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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Date: APR 21 2003

Contact Person:

Significant Index No.: 4942.03-03

Identification Number:

Telephone Number:

T:EO:B3

Employer Identification Number:

Legend:

X =
Y =

Dear Sir or Madam:

This is in reference to a request dated November 4, 2002, submitted by representatives of X (the "Foundation"), for a ruling that for purposes of the minimum investment return calculation under section 4942(e) of the Internal Revenue Code (the "Code"), the Foundation's assets do not include the value of collateral that is received in connection with the Foundation's securities lending program.

The Foundation has been recognized as exempt from federal income tax as an organization described in section 501(c)(3) of the Code and has been classified as a private foundation within the meaning of section 509(a). The Foundation is dedicated to the promotion of charitable purposes in the areas of arts and culture, civic and public affairs, education, health, and human services.

Under a securities lending and guaranty arrangement in place with Y (the "Bank"), the Foundation loans certain securities included in its investment portfolio to approved borrowers. The loans are terminable upon 5-days notice by the Foundation. The Bank acts as custodian on these transactions to receive from the borrowers collateral with a value of at least 102 percent of the market value of the loaned securities. The collateral is adjusted daily as the market value of the loaned securities fluctuates. The collateral, which is held by the Bank, is invested in commingled cash management funds as approved by the Foundation. The Foundation cannot acquire access to, sell or pledge the collateral, and the collateral will not be disposed of or realized upon unless and until the borrower defaults. The Foundation must approve investment vehicles for the collateral, and the Foundation bears market risk for any decrease in the value of the collateral investments. Upon the termination of the lending arrangement, the Foundation is entitled to receive back from the borrowers either the original securities or securities identical to those loaned. The Bank as custodian indemnifies the

Foundation for borrower defaults. As compensation for the loan of its securities, the Foundation receives a 70% share of the earnings on the collateral.

Both the securities loaned and the revenue generated by the Foundation's investment of the posted collateral are included in the Foundation's assets and investment income for purposes of calculating the minimum investment return under section 4942 of the Code. Prior to 2001, the Foundation's financial statements did not reflect either the collateral received in the securities lending transactions as assets or the offsetting obligation to repay the collateral upon the termination of the transaction as a liability.

You state that in September 2000, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," ("FASB 140"). You also state that FASB 140 replaced FASB Statement No. 125 in its entirety, and is effective with respect to disclosures regarding securitizations and collateral in financial statements for fiscal years ending after December 15, 2000. You note that under the revised rules of FASB 140, a secured borrowing, such as the Foundation's securities lending transactions through the Bank, must be disclosed on the lending entity's financial statements by means of exactly offsetting asset and liability entries on the balance sheet. The asset is the amount of collateral received and the offsetting liability is the exactly corresponding obligation to return that collateral when the borrowed securities are returned.

The Foundation's auditors have determined that under FASB 140, for financial statement purposes, the Foundation's transfers of portfolio securities to the Bank pursuant to the securities lending transactions must be accounted for in this manner as a secured borrowing. Accordingly, on its financial statements for the year ended December 31, 2001, the Foundation reflected the collateral received and the corresponding obligation to return the collateral under securities lending transactions as assets and liabilities, respectively, on its balance sheets. Specifically, the cash collateral received (which is held by the Bank as custodian) is considered the amount borrowed and recorded as a Foundation asset on the balance sheet. The Foundation's corresponding (and exactly offsetting) obligation to return the collateral to borrowers is recorded as a Foundation liability. The securities loaned continue to be reflected as assets on the books of the Foundation and are included in the Foundation's audited financial statements as "Investments." Thus, you state that while FASB 140 now requires disclosure of the collateral received and the obligation to return it on the balance sheet, there is no impact on the Foundation's net assets.

Section 4942(a) of the Code imposes an excise tax on the undistributed income of a private foundation for any taxable year. The term "undistributed income" is defined in section 4942(c) as, for any taxable year as of any time, the amount by which the statutorily required "distributable amount" exceeds qualifying distributions made before such time out of the distributable amount. The "distributable amount" for any taxable year is an amount equal to the sum of the minimum investment return plus the amounts described in section 4942(f)(2)(C), reduced by the taxes imposed on the foundation for the taxable year under subtitle A and section 4940. Section 4942(f)(2)(C) requires that the foundation must include in the distributable amount certain amounts that constitute repayments or other returns of amounts previously accounted for as qualifying distributions.

Section 4942(e) of the Code defines "minimum investment return" as five percent of the excess of the aggregate fair market value of all assets of the foundation other than those directly used to carry out the foundation's exempt purpose, over the acquisition indebtedness with respect to such assets (determined under section 514(c)(1)) without regard to the taxable year in which the indebtedness was incurred).

Section 53.4942(a)-2(c) of the Foundation and Similar Excise Taxes Regulations ("regulations") excludes future interests, assets of an estate until such assets are distributed to the foundation or the estate is terminated, present interests in trusts created and funded by another person, pledges, and any assets used or held for use directly in carrying out the foundation's exempt purpose. The regulation further defines assets used or held for use directly in carrying out exempt purposes to include administrative assets, real estate, buildings, and physical facilities used directly in exempt activities, interests in functionally related businesses or in program-related investments, reasonable cash balances, and property leased by a foundation in carrying out its exempt purpose either at no cost or for a program-related purpose.

Section 512(b)(1) of the Code, in part, excludes from the computation of unrelated business taxable income payments with respect to securities loans as defined in section 512(a)(5). Section 512(a)(5)(iii) of the Code provides that the term "payments with respect to securities loans" includes all amounts received with respect to a security transferred by the owner to another person including income from collateral security for such loan.

Section 514(c)(8)(A) of the Code provides that payments with respect to securities loans as defined in section 512(a)(5) shall be deemed to be derived from the securities loaned and not from collateral security or the investment of collateral security from such loans. Section 514(c)(8)(B) provides that any deductions that are directly connected with collateral security for such loan or with the investment of collateral security shall be deemed to be deductions that are directly connected with the securities loaned. Section 514(c)(8)(C) provides that an obligation to return collateral security shall not be treated as acquisition indebtedness as defined in section 514(c)(1).

In order to determine whether the Foundation has complied with the requirements under section 4942 of the Code, it is necessary to calculate the minimum investment return under section 4942(e)(1)(A), which refers to the aggregate fair market value of the Foundation's assets. With regard to the Foundation's securities lending program, the question presented is whether collateral received by the Foundation must be taken into account in determining its assets. Section 4942(e)(1)(A) and section 53.4942(a)-2(c)(3) of the regulations provide that assets used (or held for use) directly in carrying out the Foundation's exempt purpose are excluded from calculating its minimum investment return. Section 53.4942(a)-2(c)(2) excludes certain other assets from such calculations. None of these provisions addresses the treatment of collateral in connection with securities lending transactions.

Nevertheless, for purposes of preparing its financial statement, the Foundation may include as an asset collateral received in connection with its securities lending transactions and as a liability its obligation to return the collateral to the borrowers. By reflecting such offsetting amounts in its financial statement, the Foundation may comply with the advice of its auditors, while not increasing the size of its assets for purposes of section 4942 of the Code. The

Foundation's changing of its financial accounting to reflect collateral as an asset offset by the obligation to return such collateral as a liability will not change the substance of the underlying securities lending transaction, and will not increase the Foundation's payout requirements under section 4942. The securities loaned and revenue generated by investing the collateral should continue to be included in the Foundation's assets for purposes of computing the minimum investment return under section 4942(e).

Accordingly, we rule as follows:

For purposes of calculating the minimum investment return under section 4942(e) of the Code, the Foundation's assets do not include the value of the collateral received in connection with the Foundation's securities lending program.

This ruling is based on the understanding that there will be no material changes in the facts upon which it is based. Any such change should be reported to the Tax Exempt and Government Entities (TE/GE) Customer Service office. Because it could help resolve questions concerning your federal tax status, this ruling should be kept in your permanent records. A copy of this letter is being forwarded to the TE/GE Customer Service office

Except as we have specifically ruled herein, we express no opinion as to the consequences of these transactions under the cited provisions or under any other provisions of the Code.

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

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) Robert C Harper, Jr

Robert C. Harper, Jr.
Manager, Exempt Organizations
Technical Group 3