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

TAX EXEMPT AND GOVERNMENT ENTITIES DIVISION

UIL: 501.03-24; 4942.05-03; 4942.03-05; 4943.03-00; 4944.03-00; 4945.04-06

Date: JUL 30 2003

Contact Person:

Identification Number:

Telephone Number:

T:EO:BR3

Employer Identification Number:

LEGEND:

A =
B =
S =
T =
W =
V =
X =
Z =
a =
b =
c =
d =

Dear Sir or Madam:

This is in response to your letter dated November 22, 2002, requesting rulings under sections 4942, 4943, 4944, 4945, and 501(c)(3) of the Internal Revenue Code.

Z is a private foundation incorporated in b by its founder, B. Z was recognized as exempt from federal income tax as an organization described in section 501(c)(3) of the Code by a letter dated a, and is classified as a private foundation within the meaning of section 509(a). Z, in its application for exemption, Form 1023, listed promotion of conservation as its principal purpose.

B died in b. Under his last will and testament, a major beneficiary of his estate was a trust designated as X. X is a qualified charitable lead trust providing for annual distributions to Z for a period of twenty-five years, after which the remaining principal will be distributed to the issue of B.

In the early 1980's B was concerned about a developing need for providing food to an expanding worldwide population. He selected country S as the location to achieve his goal. B developed a non-exempt farm named T over the years. It is one of the most productive, efficient and technologically advanced farms in the area it is located. The high quantity and quality of crops grown on T demonstrate how advanced agricultural methods can improve farm productivity in S and help produce food to feed its citizenry despite global underproduction. The primary administration of T is conducted from the corporate office located in the capital of S. The day-to-day management is conducted on site, including the repayment and maintenance of farm equipment and road vehicles.

Between 1981 and b, B acquired vast tracts of land in S as part of his interest in conservation matters and food production strategies. Many developing countries are forced to achieve economic advances at the expense of their unspoiled environmental conditions, and B hoped to minimize this effect in the region where he amassed the lands. During his lifetime, B donated a large part of his lands to W, a national park system of S. In terms of its size, T is a relatively small remainder of B's much larger holdings, which were dedicated to the national park system of S as described.

Currently, T is owned by several corporations, the stock of which is held by X. The distribution of T from B's estate to X was a necessary step in the administration of B's estate. The proposed distribution of T from X to Z, which is expected to hold T indefinitely, is the completion of B's plan. Thus, the trustees of X propose to distribute the stock in the three corporations to Z, which would continue to operate T as a demonstration farm project, as described above, as well as initiating educational and agro-biodiversity projects described hereafter.

The current management of T is utilizing its best efforts to continue with the operation initiated with B. In conjunction with A, T management is focusing on extending the development of T as an educational and research facility. Specifically, the management of T has embarked on the development of T as an educational resource and demonstration project in sustainable development showing how modern agricultural management in harmony with the environment can benefit the residents of S by producing greater quantities of high quality food products on a sustainable basis and simultaneously increase the educational level of the rural populace in sustainable development of agro-biodiversity.

A is a professor of biology at a well regarded university in the United States. He began teaching in S in 1968. As an ecologist, teacher, and conservation biologist, A has been heavily involved in preserving the c of V, a conservation area within S, and located north of T. A's efforts in the 1980's and 1990's helped to preserve the c of V and the plants and animals indigenous to that area. A is a long-term advisor to V and has taught courses in biology to students of S as well as students from the United States. A's courses have used the conserved wildland as a natural laboratory throughout S, and currently his emphasis is on V, where he will carry out activities jointly with T. A is the recipient of prestigious awards for his work in ecology.

Current management of T will continue with the farm operation of producing crops. Management is currently negotiating to construct grain drying and storage facilities on site with a view to completing the vertical integration envisioned by B by installing a complete d facility at T in the future.

In tandem with A and his organization, students concentrating in farming and its related biodiversity development will be invited to participate in the T project and A's field work in V. These students will work closely with the experienced staff of T in all the various aspects of T and as intern/apprentices to A's staff working with V. Such activity includes biodiversity management and projects in pest inventory, diseases, field botany, and novel wildland crops. This supervised education will permit students to achieve more self-sufficiency as they mature to adulthood and enter the S rural economy. Both formal classes and the apprenticeships/internships will be used as the primary teaching tool.

In the future, courses in agronomy, efficient water management, crop cultivation, pest management, novel crops, agricultural waste biodegradation, and farm management may be options available to interested students. It is envisioned that an agro laboratory may be constructed on site at a later date, as well as facilities in V for field education. Such facilities will be appropriately equipped and staffed. The laboratories would experiment with the establishment of new methods and novel crops. The experiments would then be tested in T and V.

It is anticipated that various ancillary topics would be added to the program from time to time as needed, so that T could eventually become a comprehensive agricultural research and development facility that would play a major role in the agricultural economy of S. It is not anticipated that all of these segments would be offered initially. With assistance from A, management will endeavor to start with courses and apprenticeships/internships of the highest initial interest and expand the scope with time.

It is anticipated that the students will live at the farm for the school training period. Transportation to and from the farm together with room and board is intended to be provided to the students participating in the program. Surplus funds (if any) realized from crops grown on T to the extent that they exceed costs will be invested back into the program and/or donated to conservation programs.

At present, discussions and negotiations are underway between representatives of Z, V, A, and the S government regarding the establishment of the T agro-biodiversity project described above. Other organizations may be invited to participate.

Discussions are underway with another U.S. public charity that has an interest in the wise use of natural resources in comparable locales. This other organization also has related facilities in S.

The T program is envisioned as a long-term undertaking. The success and continuation of the program will be affected by a number of factors.

T will be used as an educational resource in a comprehensive demonstration project operated by V and Z, as described above. It is expected that, in the future, situations may be encountered in which additional funding may be required. It is expected that Z would make grants to enable the project to continue. It has been represented that in the case of grants other than to United States public charities, Z would exercise expenditure responsibility with respect to those grants within the meaning of section 4945(h) of the Code. However, no specific grants are identified at the time of this ruling request.

Z has no present plan to make grants or distributions, or otherwise provide additional funding for the T farm project. If an unforeseen need should occur, and Z should find it necessary to provide funding to T it will abide by the qualifying distribution rules under section 4942(g)(1)(A)(i) of the Code and section 53.4942(a)-3(a)(2)(i)(b) of the Foundation and Similar Excise Taxes Regulations (regulations).

X and Z have requested the following rulings:

1. The T farm complex, as it is now operated and as it will continue to be operated under the demonstration project described above, qualifies as a "program related investment" as defined in section 4944(c) of the Code.
2. To the extent that the T farm complex is held through stock ownership in corporations, such ownership constitutes holdings in a "functionally related business" as described in section 4942(j) of the Code.
3. Z's acceptance and holding of the stock ownership of the T farm complex will not cause Z to incur liability for the excise taxes imposed under sections 4943 and 4944 of the Code.
4. Distributions by Z in support of the T agro-biodiversity project—
   a. Will advance Z's charitable purposes and will not affect its exemption under section 501(c)(3) of the Code;
   b. Will, unless made to a nonexempt controlled entity as provided in section 4942(g)(1)(A)(i) of the Code and section 53.4942(a)-3(a)(2)(i)(b) of the regulations, constitute "qualifying distributions" for purposes of section 4942 of the Code; and
   c. Will not constitute taxable expenditures for purposes of section 4945 of the Code.

LAW AND ANALYSIS:

Section 501(c)(3) of the Code provides, in part, for exemption from federal income tax for a corporation organized and operated exclusively for charitable, scientific or educational purposes, provided no part of the net earnings inure to the benefit of any private shareholder or individual.

Section 4942(a) of the Code imposes a tax on the undistributed income of a private foundation.

Section 4942(c) of the Code provides that the term "undistributed income" means, with respect to any private foundation for any taxable year as of any time, the amount by which— (1)

the distributable amount for such taxable year exceeds (2) the qualifying distributions made before such time out of such distributable amount.

Section 4942(g)(1)(A)(i) of the Code (and section 53.4942(a)-3(a)(2) of the regulations) generally provides that the term "qualifying distribution" 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), other than any contribution to an organization controlled (directly or indirectly) by the foundation or one or more disqualified persons (as defined in section 4946) with respect to the foundation unless the controlled entity is an exempt organization meeting certain requirements.

Section 4942(j)(4) of the Code provides that the term "functionally related business" means (A) a trade or business which is not an unrelated trade or business, or (B) an activity which is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which is (aside from the need of the organization for income or funds or the use it makes of the profits derived) related to the exempt purposes of the organization.

Section 4943 of the Code imposes an excise tax on the excess business holding of a private foundation.

Section 4943(c)(1) of the Code provides that the term excess business holdings means, with respect to the holdings of any private foundation in any business enterprise, the amount of stock or other interest in the enterprise which would have to be disposed of for the remaining holdings to be permitted holdings.

Section 4943(d)(3)(A) of the Code provides that the term "business enterprise" does not include— a functionally related business (as defined in section 4942(j)(4)).

Section 4944 of the Code imposes initial taxes and additional taxes on investments by a private foundation that are made in such manner as to jeopardize the carrying out of any of its exempt purposes.

Section 4944(c) of the Code provides, in part, that investments having the primary purpose to accomplish one or more exempt 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 an investment that jeopardizes the carrying out of exempt purposes.

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

Section 4945(d)(4) of the Code defines the term taxable expenditure as including a grant to an organization unless such organization is described in section 509(a)(1), (2), (3), or (4), or the private foundation exercises expenditure responsibility with respect with respect to such grant in accordance with subsection (h).

Section 4947(a)(2) of the Code in effect imposes section 4941 and section 4945 and other private foundation provisions on split interest trusts including charitable lead trusts.

Section 4947(b)(3)(A) of the Code, in effect, imposes section 4943 and 4944 on charitable lead trusts where the aggregate value of the charitable interests in such trust exceed 60 percent of the fair market value of all interests in such trust.

Section 53.4944-3(a)(1) of the regulations provides that a program related investment shall not be classified as an investment which jeopardizes the carrying out of exempt purposes of a private foundation. A "program-related investment" is an investment which posses the following the following characteristics:

(1) The primary purpose of the investment is to accomplish one or more of the purposes described in section 170(c)(2)(B).
(2) No significant purpose of the investment is the production of income or the appreciation of property.
(3) No purpose of the investment is to engage in lobbying or intervention in a political campaign.

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) of the Code 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.

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 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.

T is currently conducted as a demonstration farm project to show how advanced agricultural methods, efficiently applied, help improve farm productivity and produce food to feed the people of S, an underdeveloped country, and qualifies as a charitable, scientific and educational activity. The T program centers on environmentally friendly farming practices. In Rev. Rul. 72-560, 1972-2 C.B. 258, the Service held that an organization formed to educate the public with respect to problems associated with solid waste pollution was an exempt activity. The ruling also considered preventing environmental pollution as a charitable activity. See also Rev. Rul. 76-204, 1976-1 C.B. 152. Another authority to support the exempt purpose of T's activity as charitable is the holding of Dumaine Farms v. Commissioner, 73 T.C. 650 (1980). In that case, the organization was practicing new forms of farming that were intended to restore the soil as well as to recreate a sound environment. The court held that the organization qualified as a scientific and educational organization. Similarly, in Indiana Crop Improvement Association, Inc. v. Commissioner, 76 T.C. 394 (1981), the court held that an organization

devoted to the improvement of crop seed and the certification of crop seed was an exempt activity.

The operation of T as a demonstration farm project would be a program related investment within the meaning of section 4944(c) of the Code.

The primary purpose of Z is the promotion of conservation. The operation of T in an environmentally friendly way and the demonstration of how a farm in S may be operated consistent with the nature of the land and without the need to destroy the ecosystem promotes Z's (and by extension X's) charitable purpose of promoting conservation.

The expansion of T's activities after the stock of T is transferred by X to Z to include educational activities and the operation of the agro-biodiversity project will continue to constitute charitable activities, and the operation of T to further such exempt purposes will also constitute a program related investment of Z.

In either case, currently as the operation of a demonstration farm, or in the future with its expanded activities, it is clear that no significant purpose for the operation of T is the production of income or the appreciation of property. For fiscal years 1999, 2000, 2001, and 2002, the farm operations of T produced net income of $109,489; $59,818; $90,194; and $7,667 respectively. While the income from the farm operations for three of those years is not insignificant standing alone, it must be considered in the context of the value of the asset and the risk associated with operations. The 8,000 acre farm (T) is an investment of $14 million to $15 million. The return on the investment is quite low, less than one percent.

Further, the holding of property like T is inherently risky and requires reliance on skilled on-site management. The political climate in S and the language differences create additional complications. Additionally, with an agricultural operation, uncertainties of weather make income returns undependable.

High annual rates of inflation and lack of marketability make it unlikely that a commercial investor would be able to realize appreciation from holding the property in the foreseeable future.

Thus, the activities of T, as described above, constitute a "program-related investment" within in the meaning of section 4944(c) of the Code and section 53.4944-3(a)(1) of the regulations both in the hands of X (for the ultimate benefit of Z) and the hands of Z.

Having established that the activities of T constitute a "program-related investment" within the meaning of section 4944(c) of the Code in the hands of Z, it follows that T constitutes a "functionally related business" within the meaning of section 4942(j)(4) of the Code both in the hands of X and in the hands of Z after the stock representing ownership of T is transferred to Z. In addition, it also follows that T does not constitute a "business enterprise" within the definition of section 4943(d)(3) because it is a program related investment and/or a functionally related business. Thus, Z's acceptance and holding of stock ownership of T will not cause it to incur the excise taxes imposed under section 4943 nor 4944.

In tandem with A, an experienced ecologist, teacher, and conservation biologist, and his organization, students concentrating in farming and related biodiversity development will be invited to participate in the T project and A's field work in V. These students will work closely with the experienced staff of T in all the various aspects of T and as intern/apprentices to A's staff working with V. Such activity includes biodiversity management and projects in pest inventory, diseases, field botany, and novel wildland crops. This supervised education will permit students to achieve more self-sufficiency as they mature to adulthood and enter the S's rural economy. Both formal classes and the apprenticeships/internships will be used as primary teaching tools.

It is anticipated that the students will live at T for the school training period. Transportation to and from T together with room and board will be provided to the students participating in the program. Surplus funds (if any) realized from rice and sugar cane grown on T, to the extent that they exceed costs, will be invested back into the T program and/or donated to conservation programs. Based on the facts and representations, the training and educational activities proposed for Z through T and A's work with T will constitute exempt educational and scientific research activity within the meaning of section 501(c)(3) of the Code. Therefore, such activities will not affect Z's exemption under section 501(c)(3) of the Code.

T is owned by several corporations, the stock of which is currently owned by X and will be distributed to Z upon receipt of a favorable ruling. Any expenditures by Z for the operation of T, a non-exempt organization, would not constitute qualifying distributions within the meaning of section 4942(g) of the Code. As a legal matter, Z would not be treating distributions to T, or on behalf of T, as qualifying distributions, at least while T is nonexempt under section 501(c)(3) and owned or controlled by Z or disqualified persons in respect to Z, as provided in section 4942(g)(1)(A)(i) of the Code (and section 53.4942(a)-3(c) of the regulations) even though such distributions promote Z's conservation purpose.

On the other hand, it is expected that Z would make grants to other exempt organizations in the future to enable the demonstration project with T to continue over the years. Generally, grants made to United States public charities and foreign "equivalents" (See Rev. Proc. 92-94, 1992-2 C.B. 507) would constitute qualifying distributions under section 4942(g) and would not be taxable expenditures under section 4945(d) and would not require expenditure responsibility by virtue of section 4945(d)(4)(A) of the Code. In the case of grants to foreign organizations and U.S. organizations that are not public charities, Z would exercise expenditure responsibility within the meaning of section 4945(d)(4)(B) and section 4945(h) of the Code. Accordingly, such distributions and expenditures will not constitute taxable expenditures for purposes of section 4945 of the Code.

Accordingly, we rule as follows:

1. The T farm complex, as it is now operated and as it will continue to be operated under the demonstration project described above, qualifies as a "program related investment" as defined in section 4944(c) of the Code.

2. To the extent that the T farm complex is held through stock ownership in corporations, ownership of such stock qualifies as holdings in a "functionally related business" as described in section 4942(j) of the Code.
3. Z's acceptance and holding of stock ownership in the T farm complex will not cause it to incur liability for the excise taxes imposed under sections 4943 and 4944 of the Code.
4. Distributions by Z in support of the T agro-biodiversity project—
(a) Will advance Z's charitable purposes and will not affect its exemption under section 501(c)(3) of the Code;
(b) Will, unless made to a nonexempt controlled entity as provided in section 4942(g)(1)(A)(i) of the Code and section 53.4942(a)-3(a)(2)(i)(b) of the regulations, constitute "qualifying distributions" for purposes of section 4942 of the Code; and
(c) Will not constitute taxable expenditures for purposes of section 4945 of the Code.

Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to your authorized representative.

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.

This ruling is directed only to the person that requested it. Internal Revenue Code section 6110(k)(3) provides that it may not be used or cited as precedent. This ruling does not purport to rule on any other issue or Code section not addressed herein.

Sincerely,

(signed) Robert C. Harper, Jr.

Robert C. Harper, Jr.
Manager, Exempt Organizations
Technical Group 3