

MEMORANDUM

TO: Leon Black
FROM: Ralph E. Lerner
RE: Private Operating Foundation for the Purpose of Holding Works of Art
DATE: December 5, 2012

The purpose of this memorandum is to set forth in a concise manner some of the items we have discussed relating to planning for your collection of works of art – specifically, those pieces that have not been otherwise promised to a museum or bequeathed under your Will.

The Plan

A foundation would be formed by incorporating it in the State of Delaware (referred to in this memorandum as the "Black Art Foundation," with the correct name to be determined later). The Black Art Foundation would apply for tax-exempt status as a "Private Operating Foundation." Prior to submitting the IRS exemption application, you would donate works of art to the Black Art Foundation. The Black Art Foundation in turn would lend these works to public museums in the United States for a period of at least one year. Copies of the loan agreements between the Black Art Foundation and the borrowers would be attached to the exemption application.

You will receive a tax deduction for the full fair market value of the works donated to the Black Art Foundation. In addition, you can donate cash or appreciated securities to the Black Art Foundation and receive a full tax deduction, and the proceeds can be used for the direct expenses of the Black Art Foundation.

Over time, you would develop and refine the mission statement and activities of the Black Art Foundation and plan for its continuation into the future. The Black Art Foundation would be structured so that during your lifetime you would have complete control of the Board of Directors. It is not necessary to have any exhibition space at the outset of this project, and we should discuss this further.

You would revise your Will so it is consistent with the objectives of the Black Art Foundation.

Discussion

A private operating foundation (the Black Art Foundation) falls somewhere between a private foundation and a public charity. The major advantage of a private operating foundation is that from the contributor's point of view, he is treated in the same manner for tax purposes as if the contribution was made to a public charity. In other words, contributions of art to a private operating foundation can be deducted to the extent of the works' full fair market value so long as the specific donation requirements are satisfied by the donor. This would include that the works have been owned by the donor for more than one year (so it is "long-term capital gain property"); the works satisfy the related use rule (that is, the use of the works is related to the exempt purpose of the donee/charity); and the donor obtains a qualified appraisal by a qualified appraiser

for the donated art. Assuming these requirements are met, the full fair market value of the donation is available for a charitable contribution deduction. The maximum amount of the deduction is limited to thirty percent (30%) of the donor's adjusted gross income with any additional amount carried over and deductible in the following five (5) years.

In order to qualify as a private operating foundation, the organization must satisfy the income test and either the assets test, the endowment test or the support test.

The income test, which must be satisfied by all private operating foundations, means that the foundation spends substantially all of the lesser of its adjusted net income or its minimum investment return (five percent (5%) of its investment assets) directly for the active conduct of the activities constituting the purpose or function for which the foundation was organized and operated. This means that the income generated in the foundation and the expenditures of monies must be used for the direct activities of the foundation and not merely for the making of grants. Grants made to other organizations to assist them in conducting activities are considered an "indirect" rather than a "direct" means of carrying out activities constituting the charitable purpose of the foundation. However, amounts paid to acquire or maintain assets which are used directly in the conduct of the foundation's exempt activities, such as the operating assets of a museum, are considered direct expenditures for the active conduct of the foundation's exempt activities. This would also include administrative expenses. For example, if an individual was paid a fee to make sure that the foundation's works of art are properly insured, properly loaned to other organizations, properly stored or exhibited when not on loan, and other related administrative activities, the fee would be an expenditure directly for an exempt purpose.

The assets test means that the foundation must have substantially more than half of its assets devoted directly to the active conduct of activities constituting the foundation's charitable, educational or other similar exempt purpose. The Internal Revenue Service regulations at section 53.4942(b)-2(a)(6) Ex 4 give an example of satisfying the assets test in order to qualify for private operating foundation status as follows:

Example (4). Z, an exempt organization described in section 501(c)(3), is devoted to improving the public's understanding of Renaissance art. Z's principal assets are a number of paintings of this period which it circulates on an active and continuing basis to museums and schools for public display. These paintings constitute 80 percent of Z's assets. Under these circumstances, although Z does not have a building in which it displays these paintings, such paintings are devoted directly to the active conduct of activities constituting Z's exempt purpose. Therefore, Z has satisfied the assets test described in this paragraph.

Revenue Ruling 74-498 specifically dealt with the qualification of a foundation that owns art as a private operating foundation. In this ruling, the foundation was formed to further the arts, owned a collection of well-known paintings, and had an endowment of stocks and bonds which produced income. Part of this income was used in a program of grants intended to further the arts, and the balance was used in a program of loaning paintings for display in museums, universities and similar institutions. At any given time, all but a very few of the paintings were in the hands of exhibiting institutions. Generally, when they were not on loan, the foundation's paintings were in transit, being reconditioned or restored, or being stored pending a scheduled exhibit. In this ruling, the Internal Revenue Service held that the foundation's paintings were

being used in an active loan program and therefore were being used directly to carry out the foundation's exempt purpose in the manner indicated in the IRS regulations.

A similar result was reached by the Internal Revenue Service in its Private Letter Ruling 9338042 dated June 29, 1993. In this letter ruling, the IRS further clarified that the artwork that was placed on loan to other institutions was excluded in determining the foundation's minimum investment return. The minimum investment return is five percent of a foundation's investment assets and is the amount that a foundation must use or expend each year for exempt purposes.

This means that you can create a private operating foundation, the Black Art Foundation, to which you can contribute works of art and claim a deduction for the full market value of these works. You would have to arrange to lend these items from time to time to other tax exempt entities so that you can satisfy the assets test as described above. You could contribute a cash amount in order to cover operating expenses, including expenses relating to the operation of the storage space and the supervision of the lending process. You and other individuals, including family members, could be members of the Board of Directors. When the works are not on loan, they should be placed in temporary storage. The objective is to be absolutely sure that the Black Art Foundation qualifies as a private operating foundation as of the date of its formation.

When the works of art are not on loan for exhibition at other institutions, they should not be stored or exhibited in your home. By way of background, I call your attention to Revenue Ruling 74-600, in which the IRS was asked to rule on the question as to whether or not the placing of paintings owned by a private foundation in the residence of a founder of the foundation constituted an act of self-dealing, that is, something that would disqualify the organization's tax-exempt status.

In the ruling, the paintings were on exhibition in various museums for a number of years and then were returned to the residence of the founder where they were displayed together with the individual's large private art collection in a part of his residence devoted to paintings and other works of art. Approximately 2,000 individuals visited the person's private collection each year as well as other special tours arranged for small groups and other persons interested in the arts. The IRS ruled that the placement of the art in the founder's residence resulted in a direct use of the foundation's assets by or for the benefit of a private person and therefore the foundation was not tax exempt.

A similar result was reached in an IRS technical advice memorandum dated November 5, 1987, dealing with sculptures that were located outside on an individual's residential property. The foregoing IRS position indicates how sensitive the government is to any personal use of a work of art after the donation has been made.

Therefore, once a work is donated to the Black Art Foundation, it cannot be in the residential part of your home or any place where you derive any personal benefit.

As mentioned above, the deduction for your donation of works of art to the Black Art Foundation would be limited to thirty percent (30%) of your adjusted gross income. Cash can also be contributed, which is deductible up to fifty percent (50%) of your adjusted gross income. Therefore, the cash would be deductible in addition to the fair market value of the works within the varying percentage limitations. There may be some erosion of the total deduction based on

the IRS rule that disallows itemized deductions to the extent they exceed three percent of adjusted gross income. In any event, your accountant can run these numbers for you so you know the parameters involved.

The major advantage of the private operating foundation is that it gives you flexibility and control in order to determine the future location of the works. For example, you do not have to commit yourself now to the physical location of the art and can do so at any time in the future so long as these works have been used for exempt purposes.

For estate tax purposes, there is a 100% tax deduction if the works of art are left to the Black Art Foundation at death. Advisors can be on the Board of the Foundation, and the works can be distributed over time to such institutions as these advisors determine will benefit the general public most effectively. During your lifetime, you can work on a mission statement for the Black Art Foundation so that after your death the works are handled in a manner agreeable to you, and there is zero estate tax.

This memorandum is not meant to be exhaustive nor does it formally address the procedures to be followed in obtaining the qualified appraisal by a qualified appraiser that is necessary to substantiate the values for the donated works.

R.E.L.

To ensure our compliance with certain Internal Revenue Service regulations, we inform you that, unless expressly stated otherwise, any advice in this letter relating to U.S. federal taxes is not intended or written to be used, and cannot be used, by any person for the purpose of avoiding any tax penalties that may be imposed by the Internal Revenue Service.
