DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Assistant Chief Counsel (Field Service)
CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your memorandum received October 4, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

decedent	=	
son	=	
grandson 1	=	
grandson 2	=	
employee	=	
date 1	=	
date 2	=	
company	=	
partnership	=	
foundation	=	
w	=	$
x	=	$
y	=	$
z	=	$

ISSUES

1. Whether the self-dealing penalties of section 4941 would apply have if:

    a. all of the partners agreed to sell the partnership;
    b. the foundation were to sell its interest to a third party, either separately or as part of a transaction involving the sale of all partnership interests;
    c. if the other partners were to purchase the foundation's interest at fair market value to facilitate a sale of all interests to a third party?

2. Whether the exception found in section 4941(d)(2)(F) regarding liquidation of corporations would apply if all of the partners agreed to dissolve or liquidate the partnership.

3. What are the maximum penalties under section 4941 in any of the above situations.

4. Whether a private letter ruling could be obtained by the foundation covering any of the above situations.

CONCLUSIONS

1.Assuming that the foundation managers or other disqualified persons receive no benefit from the sale, the sale of the foundation 's interest to a third party either separately or as part of a transaction involving the sale of all partnership interests, would not give rise to an act of self-dealing. Similarly, the sale of a disqualified person's interest in the partnership to anyone other than the foundation would not be an act of self-dealing.
On the other hand, the sale by the foundation of its partnership interest at fair market value to a disqualified person would be an act of self-dealing.

2. If the procedure followed in dissolving or liquidating the partnership is in accord with Treas. Reg. § 53.4941(d)-3(d), then the dissolution or liquidation of the private foundation's interest would not be self-dealing.

3. Section 4941 contains a two-tier series of sanctions. The first tier tax is a tax of 5% of the transaction amount which is imposed on the disqualified person regardless of intent, and a tax of 2 1/2% of the transaction amount imposed on a foundation manager who knowingly participates in the act of self-dealing. In the event that the self-dealing transaction is not corrected, a second tier tax of 200% of the transaction amount is imposed on the disqualified person and a tax of 50% of the transaction amount is imposed on a foundation manager who refuses to agree to the correction.

4. A ruling could be obtained on the sales transactions described above, or whether a liquidation or dissolution met the requirements of section 4941(d)(2)(F) of the Code.

FACTS

On date 1, decedent executed a revocable trust The trust has two trustees, decedent's son, and employee, an unrelated individual who serves as the family's business advisor. The beneficiaries of the trust are son (50%) and decedent's grandsons, grandson 1 (25%) and grandson 2 (25%), the children of decedent's predeceased child.
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On date 2, the trustees established a limited liability company. Son was designated as president and employee was designated as vice president and tax matters partner. The trust contributed $w in exchange for a 99% interest and son contributed $x for a 1% interest. On that same day, the trust and the company formed a limited partnership. The trust contributed $y in liquid assets and realty for a 99% limited partnership interest, while the company contributed its assets for a 1% general partnership interest. The trust then assigned .065% of its interest to the foundation, a tax-exempt private foundation.

Under the terms of the partnership agreement, the general partner has exclusive responsibility for the management, operations and control of the partnership's affairs. Unanimous consent of all partners is required to terminate the partnership prior to the expiration of its 50 year term or to amend the partnership agreement.

The foundation is a non-profit corporation founded by decedent's family more than thirty years earlier. Decedent was the president of foundation, and had made a substantial contribution to it. Son is now the president and employee is now the vice-president of foundation. The fair market value of all assets in foundation at the close of the taxable year which included decedent's date of death was $z

Decedent died five days after the creation of the partnership. As of that date, the partnership interests were held as follows:

Partner	Partnership Interest
Company (General Partner)	1.000%
Revocable trust (Limited Partner)	98.935%
Foundation	0.065%

Limited Partner)	
Total	100.000%

In valuing decedent’s 98.935% limited partnership interest, decadent’s executor reduced the net asset value of the partnership to reflect the minority status and lack of marketability of the interests, The minority interest discount was based in part on the opinion of the estate's attorney that the presence of the foundation as a partner, which implicates the self-dealing provisions of IRC § 4941, would limit the ability of the hypothetical purchaser of decedent’s 98.935% interest to maximize the return on that investment. Secondly, the estate argues that despite the existence of actual family control at all relevant times, section 4941 would effectively eliminate the family’s ability to liquidate the partnership, thereby precluding the application of section 2704.

LAW AND ANALYSIS

OVERVIEW

Section 2031(a) of the Code provides that the value of the gross estate is to be determined for Federal estate tax purposes "by including * * * the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated." Value is determined at the moment of death. Ahmanson Found. v. United States, 674 F.2d 761, 767 (9th Cir.1981). The standard for valuation is fair market value, defined as " 'the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.' " United States v. Cartwright, 411 U.S. 546, 551 (1973) (quoting Treas. Reg. § 20.3031-1(b); Collins v. Commissioner, 3 F.3d 625, 633 (2d Cir.1993). This objective test requires property to be valued from the viewpoint of a hypothetical buyer and seller, each of whom would seek to maximize his or her profit from any transaction involving the property. Estate of Watts v. Commissioner, 823 F.2d 483, 486 (11th Cir.1987); Estate of Bright v. United States, 658 F.2d 999, 1005-1006 (5th Cir.1981).

Section 2704 of the Code is part of a set of special valuation rules designed to mitigate the effect of Treas. Reg. § 20.3031-1(b) in certain intra-family contexts. Section 2704(b)(1) provides, in part, that in the case of a transfer of an interest in a partnership to a member of the transferor's family, if the transferor and members of the transferor's family hold, immediately before the transfer, control of the entity, then an applicable restriction will be disregarded in valuing the transferred interest. An applicable restriction is one which limits the ability of the partnership to liquidate, but which the transferor or the family, either alone or collectively, has the right to remove after the transfer. Stated another way, in the case of a transfer subject to a liquidation restriction, if the family holds control both before and after the transfer, the transfer is valued without regard to the restriction. Section 2704 differs from section 2031 in that it looks to the actual parties to the transfer, and not to a hypothetical third party.

As noted above, the estate has argued that the presence of the foundation as a partner, which implicates the self-dealing provisions of IRC § 4941, would limit the ability of the hypothetical purchaser of decedent's partnership interest to maximize the return on that investment. Secondly, the estate argues that despite the existence of actual family control at all relevant times, section 4941 would effectively eliminate the family's ability to liquidate the partnership, thereby precluding the application of section 2704. For the reasons discussed below we believe that there are realistic sales transactions and liquidation transactions which would not subject the hypothetical purchaser, the foundation managers, the general partner or any disqualified persons to self-dealing taxes. Secondly, under certain circumstances, the foundation could join with the family in voting to liquidate the partnership without subjecting the foundation managers, the general partner or any disqualified persons to self-dealing taxes. Accordingly, we agree that the presence of the foundation in the transaction does not affect the application of either section 2031 or 2704. We will now answer the specific questions that you have posed.

Issue 1

Section 4941(a)(1) of the Code imposes a tax upon any act of self-dealing between a private foundation and any of its disqualified persons as defined in section 4946.

Section 4941(d)(1)(A) of the Code defines the term self-dealing to mean any direct or indirect sale or exchange, or leasing of property between a private foundation and a disqualified person. Section 4941(d)(1)(D) defines the term self-dealing to mean any direct or indirect payment of compensation (or payment or reimbursement of expenses) between a private foundation and a disqualified person. Section 4941(d)(1)(E) defines the term self-dealing to mean any direct or indirect transfer to, or use by or for the benefit of a disqualified person of the income or assets of a private foundation.

Section 4946(a)(1) of the Code provides, in pertinent part, that the term "disqualified person" means with respect to a private foundation, a person who is-

(A) a substantial contributor to the foundation;[1]

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[1]Section 507(d)(2)(A) of the Code defines "substantial contributor" as any person who contributed or bequeathed an aggregated amount of more than $5,000 to a private foundation, if such amount is more than 2 percent of the total contributions and

(B) a foundation manager(within the meaning of subsection (b)(1);[2]

(C) an owner of more than 20 percent of–

(i) the total combined voting power of a corporation,
(ii) the profits interest of a partnership, or
(iii) the beneficial interest of a trust or unincorporated enterprise, which is a substantial contributor to the foundation;

(D) a member of the family (including a spouse, children, and grandchildren) of any individual described in sub-paragraph (A), (B), or (C);

(E) a corporation in which persons described in subparagraph (A), (B), (C), or (D) own more than 35 percent of the total combined voting power;

(F) a partnership in which persons described in subparagraph (A), (B), (C), or (D) own more than 35 percent of the profits interest;

(G) a trust or estate in which persons described in subparagraph (A), (B), (C), or (D) hold more than 35 percent of the beneficial interest.

Here, decedent's estate, the trust, the company, decedent's family, employee and the members of employee's family are "disqualified persons" for purposes of section 4941. An unrelated third party is not a disqualified person. For self-dealing to take place, there must be a disqualified person engaging in a transaction

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bequests received by the foundation before the close of the taxable year of the foundation in which the contribution or bequest is received by the foundation from such person. In the case of a trust, the term "substantial contributor" also means the creator of the trust. Section 507(d)(2)(B)(iv) provides that any person who is a substantial contributor on any date shall remain a substantial contributor for all subsequent periods.

[2] A "foundation manager" is an officer, director, or trustee of a foundation, as well as an employee having responsibility with respect to a specific act or failure to act. Section 4946(b).

with a private foundation. Therefore, any transaction between the foregoing parties and the foundation could be an act of self-dealing. The sale by the foundation of its partnership interest at fair market value to another one of the pre-death partners would be an act of self-dealing. Furthermore, if the managers of the foundation sell the foundation's interest to a third party but receive some inappropriate benefit the sale would result in self-dealing by the managers. For example, Treas. Reg. § 53.4941(d)-2(f)(1) states that "the purchase or sale of stock or other securities by a private foundation shall be an act of self-dealing if such purchase or sale is made in attempt to manipulate the price of the stock or other securities to the advantage of a disqualified person." On the other hand, the sale by the foundation of its interest to a third party would not give rise to an act of self-dealing unless the managers or other disqualified persons received some benefit from the sale. Similarly the sale of a disqualified person's interest in the partnership to any one other than the foundation would not be an act of self-dealing. Thus, it is clear that sales can be hypothesized that do not constitute acts of self-dealing.

If all the partners including the foundation were to enter into an agreement to sell their interests as a unit to a third party, this agreement could result in an act of self-dealing. Depending upon the particular facts concerning such agreement the joint sale could be a prohibited use by the disqualified persons of the foundation's assets, within the meaning of section 4941(d)(1)(E). Similarly if the foundation managers were to sell the foundation's interest in conjunction with their own interests in order to get a personal benefit, questions could be raised about whether the foundation's assets were being used by the managers. On the other hand, and with regard to section 4941(d)(2)(F) of the Code, in Deluxe Corp v. Unites States, 885 F. 2d 848 (Fed. Cir. 1989), the circuit court held that a redemption offer was a bona fide offer within the meaning of treas. Reg. § 53.4941(d)-3(d)(1) despite the exclusion of officers and directors, who were shareholders, because to include them in the offer would create a potential conflict with the securities laws restrictions applying to them. Thus, assuming that a sale of the foundation's interest did not constitute a prohibited use of the foundation's assets by disqualified persons, it would not constitute an act of self-dealing.

Issue 2

Section 4941(d)(2)(F) of the Code provides that any transaction between a private foundation and a corporation which is a disqualified person pursuant to any liquidation, merger, redemption, recapitalization, or other corporate adjustment, organization, or reorganization, shall not be an act of self-dealing if all the securities of the same class held by the foundation are subject to the same terms and such terms provide for receipt by the foundation of no less than fair market value.

Treas. Reg. § 53.4941(d)-3(d)(1) provides, in part, that securities are not 'subject to the same terms' unless, pursuant to such transaction, the corporation makes a bona fide offer on a uniform basis to the foundation and every other person who holds such securities. Treas. Reg. § 53.4941(e)-1(f) provides that for purposes of sections 53.4941(a)-1 through 53.4941(f)-1, fair market value shall be determined pursuant to the provisions of section 53.4942(a)-2(c)(4).

Section 4941(d)(2)(F) of the Code contains an exception to the general prohibition against transactions between private foundations and disqualified persons to permit certain essential transactions. The prohibitions against self-dealing were enacted in 1969 to protect private foundations from improper acts by those who control the foundation, and to curtail possible abuse of the foundation's tax-exempt status. H.R. Rep. No. 413, 91st Cong., 1st Sess. 20-21, reprinted in 1969 U. S. Code Cong. Admin. News 1645, 1665; S. Rep. No. 552, 91st Cong., 1st Sess. 28-29, reprinted in 1969 U.S. Code Cong. & Admin. News 2027, 2055. Nevertheless, as the Treasury explained when it endorsed the bill, see Hearings Before the Committee on Ways and Means, 91 Cong., 1st Sess. On the Subject of Tax Reform, pt 14 at 5059 (1969), an exception to the self-dealing rules "would be made to permit essential donor-foundation transactions." Id at 5322.

In enacting section 4941(d)(2)(F), Congress expressly rejected an absolute prohibition against transactions between private foundations and disqualified persons, but replaced the standard of the prior law, which had permitted arm's-length transactions with disqualified persons with one that requires that the foundation must be dealt with on the same terms as other parties to the transaction. The purpose of this requirement is to assure that a foundation's status is not abused, whether the transaction is a "liquidation, merger, redemption, recapitalization, or other corporate adjustment, organization or reorganization", so that a foundation does not receive less advantageous terms than any other shareholder when dealing with a disqualified person. See S. Rep. No 552, supra at 28-29, 31 reprinted at 2055-58.

Section 4941(d)(2)(F) of the Code and Treas. Reg. § 53.4941(d)-3(d)(1) speak in terms of a corporation. We believe that in some situations these provisions provide guidance in the disposition of a private foundation's interest in a partnership. See, e.g., PLR 9237032. Accordingly, if the procedure followed in dissolving or liquidating a partnership is in accord with Treas. Reg. § 53.4941(d)-3(d) then the dissolution or liquidation of the private foundation's interest would not be an act of self-dealing within the meaning of section 4941 of the Code. Cf. TAM 9205001, concluding on its facts that a stock redemption did not meet the criteria of section 4941(d)(2)(F).

Issue 3

Should a private foundation and a disqualified person engage in an act of self-dealing, a two-tier series of sanctions may be triggered. As to the first tier tax, a tax of 5% of the greater of the amount of money given or received or of the fair market value of the property given or received is automatically imposed on the disqualified person, regardless of the inadvertence of the transaction. Section 4941(a)(1). With regard to the sale of one of the current partners' partnership interest to the foundation the excise tax would be calculated on the higher of the fair market value of the partnership interest or the amount of money paid for it by the foundation. If the foundation's partnership interest were sold to the partnership or any one of the current partners the excise tax would be calculated on the higher of the fair market value of the partnership's interest or the amount of money paid for it. A liquidation or dissolution of the foundation's partnership interest would be equivalent to a sale to the partnership and the excise tax would be calculated in the same way unless the requirements of section 4941(d)(2)(F) were satisfied. If it were determined that the foundation managers or other disqualified persons improperly used the foundation's assets in arranging a sale of the entire partnership to a third party, the excise tax would be applied to the fair market value of that use. Treas. Reg. § 53.4941(e)-1(b)(2)(ii).

Not only is the 5% tax imposed for the taxable year of the transaction, but the 5% tax is applied again for each taxable year, or part of a year (within the taxable period as defined in section 4941(e)(1)), from the date on which the act of self-dealing occurs to the earlier of either the date of mailing of a deficiency notice regarding the tax imposed, the date on which the tax imposed by section 4941(a)(1) is assessed, or the date on which correction of the act of self-dealing is completed. To correct the transaction, the disqualified person must do one of two things, i.e. undo the transaction, to the extent possible, or, if rescission is not possible, then the disqualified person must place the foundation in at least the position in which it would have been had the disqualified person met the highest fiduciary standards of dealing in the original transaction. Section 4941(e)(3).

Under the first tier tax of sanctions, when the 5% tax is imposed on the disqualified person, a tax of 2 1/2% of the transaction amount may be imposed on the foundation manager. This may occur, however, only if the manager knowingly participates in the act of self-dealing. On the other hand, if the act of participation is not willful and arises from a reasonable cause, the sanction is inapplicable. Section 4941(a)(2). This tax on the manager has a limit of $10,000 for each act of self-dealing. Section 4941(c)(2).

Should the disqualified person fail to correct the self-dealing transaction within the correction period, a second tier tax is triggered and an additional tax of 200% of the transaction amount is imposed on the disqualified person. Section 4941(b)(1). An additional tax of 50% of the transaction amount is imposed on the foundation manager if the manager has refused to agree to part or all of the correction. Section 4941(b)(2). This tax on the manager has a limit of $10,000 for any one act of self-dealing. Section 4941(c)(2). The transaction amount under the second tier tax is the highest fair market value of the property during the taxable period. Section 4941(e)(2)(B).

Issue 4

A ruling could be obtained on the above sales transactions or on whether a liquidation or dissolution meets the requirements of section 4941(d)(2)(F) of the Code. The time it would take to obtain such a ruling would depend on the workload at the time.

Please call if you have any further questions.

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