



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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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Legend:

M =
N =
P =
S =
T =
U =
X =
Y1 =
Y6 =

Dear :

This responds to your request for rulings under §§ 4944(c) and 4942(g) of the Internal Revenue Code.

Facts

M is a charitable trust under state law. M is exempt from federal income taxation under § 501(a) as an organization described in § 501(c)(3), and is classified as a private foundation within the meaning of § 509(a).

M was formed for religious, charitable, scientific, literary, or educational purposes within the meaning of § 501(c)(3). Since its inception, M's principal activity has been to make grants to various organizations that are exempt under § 501(c)(3) and classified as public charities under § 509(a)(1), (2), or (3). M gives preference to large scale projects in a central region of the state.

N is a non-stock corporation, exempt from federal income taxation as an organization described in § 501(c)(3), and classified as a hospital described in § 170(b)(1)(A)(iii). P is a non-stock corporation, exempt from federal income tax as an organization described in § 501(c)(3), and classified as a supporting organization under § 509(a)(3). P is the parent of N. Neither M nor

any disqualified person (within the meaning of § 4946(a)) with respect to M controls, directly or indirectly, N or P.

The combined mission of N and P is to enhance the health of the people of a certain geographical region in the center of the state. N is in the process of building a new regional, acute care hospital (the "Hospital"). This will enable N to consolidate the inpatient services of its two current facilities, facilities which are inadequate to meet the growing healthcare demands of the community. The Hospital will offer comprehensive inpatient and outpatient services consistent with the exempt purposes of N and P.

The total cost of constructing and equipping the Hospital is estimated to be approximately \$156x. The Hospital will be financed from equity from N, a grant from M in the amount of \$12.5x, community fundraising, a grant from M matching the community fundraising campaign dollar for dollar up to \$5x, and a portion of the proceeds of bonds issued by S.

S is a public body corporate and politic and an instrumentality of the state. One of the purposes of S is to assist health care institutions in the undertaking of projects involving the acquisition, construction, improvement, reconstruction, and equipping of health care facilities. To support the construction and equipment of the Hospital, S agreed to issue tax exempt bonds (the "Bonds").

The underwriters sought a rating for the Bonds from two bond rating agencies. Based on the financial strength of N and P, those agencies were unable to give the Bonds an investment grade rating. N was advised that if it established a debt service reserve fund in the amount of approximately \$13x, the Bonds would receive an investment grade rating. The debt service reserve fund would be established solely for the support of the Bonds, and would be available to pay principal and interest on the Bonds in the event N failed to meet its obligations.

N and P do not have sufficient resources themselves to fund the debt service reserve fund. On the advice of an investment banking and strategic advisory firm that focuses exclusively on the health care industry, it was determined that the debt service reserve fund be funded in part with proceeds from the Bonds and in part by the acquisition of a surety bond to support the obligations of N. With the assistance of M, N would procure the surety bond from I. N agreed to pay I the initial surety bond premium in a lump sum payment, and agreed to reimburse I for all amounts drawn on the surety bond.

As an integral condition to the issuance of the surety bond, I required M to pledge marketable securities (the "Pledged Securities") in favor of I. The Pledged Securities serve as collateral to secure the reimbursement obligations of N. With M's commitment in hand, I agreed to issue a Debt Service Reserve Fund Financial Guarantee Insurance Policy (the "Surety") in the amount of \$7.5x.

M entered into a Pledge Agreement whereby it granted I an exclusive security interest in the Pledged Securities. Under the Pledge Agreement, M is obligated to reimburse I, from the Pledged Securities and otherwise, for all amounts drawn against Surety, plus the costs of I in the event N fails to reimburse I amounts I actually pays to the Bond Trustee under the Surety.

Further, M entered into a Control Agreement naming I as a beneficiary of the Pledged Securities and authorizing I to draw down on the collateral without notice should the Surety be drawn down.

As collateral, I requires either cash, debt obligations of the United States Government, or common stock of U. Due to the risk associated with common stock and other securities, I requires that a downward adjustment be applied in computing the value of common stock and securities. For example, because M is required to supply Pledged Securities with a value of \$7.5x, if it posts U stock, the stock value must be at least \$11.5x.

Pursuant to the various agreements discussed above, M deposited the Pledged Securities, in the form of U stock, valued at approximately \$11.5x, in an account with a custodian selected by I to be held as security for the Surety. M may not substitute other assets for the Pledged Securities without the prior written consent of I. M may not withdraw the Pledged Securities from the account without the prior written consent of I. At all times, the adjusted value of the Pledged Securities must equal or exceed the amount of the insured limit under the Surety. M may not assign, transfer, mortgage, pledge, or in any way encumber the Pledged Securities. Furthermore, M authorized I to direct the custodian to transfer the Pledged Securities to I or to sell and transfer the cash sale proceeds to I without the consent of, or notice to, M should N fail to reimburse I for any drawdown on the Surety. In the event the collateral is insufficient, I may pursue M directly for any deficiency. M may not use, enjoy, or dedicate to its own purposes the Pledged Securities in any way. Thus, the Pledged Securities are beyond M's control and are at risk for all amounts due to the Bond Trustee.

In July, Y1, the Authority issued the Bonds in a total amount in excess of \$140x. N entered into a loan agreement with the Bond Trustee under which N will make payment of interest and principal to the Bond Trustee which the Bond Trustee in turn will use to make all debt service payments on the Bonds. Security for the Bonds includes a final debt service reserve fund in the amount of approximately \$13x. The final debt service reserve fund is composed of the \$7.5x Surety and approximately \$5.5x of the Bond proceeds.

In the event of a draw on the Surety and the disposal by I of the Pledged Securities, N and P would be jointly and severally obligated to reimburse M for the value of the realized collateral. Interest must be paid by N and P on the amount of the disposed collateral at a rate equal to the prime rate plus three percent, increasing by 50 basis points 12 months after any advance is made, and by 50 basis points each year thereafter. As long as there is no drawdown of the collateral, no interest will be paid to M.

Beginning on June 30, Y6, but subject to satisfaction of certain financial ratios and other covenants, and provided such action does not result in a reduction on the rating on the Bonds, N is obligated to contribute cash annually to fund the debt service reserve fund in lieu of the Surety. As the amount of the Surety decreases, the amount of the Pledged Securities required to be held as collateral also decreases. If N fully funds the reserve fund with cash, the Surety will no longer have effect, and the Pledged Securities will be released.

Rulings Requested

1. The posting of the Pledged Securities in the amount of approximately \$11.5x as collateral for the Surety is a "program-related investment" within the meaning of § 4944(c), and not a "jeopardizing investment" within the meaning of § 4944(a).
2. The posting of the Pledged Securities in the amount of approximately \$11.5x as collateral for the Surety is a "qualifying distribution" within the meaning of § 4942(g) in an amount equal to the value of the Pledged Securities posted as collateral.

Law

Qualifying Distributions

I.R.C. § 4942(a) imposes a tax on the undistributed income of a private foundation for any taxable year which has not been distributed before the first day of the second (or any succeeding) taxable year following such taxable year.

I.R.C. § 4942(c) 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.

I.R.C. § 4942(g)(1) provides that the term "qualifying distribution" means—

- (A) any amount (including that portion of reasonable and necessary administrative expenses) paid to accomplish one or more purposes described in § 170(c)(2)(B), other than any contribution to (i) an organization controlled (directly or indirectly) by the foundation or one or more disqualified persons (as defined in § 4946) with respect to the foundation, or (ii) a private foundation which is not an operating foundation (as defined in subsection (j)(3)), except as provided in paragraph (3), or
- (B) any amount paid to acquire an asset used (or held for use) directly in carrying out one or more purposes described in § 170(c)(2)(B).

Treas. Reg. § 53.4942(a)-3(a)(1) provides that the amount of a qualifying distribution of property (as defined in subparagraph (2) of this paragraph) is the fair market value of such property as of the date such qualifying distribution is made.

Treas. Reg. § 53.4942(a)-3(a)(2)(i) provides that the term "qualifying distribution" means any amount (including program-related investments, as defined in section 4944(c), and reasonable and necessary administrative expenses), paid to accomplish one or more purposes described in § 170(c)(1) or (2)(B), other than any contribution to—

(a) A private foundation which is not an operating foundation (as defined in § 4942(j)(3)), except as provided in paragraph (c) of this section, or

(b) An organization controlled (directly or indirectly) by the contributing private foundation or one or more disqualified persons with respect to such foundation, except as provided in paragraph (c) of this section.

Jeopardizing Investments

I.R.C. § 4944(a)(1) imposes a tax on any private foundation that invests any amount in such a manner as to jeopardize the carrying out of any of its exempt purposes.

I.R.C. § 4944(c) provides that investments, the primary purpose of which is to accomplish one or more of the purposes described in § 170(c)(2)(B), and no significant purpose of which is the production of income or the appreciation of property, shall not be considered as investments which jeopardize the carrying out of exempt purposes.

Treas. Reg. § 53.4944-1(a)(2)(i) provides that, except as provided in § 4944(c), § 53.4944-3, § 53.4944-6(a), and subdivision (ii) of this subparagraph, an investment shall be considered to jeopardize the carrying out of the exempt purposes of a private foundation if it is determined that the foundation managers, in making such investment, have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment, in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes. In the exercise of the requisite standard of care and prudence, the foundation managers may take into account the expected return (including both income and appreciation of capital), the risks of rising and falling price levels, and the need for diversification within the investment portfolio (for example, with respect to type of security, type of industry, maturity of company, degree of risk, and potential for return). The determination whether the investment of a particular amount jeopardizes the carrying out of the exempt purposes of a foundation shall be made on an investment by investment basis, in each case taking into account the foundation's portfolio as a whole. No category of investments shall be treated as a per se violation of § 4944.

Program-Related Investments

Treas. Reg. § 53.4944-3(a)(1) 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 possesses the following characteristics:

(i) The primary purpose of the investment is to accomplish one or more of the purposes described in § 170(c)(2)(B) (i.e., charitable, scientific, literary, or educational purposes);

(ii) No significant purpose of the investment is the production of income or the appreciation of property; and

(iii) No purpose of the investment is to accomplish one or more of the purposes described in § 170(c)(2)(D) (i.e., the purposes of attempting to influence legislation or of participating in, or intervening in, political campaigns on behalf of (or in opposition to) candidates for public office).

Treas. Reg. § 53.4944-3(a)(2)(i) provides that an investment shall be considered as made primarily to accomplish one or more of the purposes described in § 170(c)(2)(B) if it significantly

further 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 § 4944 and §§ 53.4944-1 through 53.4944-6, the term "purposes described in § 170(c)(2)(B)" shall be treated as including purposes described in § 170(c)(2)(B) whether or not carried out by organizations described in § 170(c).

Treas. Reg. § 53.4944-3(a)(2)(iii) 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.

Treas. Reg. § 53.4944-3(b) contains examples illustrating investments that qualify or do not qualify as program related investments.

Prop. Treas. Reg. § 53.4944-3(b), 77 Fed. Reg. 23429-01 (Apr. 19, 2012), does not change the rules but adds nine additional examples that illustrate investments that qualify as program related investments. The preamble specifically notes that taxpayers may rely on the additional examples prior to the effective date, including—

Example 18. X is a non-profit corporation that provides child care services in a low-income neighborhood, enabling many residents of the neighborhood to be gainfully employed. X meets the requirements of § 501(k) and is recognized as an organization described in § 501(c)(3). X's current child care facility has reached capacity and has a long waiting list. X has determined that the demand for its services warrants the construction of a new child care facility in the same neighborhood. X is unable to obtain a loan from conventional sources of funds including B, a commercial bank, because X lacks sufficient credit to support the financing of a new facility. Pursuant to a deposit agreement, Y, a private foundation, deposits \$h in B, and B lends an identical amount to X to construct the new child care facility. The deposit agreement requires Y to keep \$h on deposit with B during the term of X's loan and provides that if X defaults on the loan, B may deduct the amount of the default from the deposit. To facilitate B's access to the funds in the event of default, the agreement requires that the funds be invested in instruments that allow B to access them readily. The deposit agreement also provides that Y will earn interest at a rate of t% on the deposit. The t% rate is substantially less than Y could otherwise earn on this sum of money if Y invested it elsewhere. The loan agreement between B and X requires X to use the proceeds from the loan to construct the new child care facility. Y's primary purpose in making the deposit is to further its educational purposes by enabling X to provide child care services within the meaning of § 501(k). No significant purpose of the deposit involves the production of income or the appreciation of property. The deposit significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the deposit and Y's exempt activities. Accordingly, the deposit is a program-related investment.

Analysis

In order to fund the debt service reserve fund to secure the obligations of N and to ensure the issuance of the Bonds on economically feasible terms, M has irrevocably pledged approximately \$11.5x of securities to T to guarantee N's obligations to T and S (the "Investment"). M made the Investment to allow N to construct and equip the Hospital, and for no other reason.

To be considered a program-related investment, the Investment must have the following characteristics as set forth in Treas. Reg. § 53.4944-3(a)(1):

- (i) the primary purpose of the Investment must be the accomplishment of one or more of the purposes described in § 170(c)(2)(B);
- (ii) no significant purpose of the Investment may be the production of income or the appreciation of property; and
- (iii) no purpose of the Investment may be the accomplishment of one or more of the purposes described in § 170(c)(2)(D).

With respect to characteristic (i), M was formed to carry out religious, charitable, scientific, literary, or educational purposes within the meaning of § 501(c)(3) consistent with the purposes described in § 170(c)(2)(B). In particular, M focuses its activities on three broad program areas: healthcare, education, and youth development. In the healthcare area, M focuses on large-scale projects that will have a significant impact on the quality and delivery of healthcare services, increase operational efficiencies, and have a significant impact in a particular central region of the state. The Investment achieves this purpose by advancing healthcare, including charitable healthcare, because it will enable the Hospital to provide consolidated, improved acute care services to the residents of that part of the state.

The investment enables N to benefit from the issuance of Bonds by S, the proceeds of which have been used to construct and equip the Hospital. Without the Investment, the Bonds would not have been issued with an investment grade rating, absent which the Bonds either could not have been sold or could have been sold only at a prohibitively high interest rate, in which case the construction and equipping of the Hospital would be economically impossible.

But for the relationship between M's exempt purposes and the critical need for consolidated, expanded acute healthcare services in the central part of the state, M would not make the investment. M has demonstrated a strong commitment to N and the Hospital. Not including the Investment, M has committed \$17.5x of outright grants to the Hospital. M's sole reason for making the Investment is the importance of the Hospital to the community and the necessity of the Bond proceeds, issued with an investment grade rating, to construct and equip the Hospital.

With respect to characteristic (ii), no significant purpose of the Investment is the production of income or the appreciation of property. If N makes all scheduled interest and principal payments under the loan agreement with the Bond Trustee or funds the debt service reserve

with cash payments over time as required, the Pledged Securities will be released. M will have put the Pledged Securities at risk for the benefit of N and beyond its own current use and enjoyment but would earn no premium on the Investment.

If N is unable to make principal and interest payments, the Surety may be drawn down and I may dispose of the Pledged Securities without notice to M. In that event, N and P will be jointly liable to M for the value of the disposed collateral, plus interest (accruing from the date of the drawdown) at a modest rate. In no event will M earn interest or any other return on its investment during the period before the drawdown. In such a case, however, M is unlikely to recover the value of the Pledged Securities or any interest thereon. Having defaulted on its obligations, N and P would likely be unable to reimburse M for the value of any Pledged Securities drawn on and liquidated.

No investor solely engaged in investment for profit would make the Investment on the same terms as M, i.e., by posting collateral with no possible return if the borrower meets its obligations, and a hypothetical possibility of return (but a much greater likelihood of total loss) if the borrower is unable to meet its obligations.

With respect to characteristic (iii), no part of the Investment will be used to accomplish purposes described in § 170(c)(2)(D), i.e., lobbying or participating in political campaigns.

The terms of the Investment bear a strong resemblance to the program-related investment described in Example 18 of Prop. Treas. Reg. § 53.4944-3(b). As in the Example, N, a public charity, is unable to obtain a loan for the construction of a new facility from conventional sources because of its low credit rating. In the Example, a private foundation deposits money in a bank to induce the bank to make a loan to the public charity to construct a new facility. If the public charity defaults on the loan, the bank may deduct the amount of the default from the deposit. Similarly, M deposits marketable securities as collateral to secure N's reimbursement obligations under a surety bond to support N's obligations under the Bonds issued by S to construct and equip the Hospital. If N fails to reimburse I amounts it pays to the Bond Trustee under the Surety, I may draw down the collateral for the amount drawn down on the Surety. In the Example, the deposit agreement provides that the private foundation will earn interest at a rate substantially less than it could otherwise earn if it invested the money elsewhere. Similarly, the possibility of M earning any return on the Investment is negligible. In the Example, the depositing of money with the bank to induce the bank to make a loan to the public charity is considered a program-related investment. Since M's Investment is critical to the issuance of the Bonds to fund the construction and equipping of N's Hospital, it, too, is a program-related investment within the meaning of § 4944(c).

Treas. Reg. 53.4942(a)-3(a)(2)(i) provides that a program-related investment within the meaning of § 4944(c) constitutes a qualifying distribution within the meaning of § 4942(g) and § 53.4942(a)-3(a). Given that M will treat the distribution as a qualifying distribution, M will need to include the stock in its distributable amount for any year in which the stock is returned to M, as a recovery of a prior-year qualifying distribution under § 4942(d)(2) and (f)(2)(C).

Conclusion

In light of the above, we rule as follows:

1. The posting of the Pledged Securities in the amount of approximately \$11.5x as collateral for the Surety is a "program-related investment" within the meaning of § 4944(c), and not a "jeopardizing investment" within the meaning of § 4944(a).
2. The posting of the Pledged Securities in the amount of approximately \$11.5x as collateral for the Surety is a "qualifying distribution" within the meaning of § 4942(g) in an amount equal to the value of the Pledged Securities posted as collateral.

This ruling will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, *Notice of Intention to Disclose*. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

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

This ruling is based on the facts as they were presented and on the understanding that there will be no material changes in these facts. This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described. Because it could help resolve questions concerning your federal income tax status, this ruling should be kept 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.

In accordance with the Power of Attorney currently on file with the Internal Revenue Service, we are sending a copy of this letter to your authorized representative.

Sincerely,

Michael Seto
Manager, EO Technical

Enclosure
Notice 437