



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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

Legend:

Date =
Grantor =
Operating Foundation =

Dear :

This is in response to your ruling request regarding whether grants you will make are properly characterized as qualified distributions under § 4942 of the Internal Revenue Code (I.R.C.).

Facts:

You are a nonprofit corporation recognized as an organization described in § 501(c)(3) and classified as a private non-operating foundation under § 509(a) not described in § 4942(j)(3). Grantor created you. You are organized and operated for charitable, religious, scientific, literary, or educational purposes. Your mission is to receive and maintain a fund or funds of real and/or personal property and to use the principal and/or income from such fund(s) exclusively for charitable, religious, scientific, literary, or educational purposes either directly or by contributions to organizations exempt under § 501(c)(3).

Your Board of Trustees consists of one Class A Trustee and three Class B Trustees. The Class A Trustee is entitled to eight votes, and each Class B Trustee is entitled to one vote. Grantor currently serves as the Class A Trustee and as a Class B Trustee. Grantor's son and nephew each currently serve as Class B Trustees. Grantor, Grantor's son, and Grantor's nephew are each a disqualified person as defined in § 4946 with respect to you and to Operating Foundation. You are not a membership corporation but your trustees maintain control and oversight similar to that of members of a nonprofit corporation, including the power to nominate and elect directors, amend the Bylaws and Certificate of Incorporation, and approve fundamental changes such as merger, dissolution, or transfer of substantial assets.

You also have a Board of Directors, which manages the general business and affairs of the corporation. Each director is entitled to one vote. Grantor, son, and nephew all serve on the Board of Directors, along with four additional unrelated directors. Grantor serves as the Chair of the

Board, and with son and nephew also serve as your officers.

Operating Foundation is a nonprofit corporation described in § 501(c)(3) and classified as a private operating foundation under § 509(a) described in § 4942(j)(3). Its purposes are charitable and educational, and its mission is to promote the appreciation of, and education about, Grantor's art medium specifically and public art generally, primarily through the creation, maintenance, and public placement of artwork created by Grantor. Operating Foundation will own many Grantor created artwork pieces, all preliminary pieces, all future pieces, and copyrights to all Grantor created artworks (together, the "Collection") Operating Foundation's governance and management structure and composition is nearly identical to yours except that your Board of Directors has four more directors than it and those four directors are unrelated whereas all of its directors are related

You will also make start-up and on-going grants to Operating Foundation. These grants are not restricted. They do not require Operating Foundation to expend them for specific purposes. They are general operating grants and may be used by Operating Foundation to acquire or maintain assets which are used directly in the conduct of its exempt activities and for reasonable administrative expenses and other operating costs, to pay its employees, and to service its debt, if any. You will ensure that Operating Foundation pays out such grant funds for the active conduct of activities constituting its purpose or function (as described in § 4942(j)(3)) not later than the close of the first taxable year after the taxable year in which such grant funds are received by requiring Operating Foundation to complete and submit expenditure responsibility reports annually.

Operating Foundation has represented that it will: (i) use your grant funds for qualifying distributions directly for the active conduct of activities constituting its purpose or function (as described in § 4942(j)(3)), including amounts paid to acquire or maintain assets which are used directly in the conduct of its exempt activities and for reasonable administrative expenses and other operating costs; (ii) make such qualifying distributions not later than the close of the first taxable year after the taxable year in which such grant funds are received, and (iii) treat such expenditures as distributions out of corpus.

Rulings Requested:

You have requested the following ruling:

You may count grants made to Operating Foundation as qualifying distributions as permitted in § 4942(g)(3) if: (i) Operating Foundation uses such grant funds for qualifying distributions directly for the active conduct of activities constituting its purpose or function (as described in § 4942(j)(3)), including amounts paid to acquire or maintain assets which are used directly in the conduct of its exempt activities and for reasonable administrative expenses and other operating costs; (ii) Operating Foundation makes such qualifying distributions not later than the close of the first taxable year after the taxable year in which such grant funds are received, and (iii) the expenditures by Operating Foundation are treated by it as distributions out of corpus.

Law:

I.R.C. § 501(c)(3) provides an exemption from federal tax for organizations that are organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

I.R.C. § 4942(a) imposes on the undistributed income of a private foundation for any taxable year, which has not been distributed before the first day of the second (or any succeeding) taxable year following such taxable year (if such first day falls within the taxable period), a tax equal to 30 percent of the amount of such income remaining undistributed at the beginning of such second (or succeeding) taxable year.

I.R.C. § 4942(g)(3) states that, for purposes of this section, the term "qualifying distribution" includes a contribution to a private operating foundation (and certain other organizations) if not later than the close of the first taxable year after its taxable year in which such contribution is received, such organization makes a distribution (within the meaning of paragraph (1) or (2), without regard to this paragraph) which is treated under subsection (h) as a distribution out of corpus (or would be so treated if such § 501(c)(3) organization were a private foundation which is not an operating foundation), and (B) the private foundation making the contribution obtains adequate records or other sufficient evidence from such organization showing that the qualifying distribution described in subparagraph (A) has been made by such organization.

I.R.C. § 4942(j)(3) defines operating foundation for purposes of § 4942 to mean one (A) which makes qualifying distributions (within the meaning of paragraph (1) or (2) of subsection (g)) directly for the active conduct of the activities constituting the purpose or function for which it is organized and operated equal to substantially all of the lesser of (i) its adjusted net income (as defined in subsection (f)), or (ii) its minimum investment return; and (B) (i) substantially more than half of the assets of which are devoted directly to such activities or to functionally related businesses (as defined in paragraph (4)), or to both, or are stock of a corporation which is controlled by the foundation and substantially all of the assets of which are so devoted, (ii) which normally makes qualifying distributions (within the meaning of paragraph (1) or (2) of subsection (g)) directly for the active conduct of the activities constituting the purpose or function for which it is organized and operated in an amount not less than two-thirds of its minimum investment return (as defined in subsection (e)), or (iii) substantially all of the support (other than gross investment income as defined in § 509(e)) of which is normally received from the general public and from 5 or more exempt organizations which are not described in § 4946(a)(1)(H) with respect to each other or the recipient foundation; not more than 25 percent of the support (other than gross investment income) of which is normally received from any one such exempt organization; and not more than half of the support of which is normally received from gross investment income.

Notwithstanding the provisions of § 4942(j)(3)(A), if the qualifying distributions (within the meaning of paragraph (1) or (2) of subsection (g)) of an organization for the taxable year exceed the minimum investment return for the taxable year, clause (ii) of subparagraph (A) shall not apply unless substantially all of such qualifying distributions are made directly for the active conduct of the activities constituting the purpose or function for which it is organized and operated.

Under Treas. Reg. § 53.4942(a)-3(a)(2) for purposes of subparagraph (2)(i)(b) of this paragraph, an organization is "controlled" by a foundation or one or more disqualified persons with respect to the foundation if any of such persons may, by aggregating their votes or positions of authority, require the donee organization to make an expenditure, or prevent the donee organization from making an expenditure, regardless of the method by which the control is exercised or exercisable.

Analysis:

Section 4942 imposes an excise tax on the undistributed income of each private foundation for each taxable year. The tax shall not apply to the undistributed income of a private foundation for any taxable year for which it is an operating foundation (as defined in subsection (j)(3)). Undistributed income is the amount that distributable income exceeds qualifying distributions. Qualifying distributions generally exclude distributions to private nonoperating foundations and controlled organizations. Operating Foundation is a controlled organization with respect to you because (i) Grantor, Grantor's son, and Grantor's nephew are each a disqualified person within the meaning of § 4946 with respect to you and Operating Foundation, and (ii) Grantor as Class A Trustee of both organizations has a majority vote of all trustees. See Treas. Reg. § 53.4942(a)-3(a)(2).

Section 4942(g) provides that excluded distributions can be qualified distributions if the recipient controlled organization (within a certain time period) makes a distribution equal to the amount of such contribution and such distribution is a qualifying distribution (within the meaning of paragraph (1) or (2), without regard to this paragraph) which is treated under subsection (h) as a distribution out of corpus (or would be so treated if such organization were a private foundation which is not an operating foundation), and the distributing private foundation obtains adequate records or other sufficient evidence from such organization showing that the qualifying distribution described in subparagraph (A) has been made by such organization.

You are making grants to Operating Foundation to acquire and maintain assets which are used directly in the conduct of its exempt activities and for reasonable administrative expenses and other operating costs, to pay its employees, and to service its debt, if any. Operating Foundation has represented that it will (i) use your grant funds for qualifying distributions directly for the active conduct of activities constituting its purpose or function (as described in § 4942(j)(3)), including amounts paid to acquire or maintain assets which are used directly in the conduct of its exempt activities and for reasonable administrative expenses and other operating costs; (ii) makes such qualifying distributions not later than the close of the first taxable year after the taxable year in which such grant funds are received, and (iii) treat such expenditures as distributions out of corpus.

Conclusion:

Based on the foregoing, we rule as follows:

You may count grants made to Operating Foundation as qualifying distributions as permitted in § 4942(g)(3) if: (i) Operating Foundation uses such grant funds for qualifying distributions directly for the active conduct of activities constituting its purpose or function (as described in § 4942(j)(3)), including amounts paid to acquire or maintain assets which

are used directly in the conduct of its exempt activities and for reasonable administrative expenses and other operating costs; (ii) Operating Foundation makes such qualifying distributions not later than the close of the first taxable year after the taxable year in which such grant funds are received, and (iii) the expenditures by Operating Foundation are treated by it as distributions out of corpus.

This ruling will be made available for public inspection under § 6110 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) 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. 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,

Michael Seto
Manager, Exempt Organizations
Technical

Enclosure
Notice 437