Private foundation investment income; interest paid for funds reloaned interest free. An exempt private foundation that obtained a loan from a commercial lending institution, made an interest-free temporary construction loan to an exempt university, made no attempt to collect the loan, and forgave a portion of it, may not deduct or otherwise take into account the interest it paid for its loan in computing its net investment income under section 4940(c) of the Code.

Advice has been requested whether, under the circumstances described below, interest paid by a private foundation exempt from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954 is deductible from gross investment income under section 4940.

The foundation obtained a loan from a commercial lending institution to make an interest-free temporary construction loan to a university exempt from Federal income tax under section 501(c)(3) of the Code. The funds were borrowed to enable the foundation to make funds immediately available to the university while retaining its investment portfolio.

The university has made no payments, although the loan made by the foundation to it has become due. The foundation has not attempted to collect on the loan and has forgiven a portion of it as a contribution to the educational institution. When the loan made by the lending institution to the foundation became due, the foundation paid the interest and renewed the loan.

Section 4940(a) of the Code imposes on each private foundation described in section 509 a tax equal to 4 percent of the net investment income of such foundation for the taxable year.

Section 4940(c) of the Code defines net investment income and provides that in the computation of net investment income there shall be allowed as a deduction from gross investment income all the ordinary and necessary expenses paid or incurred for the production or collection of gross investment income or for the management, conservation, or maintenance of property held for the production of such income.

Section 53.4940-1(c)(1) of the Foundation Excise Tax Regulations provides that in computing the income includible under this section as gross investment income and the deductions allowable under this section from such income, the principles of subtitle A shall be utilized to the extent that they are applicable to the definitions contained herein.

Section 53.4940-1(e)(1) of the regulations provides, in part, that for purposes of computing net investment income there shall be allowed as a deduction from gross investment income all
the ordinary and necessary expenses paid or incurred for the production or collection of gross income or for the management, conservation, or maintenance of property held for the production of such income, determined with the modifications set forth in section 53.4940-1(e)(2).

Sections 212(1) and 212(2) of the Code contain language substantially similar to section 53.4940-1(e)(1) of the regulations, with the exception of any reference to modifications set forth in section 53.4940-1(e)(2) of the regulations.

Thus, in determining whether the interest paid on funds borrowed to carry out charitable purposes is deductible from gross investment income, it is necessary to determine whether the interest was paid for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income, under principles applicable in interpreting sections 212(1) and 212(2) of the Code.

In view of the aforesaid limitations, the fact that the debt giving rise to the subject interest liability was initially incurred to procure the funds which were turned over to the university for its charitable use precludes such interest liability from being treated as an ordinary and necessary expense of the class required for allowance under section 4940(c) of the Code. See United States v. Gilmore, 372 U.S. 39 (1963) in which a claim for the allowance of certain attorney fees as an ordinary and necessary expense of conserving income-producing property was denied to a successful defendant in a divorce proceeding, notwithstanding the court's assumption that proceeding had cast a serious cloud over such defendant's title to certain valuable stock and otherwise jeopardized his potential future income. As the Supreme Court there indicated, 'the controlling basic test' of the true nature of any given expense is to be found in the 'origin and character' of the claim with respect to which the expense was incurred.

Having been consistently given a broad application in other comparable cases, including Woodward v. Commissioner, 397, U.S. 572 (1970); and Anchor Coupling Co. v. United States, 427 F.2d 429 (7th Cir. 1970), cert. denied, 401 U.S 908 (1971); the origin principle commonly associated with the above-cited Gilmore case must also be considered directly applicable here. It should be further noted that the propriety of this conclusion would in no way be affected by the extent, if any, to which the subject loan may have been secured by foundation assets from time to time.

Accordingly, none of the interest liabilities described above may be deducted or otherwise taken into account in the computation of the foundation's net investment income under section 4940(c) of the Code.