Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Contact Person:

Telephone Number:

In Reference to: OP:E:EO:T:3

Date: DEC 18 1998

Legend:

X =
Y =

Z =
B =
C =
R =
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Dear Sir or Madam:

This is in reference to your ruling request dated August 24, 1998, concerning the federal tax consequences of certain proposed amendments to your organizing documents as described below.

The information provided indicates that X (the "Taxpayer") was incorporated on September 6, 1995. The Taxpayer has been recognized as exempt from federal income tax as an organization described in section 501(c)(3) of the Internal Revenue Code (hereafter, "Code") and has been classified as a private foundation within the meaning of section 509(a) of the Code. The primary purpose of the Taxpayer is to support the mission of Y, a publicly supported charitable organization described in sections 501(c)(3) and 509(a)(1) of the Code. Since its inception, the Taxpayer has made grants for the benefit of Y and for the benefit of members of the charitable class served by Y.

Z, a private foundation, is the predecessor to the Taxpayer. Z was created by B and C, who are husband and wife, pursuant to a trust agreement. R and S, and several other trusts (the "Family Trusts") were created to benefit the family members of B and C. Z terminated its existence after transferring all of its assets to the Taxpayer effective December 28, 1995.

On January 1, 1996, the Taxpayer commenced terminating its status as a private foundation pursuant to section

507(b)(1)(B)(i) of the Code after notifying the Service of its intent to terminate its private foundation status. In a letter dated December 14, 1995, the Service issued an advance ruling that the Taxpayer could be expected to satisfy the requirements of section 507(b)(1)(B)(i) by operating as a public charity described in section 509(a)(3) of the Code for a continuous period of 60 calendar months, and would be treated as an organization described in section 509(a)(3) from the beginning of the termination period.

The Board of Directors of the Taxpayer are referred to as the Board of Trustees (the "Board") in its Articles of Incorporation, as amended, and in its Restatement of Bylaws. Y appoints a majority of the Board which currently consists of the following five Trustees: D, E, F, G, and H. The President of the Board is D, and the Executive Director is E. Of the current Board, F, G, and H were appointed by Y. None of the Board members have had any common investment interests with the Taxpayer.

During the two-year period from January 1, 1996, to December 31, 1997, the Taxpayer paid rent to R, a disqualified person within the meaning of section 4946 of the Code, for office space previously occupied by Z. The Taxpayer terminated its agreement with R in December, 1997, and moved to its current location.

Pursuant to the terms of a revocable trust entered into by B and C, upon the death of B on December 25, 1977, R ultimately acquired a one-half undivided interest in six parcels of real property and upon the death of C on July 8, 1990, Z acquired the other one-half interest in those parcels. After the Taxpayer's incorporation, R and the Taxpayer each owned an undivided one-half interest in the six parcels.

In June 1997, the Board, excluding E, unanimously agreed to exchange with R the respective one-half undivided interests in each parcel of the real property and cash, as necessary, in order to render a 100 percent fee simple interest in each parcel to one or the other party in a manner that would equalize the division of the property. Because E was then serving as trustee of R, he did not participate in the Board's deliberations regarding the exchange of the real property.

Prior to the exchange, the Taxpayer obtained appraisals from an independent appraiser indicating the fair market value of the various property interests subject to the exchange. As a result of the exchange, the Taxpayer received a 100 percent fee simple interest in two parcels and cash. It is represented that the fair market value of the property interests held by the Taxpayer after the exchange, including cash, was equal to the fair market

value of the real property interests held by the Taxpayer before the exchange. The real property exchange will enable the Taxpayer to donate a 100% fee simple interest in one of the parcels to Y. Y intends to build a facility for its offices on the real property.

Since its inception, the Taxpayer has reevaluated its stated purpose of supporting Y exclusively, given that the Taxpayer has other local charitable interests which it would like to support. The Taxpayer proposes to adopt restated articles of incorporation and restated bylaws that would delete all references to Y as a supported organization, and Y no longer will be the Taxpayer's primary beneficiary.

Section 501(a) of the Code provides for the exemption from federal income tax of organizations described in section 501(c)(3) of the Code.

Section 501(c)(3) of the Code provides, in relevant part, for the exemption of organizations that are organized and operated exclusively for religious, charitable, or educational purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(a)(1) of the Income Tax Regulations (hereafter, "regulations") provides that in order to be exempt as an organization described in section 501(c)(3), an organization must be organized and operated exclusively for one or more of the purposes specified in that section. If an organization fails to meet either the organizational or the operational test, it is not exempt.

Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Section 1.501(c)(3)-1(c)(2) of the regulations provides that an organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals. For the definition of the words "private shareholder or individual" the regulations refer to paragraph (c) of section 1.501(a)-1.

Section 1.501(a)-(1)(c) of the regulations states that the words "private shareholder or individual" in section 501 refer to

persons having a personal and private interest in the activities of the organization.

Section 509(a) of the Code provides that all organizations described in section 501(c)(3) are private foundations unless the organization is described in section 509(a)(1) through section 509(a)(4).

Section 509(a)(3) of the Code excludes from the definition of a private foundation an organization that (i) is organized, and at all times thereafter is operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified organizations described in section 509(a)(1) or 509(a)(2); (ii) is operated, supervised, or controlled by or in connection with one or more organizations described in section 509(a)(1) or (2); and (iii) is not controlled directly or indirectly by one or more disqualified persons.

Section 1.509(a)-4(b) of the regulations states that if an organization fails to meet either the organizational or operational test, it cannot qualify as a supporting organization.

Section 509(b) of the Code provides that a private foundation shall continue to be treated as a private foundation unless its status as such is terminated under section 507.

Section 507(a) of the Code provides that, except as provided in section 507(b) [regarding transfers to, or operation as, public charities], an organization's status as a private foundation is terminated only if either (1) the organization notifies the Service of its intent to terminate its status or (2) there have been either willful repeated acts (or failures to act), or a willful and flagrant act (or failure to act), giving rise to liability for tax under Chapter 42, and the Service notifies such organization that it is liable for the termination tax imposed by section 507(c) by reason of such acts, and, in addition to (1) or (2), the tax under section 507(c) is either paid or abated.

Section 507(b)(1)(B) of the Code provides a procedure whereby a private foundation can terminate its private foundation status without incurring tax under subsection (c) by (i) providing notice of its intent to terminate its private foundation status; and (ii) operating as a public charity for a continuous 60-month period.

Section 507(c) of the Code imposes a tax on each private foundation described in section 507(a) equal to the lower of the

aggregate tax benefit resulting from the foundation's section 501(c)(3) status or the value of its net assets.

Section 1.507-2(f)(2) of the regulations provides that any organization which fails to satisfy the requirements of section 507(b)(1)(B) for the continuous 60-month period but does satisfy these requirements for any taxable year or years during such 60-month period will be treated as a section 509(a)(1), (2), or (3) organization for such taxable years. In addition, sections 507 through 509, and Chapter 42 shall not apply to such organization for any taxable year within such 60-month period for which it does meet such requirements.

Section 4941 of the Code imposes a tax on each act of self-dealing between a disqualified person and a private foundation.

Section 4941(d)(1)(E) of the Code defines the term "self-dealing" to include any transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation.

Upon the effective date of the adoption and filing of the restated articles and restated bylaws, the Taxpayer will no longer satisfy the organizational or relationship test of section 509(a)(3). As a result, the Taxpayer will fail to complete a successful termination of its status as a private foundation under section 507(b)(1)(B) of the Code. Therefore, for all periods after that date, the Taxpayer will be classified as a private foundation within the meaning of section 509(a) of the Code.

Since the Taxpayer notified the Service prior to the commencement of the 60-month termination period of its intent to terminate its private foundation status and met the requirements of section 509(a)(3) for the period from January 1, 1996, until such time as the Taxpayer adopts and files its restated articles and restated bylaws, the Taxpayer will be treated as an organization described in section 509(a)(3) and will not be subject to the provisions of Chapter 42 of the Code, including the self-dealing provisions of section 4941. Reg. 1.507-2(f)(2).

Moreover, the Taxpayer is not subject to tax under section 507(c) of the Code since it has not notified the Service of its intent to voluntarily terminate its status under section 507(a)(1) nor have there been willful repeated acts (or failures to act), or a willful and flagrant act (or failure to act), giving rise to liability for tax under Chapter 42 which would result in an involuntary termination under section 507(a)2).

Both the rental of office space from R and the exchange of real estate with R, as described above, were in furtherance of the Taxpayer's exempt purpose.

Accordingly, we rule as follows:

1. That if the Taxpayer fails to satisfy the requirements of section 509(a)(3) of the Code for the continuous 60-month period beginning January 1, 1996, but does satisfy the requirements for any taxable year or years during this period, neither the Taxpayer nor any disqualified person with respect to the Taxpayer is subject to Chapter 42 for those years in which the Taxpayer is considered to satisfy the requirements of section 509(a)(3).

2. That the leasing of the office space at fair market value from a disqualified person and the exchange of real property at fair market value with a disqualified person during the 60-month termination period will not jeopardize the Taxpayer's exempt status as an organization described by section 501(c)(3) of the Code and no tax will be imposed under section 4941 upon any disqualified person engaged in such transaction or upon any foundation manager.

3. That when the Taxpayer adopts and files its restated articles of incorporation and restated bylaws, the Taxpayer will continue to meet the requirements described in section 501(c)(3) of the Code.

4. That the failure to terminate its private foundation status after the 60 month advance ruling period will not result in the termination of the Taxpayer's private foundation status under section 507(a) of the Code and the Taxpayer will not be subject to the tax imposed by section 507(c) of the Code.

This ruling letter 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 by others as precedent.

Because this letter could help resolve any questions about your exempt status and foundation status, you should keep it 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,

Kenneth J. Earnest

Kenneth J. Earnest
Acting Chief,
Exempt Organizations
Technical Branch 3