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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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Contact Person:

Identification Number:

Telephone Number:

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Employer Identification Number:

LEGEND

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Dear Sir or Madam:

This is in reply to L's letter of October 10, 2000, and supplemented April 30, 2001, and May 9, 2001, concerning L's proposed investment in M. In particular, L has requested that this investment be treated as a program related investment as that term is defined in section 4944(c) of the Internal Revenue Code and that the investment not be considered a taxable expenditure within the meaning of section 4945 of the Code.

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FACTS

L has been recognized as exempt under section 501(a) of the Code as an organization described in section 501(c)(3), and is a private foundation within the meaning of section 509(a) of the Code.

L has been a strong supporter of biodiversity and environmental sustainability. L recognizes that there must be linkage between- economic development required to reduce poverty and conservation of the biological resources on which nearly all economies are based.

L proposes to invest $x in M, a for-profit corporation. M is characterized as a financial intermediary created in large part with the assistance of N and O. M was formed for the purpose of financing and promoting the expansion of environmentally oriented businesses that will contribute to conservation and economic development in economically and/or environmentally sensitive areas of V. M will coordinate the funding efforts of socially conscious investors and then make direct investments in businesses that involve the sustainable use of natural resources, foster the preservation of biological diversity, or engage in organic agriculture with biodiversity linkages. The shareholders in M include governments, international development aid agencies, and some private investors.

L represents that M has twin goals. First, M has a goal of z% rate of return per investors. Second, M must be able to demonstrate a clear environmental benefit through each investment. The z return is significantly less than the acceptable rate of return on international venture capital fund investments of comparable risk, and is well below the rate that L would require under its normal investment standards. L represents that the targeted rate here, z, taken as a factor by itself, by L, in a normal investment strategy (not in conjunction with a program related investment), would not compensate for the speculative nature of the investment and the overall risk associated with M's unique investment characteristics.

L has represented that the investment guidelines M will use are consistent with the objectives of the Global Environmental Facility of the World Bank and that these objectives are derived from the Convention of Biological Diversity, which is an international framework for habitat and direct species protection signed by the United States Government and most of the countries targeted for investment by M. This objective is "conservation of biological diversity, the sustainable use of its components and fair and equitable sharing of the benefits arising out of the utilization of genetic resources".

M is controlled by its board of directors. This board includes one representative from the Investment Advisor (IA), to be described below, one selected by N, another by P, one representative from T, a foreign government which is also investing in M, and one representative to be nominated by each shareholder with a capital commitment of $y, or more. L has invested $x in this fund. L does not have a representative on the board of directors. However, L has voting rights and, as explained below, a draft of L's agreement with M sets forth very strict terms regarding L's proposed investment. These special terms and conditions go beyond the terms and conditions set forth in the general memorandum of understanding and other documents governing M's investment policy.

M's board of directors will appoint a special Investment Committee (IC). The IC will have up to six members. Two will be designated by the board of directors and will be appointed by S's investment advisor, one (who shall not be a member of N), shall be designated by IA and appointed by S's investment advisor and shall serve as long as N is a shareholder. [S is a private foreign company whose primary focus is environmental activities.] The board of directors has agreed to initially designate one person named by T. All investment decisions for M will be recommended by IA (described below) and will be approved by IC or by a majority of M's board of directors, if IC is unable to assemble a quorum, or if

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IC has failed to approve the three prior recommendations of IA. According to M's shareholders agreement, IA shall adopt and implement a written Environmental Management System (EMS) that is reasonably satisfactory to each of the shareholders of the Investment Advisor, and that is intended to assure that M's investments will be consistent with the World Bank Environmental Policies and Guidelines.

IA is a newly established organization owned jointly by Q, a section 501(c)(3) public charity that operates an investment fund and provides debt and equity financing to support environmentally-sound economic development in developing countries; and R, an investment company which fosters and promotes business opportunities in the area of sustainable development; and S. IA will administer all aspects of M. IA will work with individuals and companies in the targeted countries to identify and evaluate projects for investment. It will then perform the necessary due diligence on all investments. This will include on-site review of the potential investments under environmentally sensitive guidelines. IA will then present the potential investment first to the Biodivesity Advisory Board (BAB) (described below) for comments and, pending positive review; to IC for approval. IA is also responsible for ensuring proper distribution of funds and for monitoring all financial and environmental aspects of each investment. IA will ensure that the expected guidelines will be properly applied to all investments. IA is also responsible for documentation in connection with any investments made by M, ensuring proper distribution of funds and for monitoring all financial and environmental aspects of each investment.

As noted above, IA will work with BAB which is anticipated to include a broad range of individuals, scientists, government representatives, and representatives of not-for-profit organizations that have substantial experience in the environmental area. BAB is to provide counsel on biodiversity issues and on biodivesity related investment eligibility guidelines. L has represented that there will be representatives from non-government organizations located in the areas within which investments are to be made. It is to include representatives from world renowned environmental and investment organizations. One representative of BAB will be from N, one appointed by O, one appointed by P, one by T, one by U and one by each non-defaulting shareholder whose capital commitment is at least $y. As noted above, all investment decisions will be recommended by IA and approved by IC or by a majority vote of M's board.

In the eco-tourism area, L has provided draft proposals of the environmental considerations M and its advisors will review to ensure that the projects M will invest in will preserve natural habitat and biodiversity. Eco-tourism can have a tremendous positive or negative impact on natural ecosystems and on biodiversity. Done correctly, eco-tourism preserves biological systems as well as providing environmental education to tourists. Governments and environmental organizations also may grant concessions to selected eco-tourism operators as part of extensive land management plans and carrying capacity studies in order to maintain or improve the environment. Eco-tourism factors that will be considered include: facility lay out and location; infrastructure design and components; energy systems; waste management and sewage treatment systems; and operational systems. Special considerations would be applied to M's projects in the area of biodiversity. There would be independent scientific review and site visitations. M investment projects that involve "buffer zones" bordering on natural habitats will be especially significant. These areas extend or protect existing habitats of plant and animal species. Although M does not expect eco-tourism projects to comprise very many of M's investments, M and IA hope to support some model projects that will set precedents for the growing and hard-to-define tourist industry.

L represents that its relationship with M will be governed by a special agreement, a draft of which emphasizes that "in the event that any term or provision contained [in this agreement] conflicts with any term or provision contained in the Subscription Agreement or Shareholders Agreement [the documents

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generally governing the relationships between the investors and M], the term or provision herein shall control." It stresses that no substantial variation will be permitted without L's prior approval in writing and that any portion of the investment not committed to environmental purposes must be returned. In addition, L is permitted to monitor and evaluate operations under the investment and to attend, but not vote at, board meetings. It is also clear that full and complete financial reports will be submitted which will include descriptions of the uses of the funds and evaluations of the progress of M towards achieving environmental purposes.

LAW

Section I70(c)(2)(D) of the Code describes a charitable organization, in part, as an organization which is not disqualified for tax exemption under section 501(c)(3) by reason of attempting to influence legislation, and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

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 corporation's net earnings inure to the benefit of any private shareholder or individual.

Section I.50I(c)(3)-I(d)(2) of the Income Tax Regulations provides that the term "charitable" is used in section 50I(c)(3) in its generally accepted legal sense.

Rev. Rul. 76-204, I976-1 C.B. 152, sets forth the Service's favorable position under section 501(c)(3) regarding environmental and conservation organizations. As stated therein, "it is generally recognized that efforts to preserve and protect the natural environment for the benefit of the public serve a charitable purpose. Restatement (Second) of Trusts Sec. 375 (I959)." The revenue ruling notes that "the promotion of conservation and protection of natural resources has been recognized by Congress as serving a broad public benefit. For example, Congress declared in the National Environmental Policy Act of I969, 42 U.S.C. Sec. 4321 j(I969) that the prevention and elimination of damage to the environment stimulates the health and welfare of man and enriches the understanding of ecological systems and natural resources important to the nation." Other laws recognize that "[a] national policy of preserving unique aspects of the natural environment for future generations is clearly mandated in the Congressional declarations of purpose and policy in numerous Federal conservation laws." See, e.g., Wilderness Act, 16 U.S.C. Sec. 1131 (I964); Estuarine Areas Act, 16 U.S.C. Sec. 1221 (I68); Wild and Scenic Rivers Act, 16 U.S.C. Section 1271; Water Bank Act, 16 U.S.C. Sec 1301 (I970).

Section 509(a) of the Code provides that, unless specifically excepted, a domestic or foreign organization described in section 501(c)(3) is a private foundation.

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

Section 4944(c) of the Code provides that certain investments, referred to as program-related investments are excluded from the definition of jeopardy investments. The program related investments are defined as 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.

Section 53.4944-3(a)(I) of the Foundation and Similar Excise Tax Regulations defines a program

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related investment as an investment the primary purpose of which is to accomplish one or more of the purposes described in section 170(c)(2)(B); no significant purpose of which is the production of income or the appreciation of property; and it is not designed to accomplish one or more of the purposes described in section 170(c)(2)(D).

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. 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.

Section 53.4944-3(b) of the regulations provides various examples of program related investments:

Example (3) describes, a small business enterprise, X, which is located in a deteriorated urban area and owned by members of an economically disadvantaged minority group. Conventional sources of funds are unwilling to provide funds to X at reasonable interest rates unless it increases the amount of its equity capital. Consequently, Y, a private foundation, purchases shares of X's common stock. Y's primary purpose in purchasing the stock is to encourage the economic development of such minority group, and no significant purpose involves the production of income or the appreciation of property. The investment significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the investment and Y's exempt activities. Accordingly, the purchase of the common stock is a program-related investment, even though Y may realize a profit if X is successful and the common stock appreciates in value.

Example (5) describes a business enterprise, X, 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.

On the other hand, in Example (7), X, a private foundation, invests $100,000 in the common stock of corporation M. The dividends received from such investment are later applied by X in furtherance of its exempt purposes. Although there is a relationship between the return on the investment and the accomplishment of X's exempt activities, there is no relationship between the investment per se and such accomplishment. Therefore, the investment cannot be considered as made primarily to accomplish one or more of the purposes described in section 170(c)(2)(B) and cannot qualify as program-related.

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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 paragraph 509(a)(I), (2), (3) or (4) or is an exempt operating foundation described in section 4940(d)(2) or where the private foundation exercises expenditure responsibility with respect to such grant in accordance with subsection 4945(h).

Section 4945(h) of the Code defines the term expenditure responsibility as requiring the private foundation to be responsible to exert all reasonable efforts and to establish adequate procedures to see that the grant is spent solely for the purpose for which made, to obtain full and complete reports on how the funds are spent and to make full and detailed reports with such expenditures to the Secretary.

Section 53.4945-5(b) of the regulations provides that, in general, a private foundation is not an insurer of the activity of the organization to which it makes a grant. A private foundation will be considered to be exercising expenditure responsibility under section 4945(h) of the Code as long as it exerts all reasonable efforts and establishes adequate procedures to see that the grant is spent solely for the purpose for which made, to obtain full and complete reports from the grantee on how the funds are spent, and to make full and detailed reports with respect to such expenditures to the Commissioner.

Section 4945-5(b)(2)(i) of the regulations provides that before making a grant to an organization with respect to which expenditure responsibility must be exercised a private foundation should conduct a limited inquiry concerning the potential grantee. Such inquiry should be complete enough to give a reasonable man assurance that the grantee will use the grant for the proper purposes.

Section 53.4945-5(b)(2)(ii) of the regulations, in example (2) describes a situation where Foundation Y wishes to make a grant to foundation R for use in R's scholarship program. Y has made similar grants to R annually for the last several years and knows that R's managers have observed the terms of the previous grants and have made all requested reports with respect to such grants. No changes in R's management have occurred during the past several years. Under these circumstances, Y has enough information to have such assurance as a reasonable man would require that the grant to R will be used for proper purposes. Consequently, Y is under no obligation to make any further pregrant inquiry pursuant to this subparagraph.

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 making a program-related investment, a private foundation must require that each such investment with respect to which expenditure responsibility must be exercised must be made subject to a written commitment. Such commitment must specify the purpose of the investment and must include an agreement by the organization to use all funds only for the purposes of the investment, file annual report s and maintain books and records. In addition, not any of the funds shall be used to carry on propaganda or otherwise attempt to influence legislation, or to influence the outcome of any specific public election.

Section 53.4945-5(b)(5) imposes similar requirements on grants to foreign organizations and provides specific rules for foreign organizations to establish that they should be considered on a par with domestic charitable organizations and permit them to qualify for grants on a easier basis.

53.4945-5(c)(I) of the regulations provides that, In general, the granting private foundation shall require reports on the use of the funds, compliance with the terms of the grant, and follow the progress made by the grantee towards achieving the purposes for which the grant was made.

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ANALYSIS

The promotion of conservation, protection of natural resources, and efforts to preserve and protect the environment are charitable purposes within the meaning of section 501(c)(3) and I70(c)(2)(B) of the Code. See Rev. Rul. 76-204, supra, and the citations therein. A private foundation may make a program related investment overseas. It is reasonable to conclude an investment in an overseas fund which invests in environmental projects could qualify as a program related investment and not constitute a taxable expenditure.

Section 4944(c) of the Code and section 53.4944-3(a)(I) of the regulations define a program related investment as an investment the primary purpose of which is to accomplish one or more of the purposes described in section 170(c)(2)(B); no significant purpose of which is the production of income or the appreciation of property; and it is not designed to accomplish one or more of the purposes described in section 170(c)(2)(D).

L has represented that M is different from a typical international venture capital fund. M's investments are limited to achieving environmental and economic development goals, subject to environmental guidelines and oversight . M has a board, an investment advisory committee, and an advisory committee that include representatives of other exempt public charities interested in preserving the environment. Several international organizations with environmental interests have significant roles in the formation and administration of M to ensure its objectives are met. Other investors include a foreign government, private investors, and international financial organizations such as N and O. L has represented that the projected z return is not a return that an international venture capital fund investing solely to make a profit for its shareholders, would accept, given the risk of the investments. L has also represented that M will not use the proceeds for any political or legislative purpose or activity.

M will be investing in environmentally oriented businesses that will contribute to conservation and protect the environment. All investments will be closely scrutinized by M and its various advisory committees and only those companies which meet environmentally sensitive guidelines will be eligible for investment by M. The members of the advisory boards come from diverse backgrounds in both the public and private sectors and have strong environmental backgrounds. L has represented that M's investments will significantly further the accomplishment of L's exempt purposes and that the investments would not have been made but for the relationship between M's investments and the accomplishment of L's exempt purposes. This is analogous to the situations described in example 3 and 5 of section 53.4944-3(b) of the regulations where the investments were made to directly accomplish charitable goals. L's investment is thus distinguishable from the situation described in example (7) where there was no direct relationship between the investment per se and the accomplishment of charitable purposes. Although L expects to have a return on its investment, no significant purpose of the investment is the production of income or the appreciation of property. Accordingly, we conclude that L's investment in M is a program related investment.

For the purposes of section 4945 of the Code, the submitted information establishes that L through M's advisory boards shall carefully scrutinize the investments funded by M. This will include on-site investigations. Furthermore, L has negotiated special terms with M that go beyond the agreements subscribed to by M's other investors. These special terms include provisions that no substantial variation of the M investment will be permitted without L's written approval and that any portion of L's investment in M not committed to environmental purposes must be returned to L. L will receive annual reports, including annual shareholder reports, as long as L has an investment in M. Accordingly, we conclude that the measures taken by L will meet the expenditure responsibility requirements of section 4945(h) and section 53.4945-5(b) of the regulations and that the proposed investment in M will not be a taxable

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expenditure.

RULINGS

Based upon the information and representations submitted, we are ruling that:

1. L's investment in M will be a program-related investment as described in section 4944(c) of the Code, and

2. L's investment in M will not be a taxable expenditure under section 4945(d)(4).

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

These rulings are limited to the applicability of the provisions of sections 4944(c) and 4945(d)(4) and 4945(h) of the Code and do not purport to rule on any facts that were not represented in the ruling request as supplemented.

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. For other matters, including questions concerning reporting requirements, please contact the Ohio TE/GE Customer Service office at 877-829-5500 (a toll free number).

Sincerely yours,

Terrell M. Berkovsky
Manager, Exempt Organizations
Technical Group 2

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