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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Date: JUN 2 2003

Contact Person:

Identification Number:

Telephone Number:

Uniform Issue List: 501.03-02
509.02-02
4958.00-00

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Legend:

B =
C =
M =
N =
P =
Q =
R =

Dear Sir or Madam:

We have considered your letter dated May 21, 2002, in which you requested rulings with respect to certain grants under sections 501(c)(3), 509(a)(3) and 4958 of the Internal Revenue Code.

Facts:

M is a nonprofit public benefit corporation. The Service has recognized M as an organization described in section 501(c)(3) of the Code and as a supporting organization under section 509(a)(3).

M is endowed by the gifts of B and C, consisting primarily of shares of N. B and C, together with members of their family, control approximately 16 percent of N's stock. B and C sit on N's board of directors and serve as its chief executive officers. N is the holding company of two federal savings banks, P and Q. B and C are directors and chief executive officers of P and Q. Neither N, P, nor Q has gifted or contributed to M.

M's articles of incorporation provide that its purposes are limited to conducting or supporting activities for the benefit of R, or to carry out the purposes of R. Pursuant to M's bylaws, three directors are appointed by R and two directors are appointed by P. B and C currently serve as the directors appointed by P.

M performs the functions of R by making grants that carry out the purposes of R. Because R appoints the majority of M's board of directors, all decisions with respect to grants are controlled by R.

The federal Community Reinvestment Act of 1977, as amended (the "CRA"), was enacted to encourage financial institutions to help meet the credit needs of the communities in which they operate. P and Q are regularly examined for their performance under the CRA by the Office of Thrift Supervision (the "OTS"). The OTS has adopted regulations, found at 12 C.F.R. Part 563e, implementing the CRA.

The OTS assesses a federal savings bank's CRA performance under the lending, investment, and service tests set forth in 12 C.F.R. 563e.22 through 563e.24. Through the examination process and application of the lending, investment, and service tests, the OTS assigns a bank an overall CRA performance rating of "outstanding," "satisfactory," "needs to improve," or "substantial non-compliance." The overall rating is based on separate ratings under each of the lending, investment, and service tests. The tests are not weighted equally. The lending test accounts for 50 percent of the overall rating, whereas the investment and service tests each account for 25% of the overall rating.

The investment test is used to evaluate an institution's record of helping to meet its community's credit needs through qualified investments, such as grants for community services targeted to low- or moderate-income geographies.

A federal savings bank may request that the OTS consider the community development grants made by an affiliate as part of the CRA examination of the bank. A tax-exempt organization qualifies as an affiliate for this purpose if the bank, or the bank's parent or subsidiary, appoints 25 percent or more of the governing body of the tax exempt organization. Thus, M may be deemed to be an affiliate of P and Q for purposes of the CRA because P appoints two of M's five directors. If a federal savings bank asks the OTS to consider an affiliate's community development grants, the bank may receive credit under the investment test for qualified grants made by an affiliate.

Although the main benefit to a financial institution of a high CRA rating is intangible positive public recognition, the federal bank regulatory agencies consider a financial institution's overall CRA rating as one factor among several in evaluating applications of the financial institution or its holding company to establish or relocate branches, to acquire other institutions, or to obtain other charters. While a financial institution's CRA rating may be a basis for denying or conditioning an application, a rating of "outstanding" or "satisfactory" generally eliminates any consideration of CRA performance in the application process. For example, a federal savings bank is eligible for the OTS' expedited application process if it maintains an "outstanding" or "satisfactory" overall CRA rating.

In the most recent CRA examinations, P received an "outstanding" overall CRA rating based on its "outstanding" lending, "high-satisfactory" investment, and "outstanding" service test performances. Q received an "outstanding" overall CRA rating based on its "outstanding"

lending, "outstanding" investment, and "outstanding" service test performances. The OTS did not consider any grants made by M in these examinations.

Rulings Requested:

M has requested the following rulings:

1. Grants made by M for purposes of community assistance that are characterized as "investments" of P and Q in a CRA examination will not jeopardize M's exempt status as an organization organized and operated exclusively for purposes described in section 501(c)(3) of the Code.

2. Grants made by M for purposes of community assistance that are characterized as "investments" of P and Q in a CRA examination will not jeopardize M's classification as other than a private foundation under section 509(a)(3) of the Code.

3. Grants made by M for purposes of community assistance that are characterized as "investments" of P and Q in a CRA examination will not constitute an excess benefit transaction under section 4958 of the Code.

Law:

Section 501(a) of the Internal Revenue Code exempts from federal income taxation organizations described in section 501(c).

Section 501(c)(3) of the Code describes corporations, trusts, and association organized and operated exclusively for charitable and other exempt 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(d)(1)(ii) of the Income Tax Regulations provides that an organization is not organized or operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. Thus, to meet the requirements of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly by such private interests.

Rev. Rul. 70-186, 1970-1 C.B. 129, holds that a nonprofit organization formed by lake front property owners to preserve and improve a lake used extensively as a public recreational facility qualifies for exemption under section 501(c)(3) of the Code. The benefits to be derived from the organization's activities flow principally to the general public through the maintenance and improvement of public recreational facilities. Any private benefits derived by the lake front property owners do not lessen the public benefits flowing from the organization's operations. In fact, it would be impossible for the organization to accomplish its purposes without providing benefits to the lake front property owners.

Section 509(a)(3) of the Code provides that the term "private foundation" does not include

an organization described in section 501(c)(3) which: (A) 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 (2); (B) is operated, supervised, or controlled by or in connection with one or more organizations described in section 509(a)(1) or (2); and (C) is not controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more organizations described in section 509(a)(1) or (2).

Section 1.509(a)-4(e)(1) of the regulations provides that a supporting organization will be regarded as "operated exclusively" to support one or more specified publicly supported organizations only if it engages solely in activities which support or benefit the specified publicly supported organizations. However, an organization will not be regarded as operated exclusively if any part of its activities is not in furtherance of a purpose other than supporting or benefiting one or more specified publicly supported organizations.

Section 4958(a) of the Code imposes a tax on each excess benefit transaction to be paid by any disqualified person with respect to such transaction, and on the participation of any organization manager in an excess benefit transaction knowing that it is such a transaction.

Section 4958(c)(1)(A) of the Code provides that the term "excess benefit transaction" means any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of the consideration received for providing such benefit.

Section 4958(f)(1) of the Code provides that the term "disqualified person" means, with respect to any transaction, (A) any person who was, at any time during the 5-year period ending on the date of such transaction, in a position to exercise substantial influence over the affairs of the organization, (B) a member of the family of an individual described in subparagraph (A), or (C) a 35-percent controlled entity.

Section 4958(f)(3) of the Code provides that the term "35-percent controlled entity" means, among other things, a corporation in which persons described in subparagraph (A) or (B) of 4958(f)(1) own more than 35 percent of the total combined voting power.

Section 53.4958-3(c)(1) of the Foundation and Similar Excise Taxes Regulations provides that a person is in a position to exercise substantial influence over the affairs of an applicable tax-exempt organization if, among other things, such person serves on the governing body of the organization and is entitled to vote on any matter over which the governing body has authority.

Analysis:

For purposes of this ruling, we assume that grants made by M will be made to carry out the purposes of R and exclusively for section 501(c)(3) purposes. Under those circumstances, the fact that some or all of such grants might also be considered as "investments" for purposes of

the CRA would not lessen the public benefits flowing from M's operations, and M would not be considered as operating to serve a private interest rather than exclusively to serve a public interest. Therefore, based on this assumption, the fact that P or Q might request the OTS to consider such grants of M as part of its CRA examination would not jeopardize M's exempt status under section 501(c)(3) of the Code.

Similarly, assuming that grants made by M will be made to carry out the purposes of R and exclusively for section 501(c)(3) purposes, the fact that some or all of such grants might also be considered "investments" for purposes of the CRA would not cause such grants to be considered in furtherance of a purpose other than that of supporting or benefiting R. Therefore, based on this assumption, the fact that P or Q might request the OTS to consider such grants of M as part of its CRA examination would not jeopardize M's classification as a supporting organization under section 509(a)(3) of the Code.

Section 4958 of the Code imposes excise taxes on each excess benefit transaction between an applicable tax-exempt entity and a disqualified person. An excess benefit transaction is any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person and the value of the economic benefit provided exceeds the value of the consideration received for providing the benefit

It does not appear that either P or Q is a disqualified person with respect to M, and, therefore, section 4958 of the Code would not apply to them. They are not substantial contributors to M. They cannot be considered 35-percent controlled entities since disqualified persons do not own more than 35 percent of the combined voting power of either P or Q. For instance, B and C, who are disqualified persons with respect to M, together with their family members, own no more than 16 percent of the stock of N, the holding company of P and Q.

Even if P or Q was considered a disqualified person with respect to M because it was considered to be in a position to exercise substantial influence over the affairs of M (for instance, by reason of P's ability to appoint the two donor directors), the CRA credit that P or Q might receive from OTS because of grants made by M could not be considered an economic benefit provided by M either directly or indirectly. Therefore, the receipt of such credits would not constitute an excess benefit transaction.

Even if the CRA credit was characterized as a benefit from M to disqualified persons (whether P and Q or B and C), the value of the benefit would be too incidental and tenuous to be quantifiable under section 4958 of the Code.

Conclusion:

Accordingly we rule that:

1. Grants made by M for the benefit of R, or that carry out the purposes of R, and that are otherwise exclusively in furtherance of section 501(c)(3) purposes, will not jeopardize M's exempt status as an organization organized and operated exclusively for exempt purposes

under section 501(c)(3) of the Code even though such grants are deemed by OTS to be "investments" for CRA purposes.

2. Grants made by M for the benefit of R, or that carry out the purposes of R, and that are otherwise exclusively in furtherance of section 501(c)(3) purposes, will not jeopardize M's status as a supporting organization under section 509(a)(3) of the Code even though such grants are deemed by OTS to be "investments" for CRA purposes.

3. The fact that a grant made by M is deemed by OTS to be an "investment" for CRA purposes will not make such grant an excess benefit transaction within the meaning of section 4958 of the Code if the grant is for the benefit of R, or carries out the purposes of R, and is otherwise exclusively in furtherance of section 501(c)(3) purposes.

These rulings are based on the understanding that all grants made by M that are considered for CRA purposes further M's exempt purposes under section 501(c)(3) of the Code.

This ruling letter 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 as precedent.

Because this ruling letter could help to resolve any questions, 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,

(signed) Terrell M. Berkovsky

Terrell M. Berkovsky
Manager, Exempt Organizations
Technical Group 2