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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Date: JUL 17 2001

Contact Person:

Identification Number:

SIN: 4941.00-00
4944.00-00

Telephone Number:

T:EO:B3

Employer Identification Number:

Legend:

M =
N =
O =
P =
Q =
R =
S =
A =
B =
C =
X =
Y =
Z =

Dear Sir or Madam:

This is in response to a letter dated January IO. 2001, submitted by M's authorized representatives, who request certain rulings concerning the federal tax consequences of the transaction described below.

M is a nonprofit corporation that is exempt from federal income tax under section 501(a) of the Internal Revenue Code as an organization described in section 501(c)(3). M is classified as a private foundation within the meaning of section 509(a). M's purposes are consistent with section 501(c)(3), and its primary work is to support research to find a cure for a disease. M makes grants to charitable organizations described in section 501(c)(3) and government entities that are engaged in such research.

M is governed by a three member board of trustees, two of whom, A and B, are husband

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and wife, while the third, C, is their counsel. A and B formed N, a limited liability company, which is treated as a partnership for federal income tax purposes. A and B contributed $x in cash to N, which used $y to purchase ownership interests in O, a limited partnership. N donated to M both its limited partnership interests in O and the remaining cash, $z, it received from A and B.

M currently owns the limited partnership interests and cash in the amount of $z. This year, M plans to distribute most or all of $z, after M's normal expenses, in the form bf grants to organizations described in section 501 (c)(3) of the Code and government entities in furtherance of M's exempt purposes. M plans to continue to hold the contributed limited partnership interests indefinitely, along with any other future contributions to M, subject to its need for cash to fund its charitable activities and to meet its obligations under sections 4940 and 4942.

The general partner of O is P, and the general partner of P is Q, which is wholly owned by A. O is managed by R, and the general partner of R is S, which is owned by A. In the ruling request M's representatives stated that A effectively controls O.

O invests in publicly traded corporations that include both domestic and international companies involved in a wide range of activities. O is now invested in stock in more than 100 companies. In order to limit its exposure to market risk, O also invests in short positions that complement its long positions. As of the date of the contribution to M of the partnership interests in O, any liabilities allocable to partners represented short sales of securities.

R normally charges a management fee based on a percentage of the assets invested in O. In addition, P receives an allocation of the limited partners' gross profit from O. However, both R and P have agreed to waive the managemenf fee and profit allocation for M.

Section 4941 (a) of the Code imposes a tax on each act of self-dealing between a disqualified person and a private foundation. In the case of a foundation manager acting only as such, tax is imposed if the foundation manager participates in the act of self-dealing knowing that it is such an act, unless such participation is not willful and is due to reasonable cause.

Section 4941(d)(l)(A) and (C) of the Code defines "selfdealing" as including any direct or indirect sale or exchange, or leasing, of property between a disqualified person and a private foundation, and furnishing of goods, services, or facilities between a private foundation and a disqualified person.

Section 4941 (d)(2)(A) of the Code provides that the transfer of real or personal property by a disqualified person to a private foundation shall be treated as a sale or exchange if the property is subject to a mortgage or similar lien which the foundation assumes or if it is subject to a mortgage or similar lien which a disqualified person placed on the property within the 10-year period ending on the date of the transfer.

Section 53.4941(d)-2(a)(l) of the Foundation and Similar Excise Taxes Regulations provides, in relevant part, that the sale or exchange of property between a private foundation and a disqualified person shall constitute an act of self-dealing. Similarly, the sale of stock or

other securities by a disqualified person to a private foundation in a "bargain sale" shall be an act of self-dealing regardless of the amount paid for such stock or other securities.

Section 4946(a)(l)(A) and (B) of the Code provides that the term "disqualified person" includes a substantial contributor to the private foundation and a foundation manager. Section 4946(b)(l) provides that a foundation manager includes a trustee of a private foundation.

Section 4946(a)(l)(F) of the Code provides, in part, that the term "disqualified person" includes a partnership in which persons described in subparagraph (A) or (B) own more than 35 percent of the profits interest.

Section 4944(a)(l) of the Code imposes a tax on a private foundation that invests any amount in such a manner as to jeopardize the carrying out of any of its exempt purposes. The tax equals five percent of the amount so invested for each year (or part thereof) in the taxable period.

Section 53.4944-1(a)(2)(ii)(a) of the regulations provides that section 4944 of the Code shall not apply to an investment made by any person that is later gratuitously transferred to a private foundation. If such foundation furnishes any consideration to such person upon the transfer, the foundation will be treated as having made an investment (within the meaning of section 4944(a)(l)) in the amount of such consideration.

Section 514(b)(l) of the Code provides that the term "debt-financed property" means any property that is held to produce income and with respect to which there is "acquisition indebtedness" at any time during the taxable year (or during the 12 months preceding disposition in the case of property disposed of during the taxable year).

Section 514(c)(l) of the Code provides that the term "acquisition indebtedness" means, with respect to any debt-financed property, the unpaid amount of (A) indebtedness incurred by the organization in acquiring or improving the property, (B) indebtedness incurred before the acquisition or improvement of the property if the indebtedness would not have been incurred but for the acquisition or improvement, and (C) indebtedness incurred after the acquisition or improvement of the property if the indebtedness would not have been incurred but for the acquisition or improvement and the incurrence of the indebtedness was reasonably foreseeable at the time of the acquisition or improvement.

Rev. Rul. 95-8, 1995-1 C.B. 107, holds that if an exempt organization sells publicly traded stock short through a broker, then neither the gain or loss attributable to the change in value of the underlying stock nor the rebate fee is income or loss derived from debt-financed properly within the meaning of section 514 of the Code. The Rev. Rul. cites Deputy v. du Pont, 308 U.S. 488 (1940). which held that although a short sale created an obligation, it did not create an indebtedness.

The first issue to be considered is whether the parties described above are "disqualified persons' with respect to M within the meaning of section 4946 of the Code. Based on the information provided, A and B are disqualified persons with respect to M because they are M's

trustees and substantial contributors. See section 4946(a)(l)(A) and (B). N is also a disqualified person with respect to M because A and B own all of the interests of N. See section 4946(a)(l)(F). O, P, Q, R and S are also disqualified persons with respect to M because A owns and/or effectively controls these organizations. Thus, because these parties are disqualified persons with respect to M, the transaction must be analyzed in the context of section 4941.

Section 4941(d)(l)(A) of the Code provides that the definition of self-dealing includes any direct or indirect sale or exchange, or leasing, of property between a private foundation and a disqualified person. Section 53.4941(d)-2(a)(l) of the regulations provides, in relevant part, that specific acts of self-dealing include the sale of stock or other securities between a private foundation and a disqualified person in a "bargain sale." Section 4941 (d)(2)(A) provides, in relevant part, that a transfer of property is treated as a sale or exchange if the property is subject to a mortgage or similar lien, which the private foundation assumes. Thus, in this case, If the transfer of the partnership interests to M is a "bargain sale" or is subject to a mortgage or similar lien, then the transfer constitutes an act of self-dealing under section 4941.

The available information indicates that the partnership interests are not assets that are subject to liabilities, and therefore the transfer of such assets to M was not a 'bargain sale" for purposes of section 4941 of the Code. Although the partnership Interests are subject to short positions, Rev. Rul. 95-8, supra, holds that short sales do not create indebtedness under section 514. Since short positions do not result in indebtedness, the transfer of the limited partnership interests that are subject to short positions is not a bargain sale for purposes of section 53.4941(d)-2(a)(l) of the regulations. Therefore, the transfer does not constitute an act of self-dealing within the meaning of section 4941(d)(l)(A). Furthermore, based on the same rationale, the short positions do not constitute mortgages or liens for purposes of section 4941 (d)(2)(A), and therefore, the transfer of the partnership interests also does not constitute an act of self-dealing under this provision.

M's continued ownership of the partnership interests will not constitute an act of self-dealing under section 4941 of the Code. We note that R and P will waive their usual fees and profit allocation and provide services to M free of charge. Based on this representation, the services R and P provide to M will not constitute self-dealing within the meaning of section 4941 of the Code. See section 53.4941 (d)-2(d)(3) of the regulations, which discusses the furnishing of services by a disqualified person without charge.

Section 4944(a)(l) of the Code imposes a tax on a private foundation if it invests any amount in such a manner as to jeopardize the carrying out of any of its exempt purposes. However, section 4944 is not applicable to an investment made by a person who later donates such investment to a private foundation. See section 53.4944-1(a)(2)(ii)(a) of the regulations, The information provided establishes that the limited partnership interests were donated to M without consideration. Consequently, section 4944 does not apply to these limited partnership interests.

Accordingly, based on the information submitted and the representations made, we rule as follows:

1. The transfer by N to M of the limited partnership interests in O did not constitute an act of self-dealing within the meaning of section 4941 of the Code.

2. The continued ownership by M of the contributed limited partnership interests in O will not constitute an act of self-dealing within the meaning of section 4941 of the Code.

3. The continued ownership by M of the contributed limited partnership interests in O will not constitute a jeopardizing investment within the meaning of section 4944 of the Code.

Except as specifically ruled upon above, no opinion is expressed concerning the federal inwme tax consequences of the transactions described above under any other provision of the Code.

This ruling is based on the understanding that there will be no material changes in the facts upon which it is based.

Pursuant to a Power of Attorney on file in this office, a copy of this letter is being sent to M's authorized representatives. A copy of this letter should be kept in M's permanent records.

This ruling is directed only to the organization that requested it. Section 611 O(k)(3) of the Code provides that it may not be used or cited by others as precedent.

If there are any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Robert C. Harper, Jr.

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