of your exempt purposes. In Year 1 your trustees approved the demolition of that facility and construction of a new larger facility (the "Project") to remedy functional obsolescence and to accommodate significant population growth of the area you serve.

Your trustees also approved a section 4942(g)(2) of the Code set-aside to pay the costs of the Project. You made a timely application for set-aside in Year 1 which included written statements disclosing (i) an expected 30-month construction period but you noted that "the final timeline will be further refined as we proceed further in our planning and design work," but that "in any event, expenditures against the requested set-aside funds will be paid well within the sixty month period commencing on the date of the initial set-aside," (ii) your expectation that the Project would be funded from "existing operating cash and the proceeds of the sale of selected real estate holdings" and not from "any use of debt financing for the redevelopment work," and, (iii) your representation that in Year 1 you would make a book entry of a dollar amount equal to the Initial Set-Aside Amount as a pledge or obligation to be paid by a future date. The Internal Revenue Service (the "Service") issued a favorable private letter ruling dated March 19, Year 2 that the Initial Set-Aside Amount would be treated as qualifying distributions in Year 1, provided, in part, that such amount is paid for the Project not later than 60 months after it is set-aside, as required by section 53.4942(a)-3(b)(1) of the foundations and similar excise taxes regulations (the "regulations").

In Year 3 you determined that the cost of the Project would significantly exceed original estimates and your trustees approved an additional section 4942(g)(2) of the Code set-aside to pay for the excess costs. You made a timely application for set-aside in Year 3 which included written statements disclosing (i) some design and plan changes and your expectation for start of construction in Year 4, and, (ii) your representation that in Year 3 you would make a book entry of a dollar amount equal to the Additional Set-Aside Amount as a pledge or obligation to be paid by a future date. You also affirmed your obligation to pay for the Project amounts equal to the Initial Set-Aside Amount by December 31, Year 5 (the close of the associated 60-month set-aside distribution period). The Service issued a favorable private letter ruling dated November 10, Year 3 that the Additional Set-Aside Amount would be treated as qualifying distributions in Year 3; provided, in part, that such amount is paid for the Project not later than 60 months after it is set-aside, as required by section 53.4942(a)-3(b)(1) of the regulations.

You have now submitted a ruling request reporting two further changes to the Project. The first change is a delay of several months from the timeline presented in your application for approval of the Additional Set-Aside Amount. You now expect construction is to begin in April, Year 5, and to be completed within a year. You have affirmed again that you will pay (i) amounts equal to the Initial Set-Aside Amount by the end of Year 5, which is also the close of its associated 60-

month set-aside distribution period, and (ii) amounts equal to the Additional Set-Aside Amount by the end of Year 7, which is almost two years before the close of its associated 60-month set-aside distribution period.

The second change is that you now propose to pay all or a portion of the Set-Aside Amounts from the proceeds of loans from a local financial institution. Your trustees have reassessed their original strategy for payment of the Set-Aside Amounts. They had expected to make all such payments from current income and the proceeds of the sale of selected real estate. However, in light of the economic downturn the trustees have concluded that utilizing debt to fund all or a portion of Project costs is more prudent. You state that you have both the debt capacity and the ability to repay the debt on the Project.

#### Rulings Requested

Your use of debt to satisfy all or a portion of either the Initial Set-Aside Amount and/or the Additional Set-Aside Amount will not cause the Set-Aside Amounts to fail to be treated as qualifying distributions under section 4942(g)(2)(B)(i) of the Code and section 53.4942(a)-3(b)(2) of the regulations.

#### Law

Section 501(c)(3) of the Code exempts from federal income tax organizations organized and operated exclusively for charitable and other specified exempt purposes.

Section 509(a) of the Code classifies organizations exempt from federal income tax under section 501(c)(3) of the Code as private foundations unless described in section 509(a)(1)-(4).

Section 4942(a)(1) of the Code imposes an excise tax on any private foundation that does not expend qualifying distributions for exempt purposes at least equal to its distributable amount for its tax year, except that this tax does not apply to the undistributed income of a private foundation for any taxable year for which it is an operating foundation (as defined in section 4942(j)(3)).

Section 4942(g)(1) of the Code provides that, in general, a qualifying distribution is any amount, including reasonable and necessary administrative expenses, paid to accomplish, or to acquire an asset used directly in carrying on charitable purposes.

Section 4942(g)(2)(A) of the Code provides that an amount of income that is set aside for a specific project within one or more purposes of section 170(c)(2)(B) may be treated as a qualifying distribution if the amount meets the set-aside requirements of section 4942(g)(2)(B).

Section 4942(g)(2)(B) of the Code provides, in pertinent part, that an amount set aside for a specific project may be treated as a qualifying distribution if, at the time of the set-aside, the private foundation establishes to the satisfaction of the Secretary that the amount set aside will

be paid for the specific project within five years and that the suitability test for a set-aside under section 4942(g)(2)(B)(i) is met.

Section 4942(g)(2)(B)(i) of the Code provides a suitability test in which the private foundation at the time of the set-aside must establish to the satisfaction of the Secretary that the specific project is one that can better be accomplished by the set-aside of income rather than by the immediate payment of funds.

Section 53.4942(a)-3(a)(4)(i) of the regulations provides that if a private foundation borrows money in a particular taxable year to make expenditures for a specific charitable, educational, or other similar purpose, a qualifying distribution out of such borrowed funds will, except as otherwise provided in subdivision (ii) of this section, be deemed to have been made only at the time that such borrowed funds are actually distributed for such exempt purpose.

Section 53.4942(a)-3(b)(1) of the regulations provides that the amounts of income set aside for a specific project for charitable purposes may be treated as qualifying distributions for the tax year(s) in which such amounts are set aside, but not in the tax year in which actually paid, if 1) the requirements of section 4942(g)(2)(B)(i) of the Code are met, 2) the foundation establishes to the satisfaction of the Commissioner that the amount set aside will be paid for the specific project within 60 months after it is set aside, and 3) the set-aside otherwise meets the suitability test of section 53.4942(a)-3(b)(2) of the regulations.

Section 53.4942(a)-3(b)(2) of the regulations provides that the suitability test for a set-aside is met if the foundation establishes that the specific project is one which can be better accomplished by the use of a set-aside, including projects in which relatively long-term grants or expenditures must be made in order to assure the continuity of particular charitable projects. One example given in the regulations refers to a foundation's plan to erect a building to house its direct charitable activity.

Section 53.4942(a)-3(b)(7)(i) of the regulations provides that a private foundation must obtain the Commissioner's approval of its set-aside of income under the suitability test by applying before the end of the tax year in which the amount is set aside.

Section 53.4942(a)-3(b)(7)(i)(d) of the regulations requires taxpayer's application for set-aside include a detailed description of the project, including estimated costs, sources of any future funds expected to be used for completion of the project, and the location or locations (general or specific) of any physical facilities to be acquired or constructed as part of the project.

Section 53.4942(a)-3(b)(8) of the regulations provides that a set aside that is approved by the Commissioner shall be evidenced by the entry of a dollar amount on the books and records of a private foundation as a pledge or obligation to be paid at a future date or dates.

Rev. Rul. 78-148, 1978-1 C.B. 380, holds, in part, that so long as the requirements of section 4942(g)(2) are otherwise met, the amount set aside need not reflect an accumulation of income,

but may be a bookkeeping entry that will require funding out of corpus by the end of the set-aside period.

### Analysis

You are recognized as an organization described in section 501(c)(3) of the Code, and classified as a private foundation within the meaning of section 509. Thus, you would be subject to the tax imposed under section 4942(a)(1) on undistributed income for any taxable year for which you are not an operating foundation (as defined in section 4942(j)(3)).

Under section 4942(g)(2)(A) of the Code and section 53.4942(a)-3(b)(1) of the regulations, an amount set aside for a specific project with comes within one or more purposes described in section 170(c)(1) or (2)(B) may be treated as a qualifying distribution if, at the time of the set-aside, the foundation establishes to the satisfaction of the Secretary that the set-aside meets the requirements of the suitability test under section 4942(g)(2)(B)(i) of the Code and section 53.4942(a)-3(b)(2) of the regulations. Under section 53.4942(a)-3(b)(7)(i) of the regulations, the foundation must apply to the Commissioner for approval of a set-aside before the end of the taxable year in which the amount is set aside.

In Year 1 you obtained the Commissioner's approval of the Initial Set-Aside Amount on the condition that you would evidence the set-aside by booking the Set-Aside Amount on your Year 1 financial statements as an obligation to be paid at a future date. The approval was issued on the understanding that the Project would be funded from existing operating cash and the sale of selected real estate holdings. In Year 3 you obtained the Commissioner's approval of the Additional Set-Aside Amount on the condition that you would evidence the set-aside by booking the Set-Aside Amount on your Year 3 financial statements as an obligation to be paid at a future date. Both rulings were issued on the understanding that there would be no material changes in the facts upon which they were based. Now you are asking whether the use of debt to satisfy all or a portion of the Set-Aside Amounts would cause those amounts to fail to be treated as qualifying distributions under section 4942(g)(2)(B) of the Code.

A set-aside need not be segregated into a separate account, nor need it reflect an accumulation of income, but needs only to be evidenced by the entry of a dollar amount on the books and records of the private foundation as a pledge or obligation that will require funding by the end of the set-aside period. See section 53.4942(a)-3(b)(8) of the regulations and Rev. Rul. 78-148, 1978-1 C.B. 380. Neither the statute nor the regulations specify or limit the source of the funds expected to be used for completion of a project, other than that it must be disclosed at the time the private foundation submits its written request for a set-aside. See section 53.4942(a)-3(b)(7)(i)(d) of the regulations. Furthermore, section 53.4942(a)-3(a)(4) of the regulations implicitly recognizes that expenditures for qualifying distributions may be made out of borrowed funds. Consequently, since the use of borrowed funds was a permissible source of funds at the times you applied to the Commissioner for approval of the Set-Aside Amounts, we do not consider the substitution of debt in place of operating cash and proceeds from the sale of real estate holdings as the source of funds for the expenditures contemplated by the set-asides to

be a material change in the facts upon which the Year 1 and Year 3 rulings were based. Thus, so long as the Set-Aside Amounts are distributed by the end of their respective set-aside periods, the use of debt to pay the expenditures contemplated by the set-asides will not cause the Set-Aside Amounts to fail to be treated as qualifying distributions under section 4942(g)(2)(B)(i) of the Code and section 53.4942(a)-3(b)(2) of the regulations.

#### Ruling

Accordingly, based on the information submitted we rule as follows:

Your use of debt to satisfy payment of all or a portion of the Set-Aside Amounts will not cause those Set-Aside Amounts to fail to be treated as qualifying distributions under section 4942(g)(2)(B)(i) of the Code and section 53.4942(a)-3(b)(2) of the regulations.

This ruling will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, *Notice of Intention to Disclose*. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

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

This ruling is based on the facts as they were presented and on the understanding that there will be no material changes in these facts. This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described. For example, we are not ruling whether the debt at issue will give rise to unrelated debt financed income. Because it could help resolve questions concerning your federal income tax status, this ruling should be kept 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.

In accordance with the Power of Attorney currently on file with the Internal Revenue Service, we are sending a copy of this letter to your authorized representative.

Sincerely,

Theodore R. Lieber  
Manager, Exempt Organizations  
Technical Group 3

Enclosure  
Notice 437

cc: