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

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4942.03-03, 4942.03-05

Date:
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Contact Person:

ID Number:

Telephone Number:

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Employer Identification Number:

Legend:

The Foundation =
The Hospital =

Dear Applicant:

This is in response to your representative's letter of September 13, 2000, requesting three rulings on behalf of the Foundation concerning the tax consequences of certain liabilities, described below, that it acquired pursuant to a merger.

The Foundation, a non-profit corporation, was created in . In , the Internal Revenue Service determined the Foundation to be an exempt organization described in section 501(c)(3) of the Internal Revenue Code (the Code).

The Foundation operated a convalescent home for women that evolved into a comprehensive rehabilitation hospital. In , the Foundation formed a separate nonprofit corporation, the Hospital, to undertake the hospital operations. The Foundation transferred its operating funds to the Hospital and continued to raise funds on the Hospital's behalf. The Foundation was reclassified as a supporting organization under section 509(a)(3) of the Code. The trustees of the Foundation composed, at most, one third of the directors of the Hospital, and thus did not control the Hospital after its creation.

In , citing financial difficulties, the Hospital determined to sell its assets to a for-profit rehabilitative hospital. As part of the plan for the continued use of the Hospital's charitable assets, immediately prior to the sale, the Hospital merged into the Foundation, with the Foundation as the surviving entity. The Foundation thus received

the proceeds for the sale of the Hospital's assets. The State and County Court of Common Pleas reviewed the merger.

In , pursuant to a request by the Foundation, the Internal Revenue Service confirmed that the Foundation continued to be described in section 501(c)(3) of the Code and was classified as a nonprivate foundation under section 509(a)(2) of the Code.

After the reorganization the Foundation's principal activities became the making of grants to public charities that address (a) the health and human service needs of women and girls, and (b) quality of life issues for children and adults with disabilities. It has not attracted sufficient public support to maintain its status as a public charity described in section 509(a)(2) of the Code, and therefore, the Foundation anticipates reclassification as a private foundation under section 509 of the Code as of July 1, 2001.

As successor by merger, the Foundation retained certain liabilities of the Hospital incurred prior to the merger. These include a) payments to four retired employees of the Hospital, b) payments for split-dollar insurance for certain executive Hospital employees (which policies were acquired by the Hospital prior to the merger), and c) fees that related to certain unresolved workers' compensation cases, professional liability, and pension issues. The spilt-dollar policies provide that the Hospital, and therefore the Foundation, will receive repayment of any premiums paid upon the death of the covered employee or surrender of the policy by the employee at age . At the time of the reorganization, the Hospital and the Foundation received an opinion from an independent compensation consultant that any compensation payable to employees of the Hospital was reasonable compensation for the services rendered. The State Attorney General's Office reviewed the compensation issues as part of its review of the transaction.

The Foundation makes the following representations:

1. The amounts paid to retired employees of the Hospital, including amounts paid as premiums on the split-dollar insurance policies, represent reasonable compensation for services rendered; and

2. The amounts paid for other administrative responsibilities received from the Hospital, such as the continuing workers' compensation, professional liability, and pension issues, are reasonable and necessary.

3. The split-dollar policies are not, in any manner, the type of policies that are the basis for section 170(f)(1) of the Internal Revenue Code.

The Foundation has requested the following rulings:

1. That the payments made for liabilities assumed by the Foundation from the Hospital, including supplemental pension payments, split-dollar insurance premiums, and costs of resolving workers' compensation, professional liability, pension, and other issues will qualify as reasonable and necessary administrative expenses within the meaning of section 53.4942(a)-3(a)(2)(i), of the Foundation and Similar Excise Tax regulations (the regulations) and as such will qualify as qualifying distributions within the meaning of section 4942(g) of the Code.

2. That the Foundation's interest in the split-dollar policies, that is, its right to receive repayment of premiums at some point in the future, is a future interest excluded from assets taken into account for purposes of determining the minimum investment return under section 53.4942(a)-2(c)(2)(i) of the regulations.

3. That the payment of the liabilities assumed from the Hospital will not be taxable expenditures within the meaning of section 4945(d) of the Code because they qualify as qualifying distributions under section 4942(g) of the Code.

Section 4942(a) of the Code imposes on private foundations (other than "operating foundations" as defined in section (j)(3)) an excise tax of fifteen percent, increasing later to one hundred percent, on a foundation's undistributed income.

Section 4942(c) of the Code defines the term "undistributed income" as the amount by which the distributable amount exceeds its "qualifying distributions." The amount of income that a private foundation is required to distribute with respect to a particular taxable year is its "distributable amount."

Section 4942 (d) of the Code defines the term "distributable amount" as an amount equal to (1) the sum of the "minimum investment return" increased by certain qualifying distributions recouped by an organization and reduced by (2) the sum of taxes imposed on the private foundation under subtitle A and section 4940 of the Code.

Section 4942(e)(1) of the Code defines the term "minimum investment return" as five percent of the excess of (A) the aggregate of fair market value of all assets other than those which are used (or held for use) directly in carrying out the foundation's exempt purposes, over (B) the acquisition indebtedness (determined under section 514(c)(1) without regard to the taxable year in which the indebtedness occurred). Thus, an organization may exclude from its calculation of "minimum investment return" the value of assets which are used (or held for use) directly in carrying out the organization's exempt purpose.

Section 4942(g)(1)(A) of the Code provides that for the purposes of this section, the term "qualifying distribution" generally means any amount (including that portion of reasonable and necessary administrative expenses) paid to accomplish one or more purposes described in section 170(c)(2)(B) of the Code or any paid to acquire an asset used to (or held for uses) directly in carrying out one or more purposes described in

section 170(c)(2)(B). The purposes described in section 170(c)(2)(B) are, in part, religious, charitable, scientific, literary, or educational.

Section 53.4942(a)-2(c)(2)(v) of the regulations excludes from the assets taken into account in determining the "minimum investment return" any asset used (or held for use) directly in carrying out one or more purposes described in section 170(c)(2)(B) of the Code. The purposes described in section 170(c)(2)(B) are, in part, religious, charitable, scientific, literary or educational.

Section 53.4942(a)-2(c)(2)(i) of the regulations provides that the assets taken into account in determining minimum investment return shall not include any future interest until all intervening interests in, and rights to the actual possession or enjoyment of such property have expired; or, until such future interest has been constructively received by the foundation as where it is credited to the foundation's account, set apart for the foundation, or otherwise made available so that the foundation may acquire it at any time.

Section 53.4942(a)-3(a)(2)(i) of the regulations defines the term "qualifying distribution" to mean any amount paid to accomplish one or more purposes described in section 170(c)(1) or (2)(B), including reasonable and necessary administrative expenses.

Section 53.4945-6(b)(1)(v) of the regulations provides that a qualifying distribution under section 4942(g) will not be treated as a taxable expenditure.

Rev. Rul. 73-126, 1973-1 C.B. 220 provides that an exempt organization's payment of reasonable pensions to retired employees at the discretion of its board of directors does not adversely affect its exempt status.

Rev. Rul. 74-405, 1974-2 C.B. 384 provides that the payment of premiums by a private foundation for an insurance policy providing indemnification of a disqualified person for claims arising under the securities laws would not be an act of self-dealing under section 4941(d)(1)(E) of the Code so long as the premiums paid would not cause the total compensation of the disqualified person to be excessive.

Rev. Rul. 74-591, 1974-2 C.B. 385 provides that a pension for past personal services paid by a private foundation to one of its directors, a disqualified person whose total compensation including the pension is not excessive, does not constitute an act of self-dealing under section 4941 of the Code.

Rev. Rul. 82-223, 1982-2, C.B. 301 provides that a foundation's payment of premiums for liability insurance for its foundation manager for all liabilities, including settlement amounts arising under state mismanagement laws would not constitute an act of self dealing under section 4941(c)(1)(E) of the Code or a taxable expenditure

under section 4945(d) so long as the premiums paid by the foundation are treated as compensation paid to the manager and the compensation is not excessive.

An exempt foundation may exclude assets that are used or held for use directly in carrying out one or more exempt purposes in determining its minimum investment returns, including reasonable and necessary administrative expenses. The definition of "reasonable and necessary administrative expenses" includes reasonable compensation to employees of a foundation who carry out the organization's exempt purpose. The term compensation may include retirement benefits and payment of insurance premiums so long as the total amount does not exceed what would be reasonable compensation. Administrative expenses are includible as part of a qualifying distribution. Retirement benefits and insurance premiums are therefore includible as administrative expenses of an exempt organization. Such payments do not change character if a tax-exempt organization's obligation to pay is transferred to its tax-exempt successor.

The Foundation has not established a possessory interest in the split interest policies nor may it exercise the rights or control or ownership. The Foundation did not create the future interest. The split-interest arrangement was entered into by the Hospital prior to the merger. At the time, the Foundation did not control the Hospital, and was not party to the original negotiations. It will not receive repayment of the premiums from the split-interest insurance policies until the insured executive's death or surrender of the policy at age. Thus, the Foundation may not exercise rights or control or ownership until the occurrence of a specific event outside of its control. The Foundation's interest in the split-dollar insurance policies is a future interest, as described in section 53.4942(a)-2(c)(2)(ii) of the regulations and thereby need not be taken into account for the purpose of determining the minimum investment return under section 4942(e) of the Code.

Section 53.4945-6(b)(1)(v) of the regulations excludes from the definition of taxable expenditure any item that constitutes a qualifying distribution, including reasonable administrative expenses. The Hospital's liabilities that the Foundation assumed constitute reasonable administrative expenses. Therefore payment of these liabilities would be a qualifying distribution and would not constitute a taxable expenditure.

Based on the application of the above principles to the facts as represented in your ruling request, we rule as follows:

1. Based on your representations, that payments made for liabilities assumed by the Foundation from the Hospital, including supplemental pension payments, split-dollar insurance premiums, and costs of resolving workers' compensation, professional liability, pension, and other issues, will be reasonable and necessary administrative expenses within the meaning of section 53.4942(a)-3(a)(2)(i) of the regulations, such payments will qualify as qualifying distributions within the meaning of section 4942(g) of

the Code.

2. That the Foundation's interest in the split-dollar policies, that is, its right to receive repayment of premiums at some point in the future, is a future interest excluded from assets taken into account for purposes of determining the minimum investment return under section 53.4942(a)-2(c)(2)(i) of the regulations.

3. That the payment of the liabilities assumed from the Hospital will not be taxable expenditures within the meaning of section 4945(d) because they qualify as qualifying distributions under section 4942(g) of the Code.

These rulings are based on the understanding that there will be no material changes in the facts upon which they are based. Any changes that may have bearing on your tax status should be reported to the Service.

We are sending a copy of this ruling to the Ohio TE/GE office. Because this letter could help resolve any questions about your exempt status, you should keep it with your permanent records.

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

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

Sincerely yours,

(signed) Gerald V. Sack

Gerald V. Sack
Manager, Exempt Organizations
Technical Group 4