

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-125093-07

Director
Office of Exempt Organizations Exam

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference: No Conference Held

LEGEND:

Foundation =

Country A =

Country B =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Date 1 =

X =

Y =

Z =

Contributor 1 =

Contributor 2 =

Trust =

Treaty =

ISSUE:

Whether the Foundation's gross investment income should be taken into account in determining whether the Foundation is eligible for benefits under paragraph 4 of Article XXI (Exempt Organizations) of the Treaty.

CONCLUSION:

No. The Foundation's gross investment income should not be taken into account in determining whether the Foundation is eligible for benefits under Article XXI(4) of the Treaty.

FACTS:

The Foundation is a corporation created in Year 1 under the laws of Country A. It is a registered charity under the laws of Country A. In Year 2, the Foundation received a determination from the Internal Revenue Service that it is a section 501(c)(3) organization that is exempt from federal income tax under section 501(a) of the Internal Revenue Code. The Foundation files Form 990-PF, Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation.

The Foundation represents that it has received only two contributions from the date of its creation. The first contribution was a grant of X that the Foundation received in Year 3 from Contributor 1, a U.S. person. The second contribution was an endowment with a

value of Y donated by the Trust, which was created in Country A by Contributor 2. The donation from the Trust took effect upon Contributor 2's death in Year 4.

Contributor 2 was born in the United States and was a U.S. citizen until Date 1. The Foundation represents that on Date 1, Contributor 2 relinquished his U.S. citizenship and became a citizen of Country B. The Foundation represents that Contributor 2 was not a U.S. citizen or resident from Date 1 until his death in Year 4.

Based on the two contributions, the Foundation represents that substantially all, Z percent, of its support has come from non-U.S. persons. Currently, all of the Foundation's income comes from its gross investment income. During each of the tax years under audit, the Foundation received most of its gross investment income from U.S. sources.

The Foundation's position is that it is eligible for benefits under Article XXI(4) of the Treaty because it has received substantially all of its "support" from persons other than citizens or residents of the United States, with the result that its U.S.-source investment income is exempt from the federal excise tax imposed on the gross investment income of foreign private foundations by section 4948 of the Internal Revenue Code.

The field's position is that the Foundation is not entitled to benefits under Article XXI(4) of the Treaty because the term "support" for purposes of the Treaty includes gross investment income and most of the Foundation's income consists of the investment income that it receives from the United States. The field also questions Contributor 2's status as a non-U.S. citizen or resident on the date he created the Trust and continuing until the time of his death.

LAW AND ANALYSIS:

The excise tax that is at issue in this case is imposed by section 4948(a):

In lieu of the tax imposed by section 4940, there is hereby imposed for each taxable year on the gross investment income (within the meaning of section 4940(c)(2)) derived from sources within the United States (within the meaning of section 861) by every foreign organization which is a private foundation for the taxable year a tax equal to 4 percent of such income.

The tax imposed by section 4940 is a 2 percent excise tax imposed on the net investment income of domestic private foundations.

Paragraph 4 of Article XXI (Exempt Organization) of the Treaty provides:

A religious, scientific, literary, educational or charitable organization which is resident in [Country A] and which has received substantially all of its support from persons other than citizens or residents of the United States shall be exempt in the United States from the United States excise taxes imposed with respect to private foundations.

The Treasury Department's Technical Explanation states:

Paragraph 4 [of Article XXI] provides an exemption from U.S. excise taxes on private foundations in the case of a religious, scientific, literary, educational, or charitable organization which is resident in [Country A] but only if such organization has received substantially all of its support from persons other than citizens or residents of the United States.

The issue that must be resolved in this case is whether the Foundation "has received substantially all of its support from persons other than citizens or residents of the United States." The Foundation and the field have agreed, for this purpose, that the term "substantially all" means at least 85 percent. The question is whether, for purpose of Article XXI(4), the term "support" includes gross investment income.

Paragraph 2 of Article III (General Definitions) of the Treaty provides:

As regards the application of the Convention by a Contracting State any term not defined therein shall, unless the context otherwise requires and subject to the provisions of Article XXVI (Mutual Agreement Procedures), have the meaning which it has under the law of that State concerning the taxes to which the Convention applies.

The term "support" is not defined in the Treaty. The field's position is that the section 509(d) definition of support, which includes gross investment income, is controlling for purposes of determining whether an exempt organization is entitled to benefits under Article XXI(4) of the Treaty.

Section 509(d) provides a definition of the term "support" for purposes of part II of subchapter F of chapter 1 and for purposes of chapter 42:

For purposes of this part and chapter 42, the term "support" includes (but is not limited to)—

- (1) gifts, grants, contributions, or membership fees,
- (2) gross receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities in any activity which is not an unrelated trade or business (within the meaning of section 513),
- (3) net income from unrelated business activities, whether or not such activities are carried on regularly as a trade or business,

- (4) gross investment income (as defined in subsection (e)),
- (5) tax revenues levied for the benefit of an organization and either paid to or expended on behalf of such organization, and
- (6) the value of services or facilities (exclusive of services or facilities generally furnished to the public without charge) furnished by a governmental unit referred to in section 170(c)(1) to an organization without charge.

Section 509(e) defines the term “gross investment income” for purposes of section 509(d), to mean the gross amount of income from interest, dividends, payments with respect to securities loans (as defined in section 512(a)(5)), rents, and royalties, but not including any such income to the extent included in computing the tax imposed by section. Such term shall also include income from sources similar to those in the preceding sentence.

The purpose of Article XXI(4) is to exempt private foundations that are residents of Country A from the section 4948(a) excise tax, thereby facilitating investment in the United States by such private foundations. The exemption is limited, however, to Country A foundations that have received substantially all of their support from persons other than U.S. citizens and residents. By limiting the exemption in this way, Article XXI(4) limits the ability of U.S. citizens and residents who establish and fund private foundations in Country A to use the Treaty inappropriately to avoid U.S. excise tax on their foundations’ U.S.-source investment income.

In the context of Article XXI(4), we do not believe it is appropriate to use the section 509(d) definition of support. Under that definition, it would be possible for a private foundation established and funded solely by contributions or donations from Country A citizens and residents (who were at no time ever U.S. citizens or residents) to fail to qualify for the exemption under Article XXI(4) if substantially all of its gross investment income were derived from investments in the United States. This would be inconsistent with the spirit and the purpose of the Treaty to facilitate investment in the United States by such private foundations.

In light of the context in which the Treaty uses the term “support,” we conclude that the Foundation’s gross investment income should not be taken into account for purposes of determining whether it is eligible for benefits under Article XXI(4) of the Treaty. Consequently, based on the Foundation’s representation that its only source of support for purposes of Article XXI(4) from the date of its creation has been the contributions that it received from Contributor 1 and Contributor 2, and assuming Contributor 2 was a nonresident alien on the date he created the Trust and continuing until the date of his death, then the Foundation is eligible for benefits under Article XXI(4) of the Treaty.

CAVEAT(S):

No opinion is expressed with respect to whether Contributor 2 was a U.S. citizen or resident after Date 1 and continuing until his death in Year 4.

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.