200325005

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

Date: MAR 27 2003

SIN:
501.03-15
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Contact Person:

Identification Number:

Telephone Number:

T:EO:B1

Employer Identification Number:

Legend:

A =
B =
x =
y =

Dear Sir or Madam:

This is in response to a request for rulings regarding the federal income tax consequences of your proposed activity of investing in foreign financial institutions under the circumstances described below.

FACTS:

You were established for the primary purpose of empowering poor entrepreneurs in developing countries to start or expand their own businesses and to create additional job opportunities for other indigent individuals in these countries. You accomplish your goal by working with a number of nongovernmental not-for-profit organizations ("NGO's") that serve the poor in a number of third world countries. These NGO's are independent organizations comprised of local residents, businesspersons and clergy of local churches who work with the poor in their respective countries and who identify eligible loan recipients. You are supported in your grant-making activities by not-for-profit organizations established in certain developed countries.

You solicit contributions from individuals, businesses, and private foundations. You also receive grants from the World Bank and several U.S. governmental agencies,

including the U.S. Agency for International Development. You in turn use the funds to provide grants to the NGO's. The NGO's use the funds to provide unsecured micro-enterprise loans and business training to needy persons, as well as to support ongoing NGO activities, including their operating expenses. You execute an agreement with the NGO receiving the grant that stipulates how the funds must be used, including criteria in choosing recipients of the loans, and reporting requirements. The NGO's must submit to you regular reports regarding the use of the funds. The agreement usually requires that payments made on account of any advances be maintained in a revolving loan fund, so that the repaid amounts can then be loaned to others.

At the present time, you provide direct grants to the foreign NGO's, imposing restrictions that will ensure that the funds are used for charitable purposes in accordance with the standards set forth in section 501(c)(3) of the Code. These grants are permanently transferred, and you do not receive any interest, dividends or other return of capital with respect to such grants. During the last two calendar years, you made over 323x and 426x loans totaling approximately $64y and $86y, respectively. The average loan was approximately $200. 85 percent of these loans were made to women.

The NGO's in third world countries discussed above and the nonprofit organizations in the developed countries have formed an international association under the name A. This entity, created under the laws of B but operated out of your headquarters, provides a "united international front" for your charitable giving in third world countries. In addition to serving as the principal financial contributor of A, you also furnish a significant amount of administrative support to A, providing additional oversight to ensure that the lending program is carried out in an efficient and effective manner.

Currently, the laws of most foreign countries significantly restrict the level of financial activities in which the nonprofit organizations may engage. As a consequence, they are unable to provide various forms of banking services that would be useful to the micro-enterprise loan recipients and the NGO's themselves - services such as savings deposits, commercial paper, inter-banking borrowings, and central banking borrowings. You cite sources that indicate the NGO's currently serve only about 2 percent of global need through their microloans.

Because the business operated by A clients and the loans provided to them are very small (you described a typical situation of a loan to finance a purchase of hemp in bulk that the loan recipient uses to make hand-woven baskets that she will sell in the town market) most of the regular banking institutions established in their countries will not accommodate them. For example, you note that there are few regular financial institutions that are willing to set up savings accounts for people who can only deposit a

dollar or two each week, and who maintain extremely low account balances. You indicate that as a result, most of A's loan recipients are forced to hide their profits in their homes, or pay high rates to a private money keeper. Further, they receive no interest on any such savings. As banks, the NGO's can bridge the gap by providing savings services, and by using these savings and other sources of capital to reach far more microcredit clients.

To respond to this problem, you will be working with various NGO's to create, or convert to, regulated "financial institutions" in their respective countries. These entities will be set up as joint stock companies with shareholders. However, contrary to the usual purpose for which these entities are set up (to benefit the shareholders) the mission of each of these financial institutions will be consistent with the overall mission of you and A -- to help the poor by providing affordable access to financial services. A sample articles of incorporation provided by you states a primary purpose of "carry[ing] on the business of a thrift bank with a primary microfinance orientation using microfinance as a vehicle or platform to lift people out of poverty and to break poverty confining attitudes and lifestyles... ."

The primary purpose and activity of all the banks in which you will invest will be to make microloans. The funds the banks receive will be reinvested by making microloans. No significant other investments are contemplated. The group loan methodology (trust bank) will be the banks' core lending product. The methodology will involve a group of bank members who work as a group to co-guarantee each other's microloans, which usually have a term of approximately 4 months. The members of the group will meet weekly to discuss each other's businesses, share experiences, and provide mutual emotional support. A loan officer of the bank attends this meeting, and will bring in others periodically to provide training on a particular issue that the group has expressed a need for. The amount of loans to each member goes through an approval process at the group level and at the bank level, and this methodology ensures that all loans remain relatively small. The loans will be for business development. Most loans will probably be between $50 to $200. An individual who seeks a loan of a substantial amount will be referred to the local commercial bank.

A members will conduct client impact assessments to measure the extent to which the training and services provided by the financial institutions are helping the clients. You will monitor the poverty focus of the banks through quarterly reports, which include a measure of the average loan size normalized to Gross Domestic Product per capita. The partners must also undergo an accreditation process once every three years. Part of this process includes a review of the poverty focus.

Because the NGO's will be converted to, or will establish banks, you propose to become a shareholder in a number of these financial institutions, providing them funding

in the form of capital contributions rather than as grants. In addition to the capital contributions of you and the A partner, additional capital will be solicited from local and international persons or entities. However, because these financial institutions will not be operated to profit their shareholders, it is expected that these other "investors" will be nonprofit entities with charitable goals similar to those of you and community-minded private investors.

It is anticipated that the bylaws and shareholder agreements will provide that shareholders will not be allowed to sell their shares without the consent of the board of directors, and no sale will generally be approved unless the proposed purchase has a track record or demonstrated commitment to the concept of microfinancing wedded to life transformation activities as a tool for poverty intervention, poverty alleviation and spiritual transformation.

You will have a voting control in the boards of the banks. The policy of A is that any banks that are part of A must have at least 51 percent of their voting shares owned by members of A. In many cases, this 51 percent is made up of the shares held by you and those held by the local NGO that you helped to create. In this way, control is held by organizations committed to your mission, values and poverty focus. With this control, the bylaws of each organization will reflect your vision and purpose.

The directors of the bank will be elected by the shareholders. This helps ensure that board members make decisions that are in the best long-term interests of the bank. Most of the directors will be representing the shares of NGO's and charitable organizations that are investing in the bank. Any dividends received by these organizations will go directly into continuing the charitable purpose of the organization.

The purpose of the current grant agreements with the NGO's is to come to an agreement on shared objectives when you place funds in an unrelated entity. With investments in banks, you will have voting control in the boards. With this control, the bylaws of each organization will reflect your vision and mission. In many cases, you will also have shareholder agreements that detail the purposes of the organization and the procedures for disposing of stock. These bylaws and agreements, plus an annual planning process with the bank, will take the place of the previous grant agreement with the NGO's.

Although the actual process that will be employed in setting up these financial institutions may differ from country to country, and your participation and that of your nonprofit foreign partners may be undertaken through separately established nonprofit entities, you emphasize that the basic purpose to aid the poor will be paramount. You represent that the laws of the country in which such entities will be operated will be respected.

You request the following rulings:

1. The activities of investing in foreign financial institutions described above will not jeopardize your tax-exempt status under section 501(c)(3) of the Code.

2. Income from the investments will be characterized as income from activities related to your tax-exempt purposes, rather than investment income, for purposes of the 1/3 support test of sections 509(a)(1) and 170(b)(1)(A)(vi) of the Code.

3. Income from the investments will not subject you to the tax on unrelated business taxable income under sections 511-513 of the Code.

APPLICABLE LAW:

Section 501(c)(3) of the Code describes as exempt, as provided under section 501(a), organizations organized and operated exclusively for charitable, scientific, or educational purposes, provided no part of the organization's net earnings inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(c)(1) of the Income Tax Regulations provides that an organization will be regarded as operated exclusively for exempt purposes only if it engages primarily in activities that accomplish such exempt purposes.

Section 1.501(c)(3)-1(d)(2) of the regulations provides that the term "charitable" includes relief of the poor and distressed or of the underprivileged.

Rev. Rul. 68-489, 1968-2 C.B. 210, holds that an organization exempt under section 501(c)(3) of the Code will not jeopardize its exemption even though it distributes funds to non-exempt organizations, provided it retains control and discretion as to the use of the funds and maintains records establishing that the funds were used for section 501(c)(3) purposes.

Rev. Rul. 71-460, 1971-2 C.B. 231, provides that a 501(c)(3) organization may conduct part or all of its charitable activities in a foreign country. The ruling holds that if the organization's activities are charitable when carried on within the United States, the conduct of such activities elsewhere should not preclude qualification for exemption.

Rev. Rul. 74-587, 1974-2 C.B. 162, holds that an organization formed to relieve poverty, eliminate prejudice, reduce neighborhood tensions and combat community deterioration through a program of financial assistance in the form of low-cost or long-

term loans to, or the purchase of equity interests in, various business enterprises in economically depressed areas, is exempt under section 501(c)(3) of the Code. Financial assistance was provided to corporations or individual proprietors who were not able to obtain funds from conventional commercial sources because of the poor financial risks involved. Also, the program was designed to enable the recipient of the funds to start a new business or to acquire or improve an existing business. The loans were not undertaken for the purpose of profit or gain, but for the purpose of achieving the charitable goals of the organization.

Rev. Rul. 81-284, 1981-2 C.B. 130, amplifying Rev. Rul. 74-587, held that a small business investment company (SBIC) licensed under section 301(d) of the Small Business Investment Act of 1958 may qualify under section 501(c)(3) of the Code even though Small Business Administration regulations require an SBIC to charge interest rates sufficient in the aggregate to recover its costs, and impose various considerations that will restrict the degree of financial support that may be offered to a prospective recipient (regarding the borrower's type of business, security interests, and the relationship between the SBIC and the borrower). The organization at issue was ruled exempt under section 501(c)(3) where it was organized on a nonprofit basis to relieve poverty, eliminate prejudice and discrimination, reduce neighborhood tensions, and combat community deterioration, by providing low-cost or long-term loans to businesses not able to obtain funds from conventional commercial sources, with preference given to businesses providing training and employment opportunities for the unemployed or under-employed residents of economically depressed areas.

Section 509(a)(1) of the Code defines the term "private foundation" as an organization described in section 501(c)(3) other than an organization described in section 170(b)(1)(A) (other than in clauses (vii) and (viii)).

Section 170(b)(1)(A)(vi) of the Code describes an organization which normally receives a substantial part of its support (exclusive of income received in the exercise or performance by such organization of its charitable, educational or other exempt function) from a governmental unit or from direct or indirect contributions from the general public.

Section 1.170A-9(e)(7) of the regulations provides that for the purposes of meeting the 1/3 support test, there shall be excluded from both the numerator and the denominator any amounts received from the exercise or performance by an organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501(a). Section 1.170A-9(e)(7)(i)(a) further provides that, in general, amounts received by an organization from the exercise or performance of its exempt purpose or function include amounts received from any

activity the conduct of which is substantially related to the furtherance of such purpose or function (other than through the production of income).

Section 511 of the Code imposes a tax on the unrelated business taxable income of exempt organizations.

Section 512 of the Code defines unrelated business taxable income as gross income derived from any unrelated trade or business regularly carried on by it, less certain deductions and modifications.

Section 512 (b) of the Code excludes from unrelated business taxable income dividends, interest, and certain gains and losses from the disposition of property, except in the case of certain debt-financed property.

Section 513(a) of the Code defines unrelated trade or business as any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its exempt function or purpose.

Section 1.513-1(d)(2) of the regulations provides that for the conduct of trade or business to be substantially related to an organization's exempt purposes, the production or distribution of the goods or the performance of the services must contribute importantly to the accomplishment of those purposes.

ANALYSIS:

Your investments in the banks are different from a typical capital venture. The banks are involved in financing microloans and providing savings services to the poor and underserved. A majority of the banks' investors and boards of directors will include representatives of international organizations, or your representatives, committed to serving the economic development needs of the underprivileged and poor of impoverished countries. In this manner, you will have the control and discretion necessary to ensure that your investment will be used for your charitable purposes of relieving poverty in impoverished countries.

You are not investing in the banks as a means of making a profit, as any profit made will be put back into the banks and will be a nominal amount. Under the facts presented, your investment program will further the charitable purpose of providing relief to the poor and distressed or underprivileged. The investment program will relieve conditions of poverty in impoverished countries. The facts are similar to Rev. Ruls. 74-587 and 81-284.

In addition, any income generated by the investment program is income earned from the exercise or performance of your exempt functions, because the investment program is performed in furtherance of your charitable purposes. Pursuant to section 1.170A-9(e)(7) of the regulations, that income is not included in either the numerator or the denominator for purposes of computing public support under section 170(B)(1)(a)(vi) of the Code.

Consistent with our finding that your investment program will further your charitable purposes, we conclude that the investment program contributes importantly to the accomplishment of your charitable purposes, and as such, is substantially related to the accomplishment of your exempt purposes. Therefore, it will not constitute unrelated trade or business. Even if the business activity were unrelated, however, the income generated by the activity might still qualify for the "passive income" exceptions to unrelated taxable income set forth in section 512(b) of the Code.

CONCLUSION:

Accordingly, based on the facts and discussion above, we rule as follows:

1. The activities of investing in foreign financial institutions as described above will not jeopardize your tax-exempt status under section 501(c)(3) of the Code.

2. Income from the investments will be characterized as income from activities related to your tax-exempt purposes, rather than investment income, for purposes of the 1/3 support test of sections 509(a)(1) and 170(b)(1)(A)(vi) of the Code.

3. Income from the investments will not subject you to the tax on unrelated business taxable income under sections 511-513 of the Code.

This ruling is based on the understanding that there will be no material change in the facts upon which it is based. Any changes that may have a bearing on your tax status should be reported to the Service. 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.

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 as precedent.

Because this letter could help resolve future questions about your income tax responsibility, please 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.

We have sent a copy of this letter to your authorized representative as indicated in your power of attorney.

Sincerely,

(signed) Marvin Friedlander

Marvin Friedlander
Manager, Exempt Organizations
Technical Group 1