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

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Date: MAR 0 5 2002

Contact Person:

Identification Number:

Telephone Number:

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U.I.L. Nos.
501.03-02
4941.04-00
4943.04-03
4944.03-00
4945.04-05
4945.04-06

LEGEND:

X =

Dear Sir or Madam:

We have considered X's ruling request as supplemented concerning the proper treatment of a grant-making program under chapter 42 of the Internal Revenue Code.

FACTS:

X is a private operating foundation described in sections 501(c)(3), 509(a), and 4942(j)(3) of the Code. X proposes a grant-making program to encourage the granting of perpetual conservation easements (described in section 1.170A-14(b)(2) of the Income Tax Regulations) on lands for the protection of wildlife habitat in lands subject to rapid development.

X will make interest-free or below-market loans ("Grants") to for-profit developers ("Developers") to enable them to purchase environmentally sensitive undeveloped land in areas subject to development pressure within the United States. In each case, the Developer will use the Grant and its own capital to purchase the land, grant the easement to a qualified organization under section 170(h)(3), and develop and sell the remainder of the land. The Developer would not create the easement without the Grant from X. The Grant will be made at the time of purchase. Repayment of the Grant will be secured by the real estate. The Grant amount will approximate the value of the easement. The Developer has 3 1/3 years to repay the Grant to X. X will conduct pre-grant inquiries and structure the Grant agreements to satisfy sections 53.4945-5(b)(2) and (4) of the Foundations and Similar Excise Taxes Regulations, and will require reports from the grantees to satisfy section 53.4945-5(c). X will foreclose if the Developer defaults on the Grant repayment or mortgage, and will charge 18% interest from the date of the Grant if the easement is not created and granted to a qualified organization.

The easement will either include a Conservation Reserve Enhancement Program (CREP) easement or contain similar requirements to CREP easements to improve the environmental quality of the land (e.g., planting forest or vegetative buffers, or restoring wetlands). Under the

CREP program, landowners receive government grants for setting aside land and incurring expenses for environmental benefits.

X will approve the selection of the easement land to ensure that it is environmentally significant, with the qualities set forth in section 1.170A-14(d)(1)(ii) and (3). X will initially focus on environmentally significant land in rural areas, particularly farmland with drained wetlands, forested lands, and lands near riverbanks. The Grant Agreement will prohibit the Developer's purchase of land from a disqualified person with respect to X.

No Developer will be a disqualified person within the meaning of section 4946. X represents that disqualified persons, as defined in section 4946 of the Code, will hold cumulatively not more than a 2% stock or partnership interest (or comparable financial interest such as having a consultant fee or other compensatory financial arrangement) in a grantee Developer. X clarifies its earlier representations that the grant-making program will be well publicized with the general public and any Developer is eligible to receive grants if it demonstrates a commitment to environmental concerns and has the experience and expertise necessary to accomplish the environmental purpose. X anticipates that there will be a number of eligible grantee Developers besides those Developers with a de minimis financial association with disqualified persons.

RULINGS REQUESTED:

X requests the following rulings:

1. Neither the making of the Grant to the Developer, nor the purchase of the Land, nor the reimbursement of the Grant, whether in the normal course or otherwise, nor any other transaction described in this ruling request, shall constitute a prohibited act of self-dealing under section 4941 of the Code.

2. The Grant to the Developer will constitute a program-related investment under section 4944(c) of the Code, and, therefore, the Grant will not be considered as an investment that jeopardizes the carrying out of X's exempt purpose.

3. The Grant to the Developer will not be treated as an interest in the Developer that constitutes an excess business holding for purposes of section 4943 of the Code.

4. Neither the Grant to the Developer nor the purchase of the Land by the Developer will constitute a taxable expenditure for purposes of section 4945 of the Code, provided X exercises expenditure responsibility with respect to the Grant as contemplated by section 4945(h) of the Code.

5. The Grant Agreement will satisfy the expenditure responsibility rules under sections 53.4945-5(b)(4) and 53.4945-5(c)(1) of the Regulations, and X will not be required to exercise expenditure responsibility with respect to the grant of the conservation easement to the Qualified Organization, including obtaining the reports required by section 4945(h)(2) of the Code from the Qualified Organization.

6. X's involvement in the selection of the Land to be purchased by the Developer will not cause the purchase of the Land with the Grant proceeds to constitute an earmarked (secondary) grant within the meaning of section 53.4945-5(a)(6) of the regulations.

7. The Grant to the Developer will not jeopardize or cause X to lose its tax-exempt status under section 501(c)(3) of the Code.

LAW:

Section 170(f)(3)(B)(iii) of the Code excepts a qualified conservation contribution from the general rule denying a charitable deduction for a contribution of a partial interest in property.

Section 170(h)(1) of the Code defines a "qualified conservation contribution" as a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes.

Section 170(h)(2)(C) of the Code defines a "qualified real property interest" as including a restriction (granted in perpetuity) on the use that may be made of the real property.

Section 170(h)(3) of the Code defines a "qualified organization" as described in section 170(b)(1)(A)(v) or (vi) or 509(a)(2), or as a 509(a)(3) organization "controlled by" certain publicly supported organizations.

Section 170(h)(4)(A) of the Code defines a "conservation purpose" as:

(i) the preservation of land areas for outdoor recreation by, or the education of, the general public,

(ii) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem,

(iii) the preservation of open space (including farmland and forest land) where such preservation is--

(I) for the scenic enjoyment of the general public, or

(II) pursuant to a clearly delineated Federal, State, or local governmental conservation policy,

and will yield a significant public benefit, or

(iv) the preservation of an historically important land area or a certified historic structure.

Section 170(h)(5)(A) of the Code provides that a contribution shall not be treated as exclusively for conservation purposes unless the conservation purpose is protected in perpetuity.

Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations organized and operated exclusively for charitable purposes.

Section 4941(a) of the Code imposes an excise tax on disqualified persons for each act of self-dealing between a disqualified person and a private foundation.

Section 4941(d)(1) of the Code defines self-dealing as including any direct or indirect--

(A) sale or exchange, or leasing, of property between a private foundation and a disqualified person;

(B) lending of money or other extension of credit between a private foundation and a disqualified person;

(C) furnishing of goods, services, or facilities between a private foundation and a disqualified person;

(D) payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person;

(E) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation.

(F) agreement by a private foundation to make any payment of money or other property to a government official, other than an agreement to employ such individual for any period after the termination of his government service if such individual is terminating within a 90-day period.

Section 4943(a)(1) of the Code imposes an excise tax on a private foundation's excess business holdings in a business enterprise during any tax year.

Section 4944(a)(1) of the Code imposes an excise tax on a private foundation's making of an investment in such a manner as to jeopardize the carrying out of any of its exempt purposes.

Section 4944(c) of the Code provides that investments, the primary purpose of which is to accomplish one or more of the purposes described in section 170(c)(2)(B), and no significant purpose of which is the production of income or the appreciation of property, shall not be considered as investments which jeopardize the carrying out of exempt purposes.

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

Section 4945(d) of the Code defines a "taxable expenditure" as including an amount paid or incurred by a private foundation:

(1) to carry on propaganda, or otherwise to attempt, to influence legislation, within the meaning of section 4945(e),

(2) except as provided in section 4945(f), to influence the outcome of any specific public election, or to carry on, directly or indirectly, any voter registration drive,

(3) as a grant to an individual for travel, study, or other similar purposes by such individual, unless such grant satisfies the requirements of section 4945(g),

(4) as a grant to an organization unless--

(A) such organization is described in paragraph (1), (2), or (3) of section 509(a) or is an exempt operating foundation (as defined in section 4940(d)(2)), or

(B) the private foundation exercises expenditure responsibility with respect to such grant in accordance with section 4945(h), or

(5) for any purpose other than one specified in section 170(c)(2)(B).

Section 4945(h) of the Code provides that the expenditure responsibility referred to in section 4945(d)(4) means that the private foundation is responsible to exert all reasonable efforts and to establish adequate procedures--

(1) to see that the grant is spent solely for the purpose for which made,
(2) to obtain full and complete reports from the grantee on how the funds are spent, and
(3) to make full and detailed reports with respect to such expenditures to the Secretary.

Section 53.4941(d)-1(b)(4) of the Foundations and Certain Excise Taxes Regulations provides that a transaction between a private foundation and an organization which is not controlled by the foundation (within the meaning of section 53.4941(d)-1(b)(5)), and which is not described in section 4946(a)(1)(E), (F), or (G) because persons described in section 4946(a)(1)(A), (B), (C), or (D) own no more than 35 percent of the total combined voting power or profits or beneficial interest of such organization, shall not be treated as an indirect act of self-dealing between the foundation and such disqualified persons solely because of the ownership interest of such persons in such organization.

Section 53.4941(d)-2(f)(2) of the regulations provides that the fact that a disqualified person receives an incidental or tenuous benefit from the use by a foundation of its income or assets will not, by itself, make such use an act of self-dealing. For example, a grant by a private foundation to a section 509(a)(1), (2), or (3) organization will not be an act of self-dealing merely because one of the section 509(a)(1), (2), or (3) organization's officers, directors, or trustees is also a manager of the foundation.

In Example (1) of section 53.4941(d)-2(f)(9) of the regulations, M, a private foundation, makes a grant of $50,000 to the governing body of N City for the purpose of alleviating the slum conditions which exist in a particular neighborhood of N. Corporation P, a substantial contributor to M, is located in the same area in which the grant is to be used. Although the general improvement of the area may constitute an incidental and tenuous benefit to P, such benefit by itself will not constitute an act of self-dealing.

Section 53.4942-10(a)(2) of the regulations provides that a bond or other evidence of indebtedness does not constitute a holding in a business enterprise unless determined to be an equitable interest in such enterprise.

Section 53.4943-10(b) of the regulations provides that business holdings do not include program-related investments as defined in section 4944(c) and the regulations thereunder.

Section 53.4944-3(a)(2)(i) of the regulations provides that an investment shall be considered as made primarily to accomplish one or more of the purposes described in section 170(c)(2)(B) if it significantly furthers the accomplishment of the private foundation's exempt activities and if the investment would not have been made but for such relationship between the investment and the accomplishment of the foundation's exempt activities. For purposes of section 4944 and sections 53.4944-1 through 53.4944-6, the term "purposes described in section 170(c)(2)(B)" shall be treated as including purposes described in section 170(c)(2)(B) whether or not carried out by organizations described in section 170(c).

Section 53.4944-3(a)(2)(iii) of the regulations provides that in determining whether a significant purpose of an investment is the production of income or the appreciation of property, it shall be relevant whether investors solely engaged in the investment for profit would be likely to make the investment on the same terms as the private foundation. However, the fact that an investment produces significant income or capital appreciation shall not, in the absence of other factors, be conclusive evidence of a significant purpose involving the production of income or the appreciation of property.

In Example (5) of section 53.4944-3(b) of the regulations, X is a business enterprise which is financially secure and the stock of which is listed and traded on a national exchange. Y, a private foundation, makes a loan to X at an interest rate below the market rate in order to induce X to establish a new plant in a deteriorated urban area which, because of the high risks involved, X would be unwilling to establish absent such inducement. The loan is made pursuant to a program run by Y to enhance the economic development of the area by, for example, providing employment opportunities for low-income persons at the new plant, and no significant purpose involves the production of income or the appreciation of property. The loan significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, even though X is large and established, the investment is program-related.

In Example (9) of section 53.4944-3(b) of the regulations, X is a socially and economically disadvantaged individual. Y, a private foundation, makes an interest-free loan to X for the primary purpose of enabling X to attend college. The loan has no significant purpose involving the production of income or the appreciation of property. The loan significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, the loan is a program-related investment.

Section 53.4945-4(a)(2) of the regulations provides that for purposes of section 4945, the term "grants" shall include, but is not limited to, such expenditures as scholarships, fellowships,

internships, prizes, and awards. Grants shall also include loans for purposes described in section 170(c)(2)(B) and "program related investments" (such as investments in small businesses in central cities or in businesses which assist in neighborhood renovation). Similarly, "grants" include such expenditures as payments to exempt organizations to be used in furtherance of such recipient organizations' exempt purposes whether or not such payments are solicited by such recipient organizations. Conversely, "grants" do not ordinarily include salaries or other compensation to employees. For example, "grants" do not ordinarily include educational payments to employees which are includible in the employees' incomes pursuant to section 61. In addition, "grants" do not ordinarily include payments (including salaries, consultants' fees and reimbursement for travel expenses such as transportation, board, and lodging) to persons (regardless of whether such persons are individuals) for personal services in assisting a foundation in planning, evaluating or developing projects or areas of program activity by consulting, advising, or participating in conferences organized by the foundation.

Section 53.4945-5(a)(6)(i) of the regulations provides that a grant by a private foundation to a grantee organization which the grantee organization uses to make payments to another organization (the secondary grantee) shall not be regarded as a grant by the private foundation to the secondary grantee if the foundation does not earmark the use of the grant for any named secondary grantee and there does not exist an agreement, oral or written, whereby such grantor foundation may cause the selection of the secondary grantee by the organization to which it has given the grant. For purposes of this subdivision, a grant described herein shall not be regarded as a grant by the foundation to the secondary grantee even though such foundation has reason to believe that certain organizations would derive benefits from such grant so long as the original grantee organization exercises control, in fact, over the selection process and actually makes the selection completely independently of the private foundation.

Section 53.4945-5(b)(4) of the regulations provides that in order to meet the expenditure responsibility requirements of section 4945(h), with regard to the making of a program-related investment (as defined in section 4944 and the regulations thereunder), a private foundation must require that each such investment with respect to which expenditure responsibility must be exercised under section 4945(d)(4) and (h) and this section be made subject to a written commitment signed by an appropriate officer, director, or trustee of the recipient organization. Such commitment must specify the purpose of the investment and must include an agreement by the organization--

> (i) To use all the funds received from the private foundation (as determined under section 53.4945-5(c)(3)) only for the purposes of the investment and to repay any portion not used for such purposes, provided that, with respect to equity investments, such repayment shall be made only to the extent permitted by applicable law concerning distributions to holders of equity interests,
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> (ii) At least once a year during the existence of the program-related investment, to submit full and complete financial reports of the type ordinarily required by commercial investors under similar circumstances and a statement that it has complied with the terms of the investment,

(iii) To maintain books and records adequate to provide information ordinarily required by commercial investors under similar circumstances and to make such books and records available to the private foundation at reasonable times, and

(iv) Not to use any of the funds--

(a) To carry on propaganda, or otherwise to attempt, to influence legislation (within the meaning of section 4945(d)(1)),

(b) To influence the outcome of any specific public election, or to carry on directly or indirectly, and voter registration drive (within the meaning of section 4945(d)(2)), or

(c) With respect to any recipient which is a private foundation (as defined in section 509(a)), to make any grant which does not comply with the requirements of section 4945(d)(3) or (4).

Section 53.4945-5(c)(1) of the regulations provides generally that in the case of grants described in section 4945(d)(4), the granting private foundation shall require reports on the use of the funds, compliance with the terms of the grant, and the progress made by the grantee toward achieving the purposes for which the grant was made. The grantee shall make such reports as of the end of its annual accounting period within which the grant or any portion thereof is received and all such subsequent periods until the grant funds are expended in full or the grant is otherwise terminated. Such reports shall be furnished to the grantor within a reasonable period of time after the close of the annual accounting period of the grantee for which such reports are made. Within a reasonable period of time after the close of its annual accounting period during which the use of the grant funds is completed, the grantee must make a final report with respect to all expenditures made from such funds (including salaries, travel, and supplies), and indicating the progress made toward the goals of the grant. The grantor need not conduct any independent verification of such reports unless it has reason to doubt their accuracy or reliability.

Section 53.4945-6(c)(1)(i) of the regulations provides that since a private foundation cannot make an expenditure for a purpose other than a purpose described in section 170(c)(2)(B), a private foundation may not make a grant to an organization other than an organization described in section 501(c)(3) unless the making of the grant itself constitutes a direct charitable act or the making of a program-related investment.

Rev. Rul. 75-42, 1975-1 C.B. 359, held that a grant authorized by an exempt private foundation to an exempt hospital for modernization, replacement, and expansion did not constitute an act of self-dealing under section 4941 of the Code even though two individuals served as trustees of both organizations. The ruling found that any benefit to the disqualified persons was incidental.

Rev. Rul. 76-204, 1976-1 C.B. 152, held exempt under section 501(c)(3) of the Code an organization formed to preserve the natural environment by acquiring, by gift or purchase, ecologically significant undeveloped land (e.g., swamps, marshes, forests, wilderness tracts, and other natural areas), and either maintaining the land itself with limited public access or transferring

the land to a government conservation agency by outright gift or being reimbursed by the agency for its cost. The Service reasoned that it is generally recognized that efforts to preserve and protect the natural environment for the benefit of the public serve a charitable purpose, and noted that the promotion of conservation and protection of natural resources for future generations has been recognized by Congress as serving a broad public benefit.

RATIONALE:

Each of the requested rulings is discussed in turn below.

1. The Developers, and the sellers of the undeveloped land to the Developer, will not be disqualified persons with respect to X. Therefore there can be no direct self-dealing. In respect to indirect self-dealing, under the facts and circumstances presented, any potential benefit to disqualified persons would be incidental or tenuous under section 53.4941-2(f)(2) of the regulations. See also Rev. Rul. 75-42, supra.

2. Since X will expect a return from the Developer of the Grant principal, and in some cases interest, the Grant constitutes an investment. See Example (9) of section 53.4944-3(b) of the regulations. The primary purpose of the grant is to accomplish a charitable purpose, as discussed below in #7. Under the facts presented, there is no significant purpose to produce income or gain from the appreciation of property, as private investors would not likely make investments on X's terms. Thus, the Grant constitutes a program-related investment.

3. Since program-related investments are not business holdings (section 53.4943-10(b) of the regulations), the Grants will not constitute excess business holdings. The Grants, as loans, are also excluded from business holdings under section 53.4942-10(a)(2).

4. The Grant furthers charitable purposes (as discussed below) and is a program-related investment, so the Grant is not a taxable expenditure for a non-charitable purpose under section 4945(d)(5) of the Code. X must exercise expenditure responsibility over the Grants to Developers under section 4945(d)(4) and (h), and represents that it will do so.

5. X's Grant Agreement meets the requirements imposed on such agreements under sections 53.4945-5(b)(4) and 53.4945-5(c)(1) of the Regulations. The Qualified Organization will be an organization of the kind described in section 4945(d)(4)(A); thus, X need not exercise expenditure responsibility over the grant by the Developer to the Qualified Organization of the conservation easement.

6. The Developer's purchase of the land from a seller is not a grant within the meaning of sections 4945 of the Code and 53.4945-4(a)(2) of the regulations. Thus, X's involvement in the selection of the land will not cause the purchase of the Land with the Grant proceeds to constitute an earmarked (secondary) grant over which X would need to exercise expenditure responsibility under section 53.4945-5(a)(6).

7. X proposes to make below-market loans to Developers to encourage the creation of qualified conservation easements on environmentally significant land to be developed. The land is likely to be developed in the near future, and the Developers would not create the easements

absent such inducement. Like the program described in Rev. Rul. 76-204, the program furthers a charitable purpose of preserving environmentally significant land in its relatively natural state for the benefit of present and future generations. Congress recognized the importance of such easements in granting a charitable deduction for them. Just as receiving and maintaining such easements is charitable, so too assisting in the creation of such easements also is charitable. The benefit to the developers in receiving a below-market loan and a charitable deduction for giving the easement to a qualified organization is incidental to the accomplishment of X's charitable purpose of preserving environmentally significant land under the facts presented.

RULINGS:

Accordingly, we rule as follows:

1. Neither the making of the Grant to the Developer, nor the purchase of the Land, nor the reimbursement of the Grant, whether in the normal course or otherwise, nor any other transaction described in this ruling request, shall constitute a prohibited act of self-dealing under section 4941 of the Code.

2. The Grant to the Developer will constitute a program-related investment under section 4944(c) of the Code, and, therefore, the Grant will not be considered as an investment that jeopardizes the carrying out of X's exempt purpose.

3. The Grant to the Developer will not be treated as an interest in the Developer that constitutes an excess business holding for purposes of section 4943 of the Code.

4. Neither the Grant to the Developer nor the purchase of the Land by the Developer will constitute a taxable expenditure for purposes of section 4945 of the Code, provided X exercises expenditure responsibility with respect to the Grant as contemplated by section 4945(h) of the Code.

5. The Grant Agreement will satisfy the expenditure responsibility rules under sections 53.4945-5(b)(4) and 53.4945-5(c)(1) of the Regulations, and X will not be required to exercise expenditure responsibility with respect to the grant of the conservation easement to the Qualified Organization, including obtaining the reports required by section 4945(h)(2) of the Code from the Qualified Organization.

6. X's involvement in the selection of the Land to be purchased by the Developer will not cause the purchase of the Land with the Grant proceeds to constitute an earmarked (secondary) grant within the meaning of section 53.4945-5(a)(6) of the regulations.

7. The Grant to the Developer will not jeopardize or cause X to lose its tax-exempt status under section 501(c)(3) of the Code.

Except as we have ruled above, we express no opinion as to the tax consequences of the transaction under the cited provisions of the Code or under any other provisions of the Code.

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

Because this letter could help resolve future tax questions, you should keep a copy of this ruling in your permanent records.

If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely yours,
(signed) Terrell M. Berkovsky

Terrell M. Berkovsky
Manager, Exempt Organizations
Technical Group 2