Private Letter Ruling 8718006, 2/02/1987, IRC Sec(s). 4944

Feb. 2, 1987

Issues

1. Whether A's investment in B through the purchase of stock jeopardized the carrying out of A's exempt purposes pursuant to sections 4944(a)(1) and 4944(a)(2) of the Internal Revenue Code.

2. Whether A is subject to the excise taxes imposed on jeopardy investments under section 4944 of the Code.

Facts

A was incorporated on July 24, 1967. A has been recognized exempt under section 501(c)(3) and classified as a private foundation under section 509(a).

A's stated purposes are to provide for the prevention of cruelty to animals and to pay funds over to charitable organizations to promote, provide or encourage the more humane treatment of animals of all kinds.

A states that part of its investment policy includes maintaining holdings in gold and or gold mining stock as a hedge or buffer against inflation. A purchased and sold stock in B pursuant to it's stated investment policy and retained the services of a brokerage firm to handle its investments.

A completed the following transactions involving B stock during the years in question:

1. Purchased 1000 shares 1/24/80 for $6,729.70

    sold 1000 shares 7/6/82 for 898.40 Loss (5,831.30)

2. Purchased 1000 shares 11/29/80 for $4,995.25 Sold 1000 shares 2/10/84 for 3,362.60 Loss (1,632.65)

3. Purchased 1000 shares 11/29/82 for $2,828.62 Sold 1000 shares 2/10/84 for 3,362.60 Gain 533.98

A received the following dividends from B stock during in the years in question:

September, 1980 $ 556.00

March, 1981 1,100.00

September, 1981 212.00

March, 1982 204.00

March, 1983 80.00

September, 1983 86.00

March, 1984 348.00

Total Dividends 2,586.00

A states that during the period in question, a total of $31,358.00 in capital gains was realized on a portfolio of 21 stocks with a cost basis of $357,726.00 as of July 1, 1982. Total dividend income received from all investments was $23,746.00 during the years in question.

Applicable Law:

Section 4944(a)(1) provides that if a private foundation invests any amount in such a manner as to jeopardize the carrying out of any of its exempt purposes, there is hereby imposed on the making of such investment a tax equal to 5 percent of the amount so invested for each year (or part thereof) in the taxable period. The section 4944(a)(1) tax is to be paid by the private foundation.

Section 4944(a)(2) provides that in any case in which a section 4944(a)(1) tax is imposed, there is hereby imposed on the participation of any foundation manager in the making of the investment, knowing that it is jeopardizing the carrying out of any of the foundation's charitable purposes, a tax equal to 5 percent of the amount so invested for each year (or part thereof) in the taxable period, unless such participation is not willful and is due to reasonable cause. The section 4944(a)(2) tax shall be paid by any foundation manager who participated in the making of the investment.

Section 4944(b) provides for additional taxes on the making of an investment described in section 4944(a)(1) if the investment is not removed from jeopardy within the taxable period.

With respect to jeopardizing investments, Section 53.4944-1(a)(2)(i) of the Foundation and Similar Excise Taxes Regulations provides the following: 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 section 4944. However, the following are examples of types or methods of investment which will be closely scrutinized to determine whether the foundation managers have met the requisite standard of care and prudence: Trading in securities on margin, trading in commodity futures, investments in working interests in oil and gas wells, the purchase of “puts” and “call,” and “straddles,” the purchase of warrants, and selling short. The determination whether the investment of any amount jeopardizes the carrying out of a foundation's exempt purposes is to be made as of the time that the foundation makes the investment and not subsequently on the basis of hindsight. Therefore, once it has been ascertained that an investment does not jeopardize the carrying out of a foundation's exempt purposes, the investment shall never be considered to jeopardize the carrying out of such purposes, even though, as a result of such investment, the foundation subsequently realizes a loss . . . .

The requisite standard of care and prudence required in section 53.4944-1(a)(2)(i) requires a case by case determination which involves some subjective evaluation. The prudent man rule is an investment standard which varies somewhat from state to state. It is defined in BLACK'S LAW DICTIONARY 5th ed. 1979) as " . . . the trustee may invest in a security if it is one which a prudent man of discretion and intelligence, who is seeking a reasonable income and preservation of capital, would buy."

Rationale

A's investment in B through the purchase of stock during the years in question does not constitute a jeopardy investment under sections 4944(a)(1) and 4944(a)(2) of the Code. A's investment in B under the facts and circumstances described does not jeopardize the carrying out of A's exempt purposes pursuant to section 4944.

As provided in section 53.4944-1(a)(2)(i) of the regulations 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 the 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.

A's purchase of B stock is consistent with its investment policy of investing in gold as a buffer against inflation. Although A's purchase and subsequent sale of B stock resulted in some losses during the years in question, A received dividends from B holdings during this same period. Further, A's investment portfolio included holdings in other precious metals companies and such holdings resulted in gains upon disposition.

As stated above, section 53.4944-1(a)(2)(i) of the regulation provides that in determining whether a particular amount jeopardizes the carrying out of the exempt purposes of a foundation, the foundation's investment portfolio as a whole should be taken into account. During the period in question A maintained an investment portfolio of 21 stocks with a cost basis of $357,726.00. A received dividend income of $23,746.00 including the losses realized from the disposition of B stock. Therefore, it appears that A's investments were managed in a manner to provide for its long and short term financial needs to carry out its exempt purposes pursuant to section 53.4944-(1)(a)(i).

Conclusion

Based on the above we conclude as follows:

1. A's investment in B through the purchase of B stock under the circumstances described does not jeopardize the carrying out of A's exempt purposes pursuant to section 4944 of the Code.

2. A is not subject to the excise taxes imposed on jeopardy investments under section 4944 of the Code.