TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

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Date September 6, 2005:

Contact Person:

Identification Number:

Telephone Number:

UIL Index
4941.04-00
4942.03-03
4943.04-03
4944-05-00

Legend:

B =
C =
D =
E =
F =
G =
H =
J =
M =
N =
P =
Q =
R =
x =
Date y =

Dear :

This responds to a letter from M's authorized representative, requesting rulings under sections 4941, 4942, 4943, and 4944 of the Internal Revenue Code on M's behalf.

Facts:

M is recognized as exempt from federal income tax under section 501(a) of the Code as an organization described in section 501(c)(3). M is classified as a private foundation within the meaning of section 509(a) of the Code. M's purpose is to accept contributions of money or property and, in turn, to use and apply those contributions exclusively for charitable purposes.

M was created by B and has three trustees which are B's nephew and nieces, C, D, and E. In 2001, C, E, and N, as trustee of P, entered into a partnership agreement establishing Q, a limited liability limited partnership under state law.

The purpose of Q is to hold, manage, invest, and reinvest the property contributed to it by the partners in order to maximize current income production and long term appreciation. Q's primary assets are marketable securities and unimproved real estate. Q compensates each of its individual general partners $10x for attendance at each of its quarterly meetings. The managing general partner, C, is compensated $20x for attendance at each of Q's quarterly meetings and for management services provided to Q throughout the year.

Q manages its real property holdings through a real estate management committee which consists of F, G, and H, the children of C, D, and E respectively. F, G, and H are responsible for the day to day management of Q's real estate holdings, and are compensated $1x per meeting attended. The committee submits a written summary of all its activities as well as its recommendations for each of Q's properties to the general partners at the quarterly partnership meetings.

Under the partnership agreement, limited partners of Q may not participate in the management of Q and have no right or authority to act for or bind the partnership or its partners. Limited partners may not sell, transfer, or otherwise dispose of all or any part of their interests in Q without first having obtained written consent of the general partners to any such proposed disposition.

In 2002, B established R as a charitable remainder unitrust within the meaning of section 4 of Rev. Proc. 90-31 and section 664(d)(2) and (3) of the Code. B was the lifetime beneficiary of R. At the same time, the Q partnership agreement was amended to effect a transfer of a limited partnership interest from N, trustee of P, to N as trustee of R, as directed by B. Subsequently, the Q partnership agreement was again amended to reflect the admission of D and D's additional capital contribution to Q for a general partnership interest. Since then, and up to the current time, ownership of Q is as follows:

General Partners:	
P	1.00%
C	0.10%
E	0.10%
D	0.10%
Limited Partners:	
P	65.40%
R	33.30%
Total	100.00%

B died in 2003. Per the terms of R, upon B's death, R is to distribute all of its assets, including the 33.3% limited partnership interest in Q, to its charitable beneficiary, M.

The primary beneficiary under B's will is P, of which C, D, E, and J are the residuary beneficiaries. The Q partnership interests held by P will be distributed equally to C, D, E, and J. After distribution of the Q partnership interests by R and P, ownership of Q will be as follows:

General Partners:	
C	0.10%
E	0.10%
D	0.10%
Limited Partners:	
C	16.60%
E	16.60%
D	16.60%
J	16.60%
M	33.30%
Total	100.00%

The vested interest of C, D, and E in P represent greater than 35 percent of the total value of the assets held in P. N is the executor under the will of B (the "Estate") and serves as trustee of P and R.

Prior to B's death, B transferred a substantial portion of B's assets to P, with any remaining assets held in B's name to be transferred to the P upon B's death. At Date y, P had approximately $124,000x in non-marketable assets and approximately $42,000x in marketable assets net of unpaid specific bequests and administration expenses. N estimates that the total federal and estate tax liability will be approximately $80,000x, producing a deficit in liquid assets of approximately $38,000x. Consequently, N, as trustee of P and executor under will, has borrowed $50,000x in order to satisfy the estate tax liability and fund a reserve for purposes of administering the Estate.

N solicited proposals from several commercial lending institutions, including N, for the $50,000x loan. Following several rounds of offers, N was selected as the lender and a Loan Agreement was entered into. To secure the $50,000x loan, P entered into a Put Agreement with Q whereby P could put so much of its 65.4 percent limited partnership interest in Q back to Q as necessary to liquidate the $50,000x loan should an event of default occur under the Loan Agreement. P's interest in the Put Agreement was assigned to N as the lender with the consent of the general partners of Q as required by the partnership agreement. The put option price is based on the appraised value of the limited partnership interest, employing the same methodology for appraisal as will be used for estate tax purposes, which considers discounts for lack of marketability and control consistent with valuation principles contained in the regulations under section 2031 of the Code. In no event, however, is the put option price less than the current principal balance of the outstanding loan plus accrued interest.

<u>Rulings Requested</u>:

The following rulings have been requested:

1. R did not terminate upon the death of B, the life beneficiary, but instead continues for a period reasonably necessary for the winding up of its affairs in accordance with section 1.641(b)-3(b) of the regulations. This "period" includes a reasonable amount of time necessary to obtain a ruling from the Service providing guidance on whether or not M may hold the limited partnership interest in Q without violating section 4941, 4943, and 4944 of the Code.

2. M should not recognize the 33.3 percent limited partnership interest in Q in calculating its minimum investment return until it has actually or constructively received the property in accordance with section 53.4942(a)-2(c)(2)(i) of the regulations.

3. For purposes of calculating M's minimum investment return pursuant to section 4942 of the Code, M's trustees may determine the value of M's interest in Q on an annual basis pursuant to section 53.4942(a)-2(c)(4)(iv)(a) of the regulations by applying commonly accepted methods of valuation consistent with section 53.4942(a)-2(c)(4)(iv)(c).

4. For purposes of valuing M's interest in Q under section 53.4942(a)-2(c)(4)(iv)(c) of the regulations, section 4942(e)(2)(B) of the Code is inapplicable, and thus discounts in excess of ten percent are appropriate where warranted by application of the valuation principles stated in the regulations under section 2031.

5. For purposes of valuing M's interest in Q, M may determine the value of the real estate held by Q on a five-year basis in accordance with section 53.4942(a)-2(c)(4)(iv)(b) of the regulations.

6. Co-ownership of Q by M and P before P distributes the partnership interests to its beneficiaries does not constitute a direct or indirect act of self-dealing under section 4941 of the Code.

7. Neither M nor R has an expectancy interest in the assets of P, specifically P's partnership interests in Q, pursuant to section 53.4941(d)-1(b)(3) of the regulations. Therefore, the act of N, as trustee of P, of entering into the Put Agreement and assigning its interest in the Put Agreement to N as lender to secure the loan to pay the Estate's estate tax liability does not constitute a direct or indirect act of self-dealing under section 4941 of the Code with respect to M or R.

8. Q is not "controlled" by M within the meaning of section 53.4941(d)-1(b)(5) of the regulations. Therefore, pursuant to section 53.4941(d)-1(b)(4), transactions between Q and its general partners, C, D, and E, will not be treated as indirect acts of self-dealing solely because of the ownership interests of those individuals in Q.

9. Co-ownership of Q by M and its trustees, C, D, and E, will not constitute a direct or indirect act of self-dealing under section 4941 of the Code with respect to M.

10. Q's act of paying reasonable compensation to its general partners and managing general partner will not constitute a direct or indirect act of self-dealing with respect to M under section 4941 of the Code.

11. Q's act of paying reasonable compensation to the members of its real estate management committee will not constitute a direct or indirect act of self-dealing with respect to M under

section 4941 of the Code.

12. When applying section 4941(d)(1)(E) of the Code to M, its “asset” in the case of its interest in Q is its capital or profits interests in the partnership, not the underlying assets of the partnership.

13. M’s 33.3 percent limited partnership interest in Q will not constitute an excess business holding under section 4943 of the Code provided Q keeps its investment in any one business enterprise within the twenty percent limitation provided for in section 4943(c)(3) of the Code and section 53.4943-3(c) of the regulations.

14. If the 33.3 percent limited partnership interest in Q constitutes an “excess business holding” within the meaning of section 4943(c), M will have five years from the date of actual or constructive receipt of the property to dispose of such interest in accordance with section 4943(c)(6) of the Code. The five-year period under section 4943(c)(6) will not begin to run until the partnership interest is actually distributed by R or deemed distributed pursuant to section 1.641(b)-3(b) of the regulations.

15. M’s limited partnership interest in Q will not constitute a jeopardizing investment to M pursuant to section 4944 of the Code where such investment has been gratuitously transferred to M.

16. M’s limited partnership interest in Q will not constitute a jeopardizing investment pursuant to section 4944 of the Code provided M does not change the form or terms of such investment pursuant to section 53.4944-1(a)(2)(iii) of the regulations. For this purpose, changes in the partnership’s investments by Q in the ordinary course of managing its investments will not constitute a change in the form or terms of the investment by M.

<u>Law and Analysis</u>:

<u>1. Section 4942 Taxes on Failure to Distribute Income.</u>

A. Imposition of Tax

Section 4942(a) of the Code imposes a tax equal to 15 percent on the undistributed income of a private foundation for any taxable year which has not been distributed before the first day of the second (or any succeeding) taxable year following such taxable year for which the distributable amount was determined.

Section 4942(c) of the Code provides that the term “undistributed income” means, with respect to any private foundation for any taxable year as of any time, the amount by which the distributable amount for such taxable year exceeds the qualifying distributions made before such time out of such distributable amount.

Section 4942(d) of the Code defines “distributable amount” with respect to any private foundation for any taxable year as an amount equal to the sum of the minimum investment return plus the amounts described in section 4942(f)(2)(C) reduced by the sum of the taxes imposed on such private foundation for the taxable year under Subtitle A and section 4940.

Section 4942(e) of the Code defines “minimum investment return” with respect to any private foundation for any taxable year as five percent of the excess of the aggregate fair market value of all assets of the foundation (other than those used, or held for use, in carrying out the private foundation’s exempt purpose) over the acquisition indebtedness with respect to such assets.

B. Assets excluded from calculation of “minimum investment return.”

Section 53.4942(a)-2(c)(2)(i) of the Foundation and Similar Excise Taxes Regulations excludes from the calculation of a private foundation’s minimum investment return any future interest (such as a vested or contingent remainder, whether legal or equitable) of a foundation in the income or corpus of any real or personal property until all intervening interests in, and rights to the actual possession or enjoyment of, such property have expired, or, although not actually reduced to the foundation’s possession, until such future interest has been constructively received by the foundation, as where it has been credited to the foundation’s account, set apart for the foundation, or otherwise made available so that the foundation may acquire it at any time or could have acquired it if notice of intention to acquire had been given.

Section 53.4942(a)-2(c)(2)(ii) of the regulations excludes from the calculation of a private foundation’s minimum investment return the assets of an estate until such time as such assets are distributed to the foundation or, due to a prolonged period of administration, such estate is considered terminated for Federal income tax purposes by operation of section 1.641(b)-3(a) of the Income Tax Regulations.

Although section 53.4942(a)-2(c)(2)(ii) of the regulations is specifically directed toward the exclusion of assets to be distributed to a foundation by an estate, the automatic termination provisions to which it directs the reader in section 1.641(b)-3(a) are identical to the ones found in section 1.641(b)-3(b) with respect to the termination of trusts. Both paragraphs provide automatic termination upon expiration of a reasonable period for the performance of the fiduciary’s administrative duties. These termination provisions are also in harmony with section 53.4942(a)-2(c)(2)(i) providing for the exclusion of future interests in property for purposes of calculating a foundation’s minimum investment return until the property is actually or constructively received by the foundation. A deemed termination of an estate or trust pursuant to section 1.641(b)-3(a) or (b), respectively, would cause a foundation to recognize its interest in the property as though it had actually received it in accordance with 53.4942(a)-2(c)(2)(i). The only difference is that, in the case of an estate, the provision for inclusion of assets in calculating a foundation’s minimum return upon the deemed termination of an estate is specifically incorporated in section 53.4942(a)-2(c)(2). To accord a different treatment for recognition of assets held in trust would frustrate the logical relationship between section 1.641(b)-3(b) and 53.4942(a)-2(c)(2)(i). Furthermore, property held in trust is analogous to property held by an estate in that a foundation has no rights to the actual possession or enjoyment of such property until it is actually distributed. Therefore, M should not recognize any interest in assets held by R until the earlier of actual distribution or termination under section 1.641(b)-3(b) for purposes of calculating its minimum investment return under section 4942 of the Code.

C. Valuation of M’s interest in Q.

Section 53.4942(a)-2(c)(4)(iv)(a) of the regulations provides, generally, that the fair market value of assets other than certain securities, cash, and common trust funds shall be determined annually. If, however, a private foundation owns voting stock of an issuer of unlisted securities and has, or together with disqualified persons or another private foundation has, effective control of the issuer (within the meaning of section 53.4943-3(b)(3)(ii)), then to the extent that the issuer's assets consist of shares of listed securities issues, such assets shall be valued monthly on the basis of market quotations or in accordance with section 4942(e)(2)(B), if applicable. The purpose of this rule is to prevent a foundation from avoiding the ten percent discount limitation of section 4942(e)(2)(B) by the simple device of incorporating its investment portfolio as a holding company. *See* T.D. 7715, 45 FR 56802-02. Thus, for example, if a private foundation and a disqualified person together own all of the unlisted voting stock of a holding company which in turn holds a portfolio of securities of issues which are listed on the New York Stock Exchange, in determining the net worth of the holding company, the underlying portfolio securities are to be valued monthly by reference to market quotations for their issues unless a decrease in such value is authorized in accordance with section 4942(e)(2)(B). Such determination may be made by employees of the private foundation or by any other person, without regard to whether such person is a disqualified person with respect to the foundation. A valuation made pursuant to the provisions of this subdivision, if accepted by the Commissioner, shall be valid only for the taxable year for which it is made. A new valuation made according to these provisions is required for the succeeding taxable year.

Section 53.4942(a)-2(c)(4)(iv)(b) of the regulations provides generally that the fair market value of any interest in real property may be determined on a five-year basis. Such value must be determined by means of a certified, independent appraisal made in writing by a qualified person who is neither a disqualified person with respect to, nor an employee of, the private foundation. The appraisal is certified only if it contains a statement at the end thereof to the effect that, in the opinion of the appraiser, the values placed on the assets appraised were determined in accordance with valuation principles regularly employed in making appraisals of such property using all reasonable valuation methods. If a valuation made pursuant to the provisions of this subdivision in fact falls within the range of reasonable values for the appraised property, such valuation may be used by the foundation for the taxable year for which the valuation is made and for each of the succeeding 4 taxable years. A valuation, if properly made in accordance with the rules set forth in this subdivision, will not be disturbed by the Commissioner during the 5-year period for which it applies even if the actual fair market value of such property changes during such period.

Section 53.4942(a)-2(c)(4)(iv)(c) of the regulations provides that valuations made in accordance with the principles stated in the regulations under section 2031 of the Code constitute acceptable methods of valuation.

Section 4942(e)(2)(B) of the Code provides, in pertinent part, that the reduction in value for the fact that securities held by a private foundation are securities in a closely held corporation shall not exceed ten percent of the fair market value of such securities.

Section 53.4942(a)-2(c)(4)(i)(c) of the regulations limits the application of section 4942(e)(2)(B) of the Code to securities for which market quotations are readily available.

Because M's interest in Q will not constitute listed securities, cash, or a common trust fund, the Q interest must be valued in accordance with section 53.4942(a)-2(c)(4)(iv) of the regulations as "other assets." M's profits interest in Q is analogous to the "voting stock of an issuer of unlisted securities." M and disqualified persons have effective control over Q within the meaning of section 53.4943-3(b)(3)(ii). Therefore, insofar as Q's assets consist of shares of listed securities issues, such assets shall be valued monthly on the basis of market quotations or in accordance with section 4942(e)(2)(B) of the Code, if applicable. The valuation of the partnership interest may be made by the employees of M or any other person without regard to whether such person is a disqualified person with respect to M in accordance with section 53.4942(a)-2(c)(4)(iv)(a).

Because the value of the Q limited partnership interest is related to the value of the underlying property held by the partnership, the value of real estate and any other property held by Q must be taken into consideration. Although the regulations do not define an "interest in real property," it would appear reasonable to value the real estate held by Q on a five-year basis in accordance with section 53.4942(a)-2(c)(4)(iv)(b) of the regulations. Therefore, for purposes of determining the value of its limited partnership interest in Q, M should be afforded the favorable valuation rule in section 53.4942(a)-2(c)(4)(iv)(b) and value Q's real property on a five-year basis if it so selects.

2. Section 4941 Taxes on Self-dealing

Section 4941(a) of the Code imposes a tax on each act of self-dealing between a disqualified person and a private foundation.

Section 4946(a)(1) of the Code provides, in pertinent part, that the term "disqualified person" with respect to a private foundation means a foundation manager, family members of a foundation manager, a partnership in which foundation managers own more than 35 percent of the profits interest, and a trust or estate in which foundation managers hold more than a 35 percent beneficial interest.

Section 4946(b)(1) of the Code defines a "foundation manager" as an officer, director, or trustee of a foundation (or an individual having powers or responsibilities similar to those of officers, directors, or trustees of the foundation).

Section 4946(d) of the Code provides, in pertinent part, that a foundation manager's family members shall include his or her children.

Section 4941(d)(1) of the Code defines "self-dealing" as any direct or indirect act between a disqualified person and a private foundation consisting of a sale, exchange, or leasing of property, lending of money, or other extension of credit, and the furnishing of goods, services, or facilities. Self-dealing also includes a direct or indirect payment of compensation or reimbursement of expenses by a private foundation to a disqualified person, a direct or indirect transfer to, or use by or for the benefit of, a disqualified person of the income or assets of the private foundation, and an agreement by a private foundation to make a payment of money or property, directly or indirectly, to a government official.

Section 4941(d)(2)(E) of the Code provides that the payment of compensation (and the payment or reimbursement of expenses) by a private foundation to a disqualified person for personal services which are reasonable and necessary to carrying out the exempt purpose of the private foundation shall not be an act of self-dealing if the compensation (or payment or reimbursement) is not excessive.

Section 53.4941(d)-3(c)(2) of the regulations, in examples (1), (2), and (3), provides that the term “personal services” includes legal, investment management, and general banking services, respectively, and that compensation paid by a private foundation to a disqualified person for such services will be treated as reasonable and necessary to the carrying out of the private foundation’s exempt purposes provided the compensation is not excessive.

Section 53.4941(d)-1(b)(3) of the regulations provides, in pertinent part, an exception to “indirect self-dealing” for a transaction with respect to a private foundation’s interest or expectance in property held by an estate or revocable trust provided the transaction meets the criteria specified in that section.

Section 53.4941(d)-1(b)(4) of the regulations provides that a transaction between a private foundation and an organization which is not controlled by the foundation (within the meaning of section 53.4941(d)-1(b)(5)), and which is not described in section 4946(a)(1)(E), (F), or (G) of the Code because persons described in section 4946(a)(1)(A), (B), (C), or (D) own no more than 35 percent of the total combined voting power or profits or beneficial interest of such organization, shall not be treated as an indirect act of self-dealing between the foundation and such disqualified persons solely because of the ownership interest of such persons in such organization.

Section 53.4941(d)-1(b)(5) of the regulations provides that an organization is controlled by a private foundation if the foundation or one or more of its managers (acting only in such capacity) may, only by aggregating their votes or positions of authority, require the organization to engage in a transaction which if engaged in with the private foundation would constitute self-dealing. Similarly, an organization is controlled by a private foundation in the case of such a transaction between the organization and a disqualified person, if such disqualified person, together with one or more persons who are disqualified persons by reason of such a person’s relationship (within the meaning of section 4946(a)(1)(C) through (G)) to a disqualified person, may, only by aggregating their votes or positions of authority with that of the foundation, require the organization to engage in such a transaction. The controlled organization need not be a private foundation; it may be any type of exempt or nonexempt organization. For purposes of this paragraph, an organization will be considered to be controlled by a private foundation or by a private foundation and disqualified persons referred to in the second sentence of this subparagraph if such persons are able, in fact, to control the organization (even if their aggregate voting power over is less than 50 percent of the total voting power of the organization’s governing body) or if one or more of such persons has the right to exercise veto power over the actions of such organization relevant to any potential acts of self-dealing.

Section 53.4941(d)-1(b)(7) of the regulations provides that the term “indirect self-dealing” shall not include a transaction involving one or more disqualified persons to which a private foundation is not a party, in any case in which the private foundation, by reason of section 4941(d)(2) of the Code, could itself engage in such a transaction.

Rev. Rul. 76-158, 1976-1 C.B. 354, states that an example of indirect self-dealing would be a transaction of the type described in section 4941(d)(1) of the Code between a disqualified person with respect to a private foundation and a corporation controlled by the private foundation within the meaning of section 53.4941(d)-1(b)(5) of the regulations. In that ruling, the private foundation owned 35 percent of the voting stock of a corporation while a foundation manager owned the remaining 65 percent. The foundation did not "control" the corporation within the meaning of section 53.4941(d)-1(b)(5) because the foundation manager held no stock nor occupied a position of authority in the corporation by virtue of being a foundation manager, the foundation could not, either alone or with the manager (acting only in such capacity), control the corporation, the manager could control the corporation without aggregating his votes with those of the foundation, and the foundation did not have the right to exercise veto power over the actions of the corporation.

C, D, and E are disqualified persons under section 4946(a)(1)(B) of the Code with respect to M because they are trustees of M and, therefore, foundation managers within the meaning of section 4946(b)(1) of the Code. F, G, and H are disqualified persons under section 4946(a)(1)(D) with respect to M because they are family members of the trustees of M. The Estate and P are disqualified persons under section 4946(a)(1)(G) with respect to M because C, D, and E are foundations managers within the meaning of sections 4946(a)(1)(B) and 4946(b)(1) and hold more than a 35 percent beneficial interest in P includable in the Estate under section 2038. After P distributes its partnership interests in Q in part to C, D, and E, Q will be a disqualified person under section 4946(a)(1)(F) with respect to M because its trustees will own collectively a greater than 35 percent interest in Q. N is a disqualified person with respect to R because it serves as Trustee of R and is therefore a foundation manager within the meaning of section 4946(a)(1)(B) and 4946(b)(1). Under section 4946(a)(1)(F), Q is also a disqualified person with respect to R during the period that N, as Trustee of P, holds the 66.4 percent partnership interests in Q.

Section 53.4941(d)-1(b)(3) of the regulations, providing for an exception to indirect self-dealing for transactions during the administration of an estate or revocable trust, illustrates that transactions which affect the assets of an estate are also treated as affecting the assets of a private foundation which, as a beneficiary of the estate, has an expectancy or interest in the assets held by the estate. *See* Estate of Reis v. Comm'r, 87 T.C. 1016. Here, M has an expectancy or interest in the Q limited partnership interest held by R, but neither M nor R has an expectancy or interest in the Q partnership interests held by P. Therefore, there was no direct or indirect act of self-dealing with respect to R or M when N, as Trustee of P, assigned to N, as Lender, a put option issued to P by Q of its 65.4 percent limited partnership interest in Q in order to secure the loan to pay the estate tax liability. Under the Put Agreement, P has agreed to sell, and Q has agreed to purchase, some or all of the limited partnership interests owned by P at the put price described in the Put Agreement. The put price is based on the value of the partnership interest consistent with valuation principles contained in the regulations under section 2031 of the Code. Those same principles will be used to value the Q partnership interests for estate tax purposes. Because the loan is not secured by a pledge of the underlying assets of Q, no disqualified persons with respect to R or M could be deemed to have benefited from the use of R's or M's assets.

Conceivably, the act of Q's pledging its assets as collateral for a loan could constitute a direct or indirect act of self-dealing under section 4941(d)(1)(E) of the Code with respect to R whereby N, in its capacity as lender or executor, benefits from a loan secured by assets of which R has an interest, albeit indirectly through Q. Likewise, after R distributes its 33.3 percent partnership interest to M, a loan secured by partnership assets of which M has an interest could be viewed as a direct or indirect act of self-dealing under section 4941(d)(1)(E) whereby P and its beneficiaries, C, D, and E, may be viewed as benefiting from such loan. However, even if Q's underlying assets constitute R's or M's assets for purposes of applying section 4941(d)(1)(E), there would still be no direct or indirect act of self-dealing because the Loan Agreement and Put Agreement were structured such that Q's assets were not pledged as security for the loan.

Co-ownership of Q by M and P does not constitute a direct or indirect act of self-dealing under section 4941 of the Code, where section 4943 contemplates co-investment arrangements between a private foundation and disqualified persons under specified circumstances. For the same reason, co-ownership of Q by M and its trustees, C, D, and E, after distribution of the partnership interests from P, does not constitute a direct or indirect act of self-dealing under section 4941.

Because M does not control Q within the meaning of section 53.4941(d)-1(b)(5) of the regulations, transactions between Q and its general partners, C, D, and E, will not be treated as indirect acts of self-dealing solely because of the ownership interests of those individuals in Q. M, as a limited partner, does not, either alone or with its trustees (acting only in such capacity), have the authority to require Q to engage in a transaction which if engaged in with the private foundation would constitute self-dealing, and the general partners, disqualified persons with respect to M, control Q alone. As such, M alone, or in conjunction with disqualified persons, neither has the authority to control Q nor may exercise veto power over the actions of Q. Therefore, M does not control Q within the meaning of section 53.4941(d)-1(b)(5).

Transactions such as those involving the compensation of C, D, and E by Q for management of the partnership will not constitute indirect acts of self-dealing with respect to M where such compensation is reasonable and necessary for the maintenance of the partnership and consequently to the value of M's investment. Absent the partnership structure, M would require the personal services of an investment management professional for guidance concerning its underlying investments in the partnership. This would be necessary to ensure that M maximizes the value of its investments and is able to carry out its exempt purpose of distributing funds for charitable purposes. Section 53.4941(d)-3(c) of the regulations expressly permits compensation for investment management services provided that the compensation is not excessive. Therefore, under section 53.4941(d)-1(b)(7), the compensation paid by Q to the general partners for management services is not an indirect act of self-dealing consisting of a "transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation" under section 4941(d)(1)(E) of the Code where M's act of compensating the individuals directly would not constitute an act of self-dealing under section 4941(d)(1)(D) by application of section 4941(d)(2)(E).

Likewise, the act of Q's compensating F, G, and H for their services provided to Q through the real estate management committee will not constitute a direct or indirect act of self-dealing with respect to M under section 4941 of the Code where such services are necessary for the maintenance of the partnership's property. If M owned the real estate directly, its act of compensating these individuals for their services would not violate section 4941(d)(1)(D) because such services would be reasonable and necessary for the maintenance of its properties and thus reasonable and necessary to M's carrying out its exempt purposes as described in section 4941(d)(2)(E).

This ruling does not cover possible acts of direct or indirect self-dealing other than those specifically described in the above paragraphs.

3. Section 4943 Taxes on Excess Business Holdings

Section 4943(a)(1) of the Code imposes a tax on a private foundation's excess business holdings in a business enterprise during any taxable year which ends during the taxable period (as defined in section 4943(d)(2)).

Section 4943(c)(1) of the Code provides that the term "excess business holdings" means, with respect to the holdings of any private foundation in any business enterprise, the amount of stock or other interest in the enterprise which the foundation would have to dispose of to a person other than a disqualified person in order for the remaining holdings of the foundation in such enterprise to be permitted holdings.

Section 4943(c)(2)(A) of the Code generally defines the permitted holdings of any private foundation in an incorporated business enterprise to be 20 percent of the voting stock reduced by the percentage of voting stock owned by all disqualified persons with respect to a private foundation.

Section 4943(c)(3) of the Code provides, in pertinent part, that the permitted holdings of a private foundation in any unincorporated business enterprise shall be determined under regulations consistent in principle with section 4943(c)(2) except that "profits interest" shall be substituted for "voting stock" and "capital interest" shall be substituted fort "nonvoting stock."

Section 53.4943-3(c) of the regulations (with reference to section 53.4943-3(b)) provides that the permitted holdings in the case of a private foundation's ownership of an interest in a partnership are limited to 20 percent of the profits interest reduced by the percentage profits interest in the partnership actually or constructively owned by all disqualified persons.

Section 4943(d)(1) of the Code provides, generally, that in computing the holdings of a private foundation or a disqualified person in any business enterprise, any stock or other interest owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries. However, section 53.4943-8(a)(1) excepts partnerships from this proportionate ownership treatment by reference to section 53.4943-8(d).

Section 53.4943-8(d) of the regulations provides that any interest in a business enterprise which is owned by a partnership shall be deemed to be constructively owned by the partners in such partnership.

Section 4943(d)(3) of the Code provides, in pertinent part, that the term "business enterprise" does not include a functionally related business (as defined in section 4942(j)(4)) or a trade or business at least 95 percent of the gross income of which is derived from passive sources. "Passive sources" includes the items excluded by section 512(b)(1), (2), (3), and (5).

Section 4942(j)(4) of the Code provides, in pertinent part, that a "functionally related business" is a trade or business which is not an unrelated trade or business as defined in section 513.

Section 53.4943-10(a)(1) of the regulations provides that, except as provided in section 53.4943-10(b) or (c), the term “business enterprise” includes the active conduct of a trade or business, including any activity regularly carried on for the production of income from the sale of goods or the performance of services and which constitutes an unrelated business under section 513 of the Code.

Section 53.4943-10(b) of the regulations provides that the term “business enterprise” does not include a functionally related business and that business holdings do not include program-related investments.

Section 53.4943-10(c) of the regulations provides, in pertinent part, that, for purposes of section 4943(d)(3) of the Code, the term “business enterprise” does not include a trade or business at least 95 percent of the gross income of which is derived from passive sources. Thus stock in a passive holding company is not to be considered a holding in a business enterprise even if the company is controlled by the foundation. Instead, the foundation is treated as owning its proportionate share of any interests in a business enterprise held by such company under section 4943(d)(1). Gross income from passive sources includes the items excluded by section 512(b)(1), (2), (3), and (5) (dividends and interest, royalties, rents, and gains or losses from the disposition of certain property).

Section 513(a) of the Code provides that the term “unrelated trade or business” means any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501.

Section 513(c) of the Code defines the term “trade or business” as any activity which is carried on for the production of income from the sale of goods or the performance of services.

Section 1.513-1(b) of the regulations provides that the term “trade or business” has the same meaning it has in section 162, and generally includes any activity carried on for the production of income from the sale of good or performance of services. Thus, the term “trade or business” in section 513 is not limited to integrated aggregates of assets, activities, and goodwill which comprise business for the purposes of certain other provisions of the Code.

Section 512(a)(1) of the Code defines “unrelated business taxable income” as the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed under chapter 1 of subtitle A which are directly connected with the carrying on of such trade or business, both computed with modifications provided in subsection (b).

Section 512(b)(1), (2), (3), and (5) of the Code provides generally that “unrelated business taxable income” shall not include dividends, interest, royalties, rents, and gains or losses from the sale, exchange or other disposition of certain property.

Section 512(c)(1) of the Code provides that if a trade or business regularly carried on by a partnership of which an organization is a member is an unrelated trade or business with respect to such organization, such organization in computing its unrelated business taxable income shall, subject to the exceptions, additions, and limitations contained in subsection (b), include its share (whether or not distributed) of the gross income of the partnership from such unrelated trade or business and its share of partnership deductions directly connected with such gross income.

Once R distributes the limited partnership interest in Q to M, M and disqualified persons C, D, and E will own 83.4 percent of Q. If Q were considered a “business enterprise,” M and disqualified persons would be over the permitted twenty percent threshold of ownership permitted under section 4943(c) of the Code. Section 53.4943-10(a)(1) defines “business enterprise,” however, as an unrelated trade or business within the meaning of section 513, and section 513 and the regulations thereunder generally define a “trade or business” at the individual activity level, “not limited to integrated aggregates of assets, activities, and goodwill which comprise businesses for the purposes of certain other provisions of the Code.” *See* section 1.513-1(b) of the regulations. This definition is consistent with instructions for computing a private foundation’s holdings in a business enterprise under section 53.4943-8(d). That section provides that any interest in a business enterprise owned by a partnership will be deemed to be constructively owned by the partners in such partnership. Thus, the individual activities of Q must be examined in order to determine if the partnership interest held by M constitutes a holding in a “business enterprise” within the meaning of section 4943(d)(3) of the Code and section 53.4943-10(a)(1) of the regulations.

In order for any of Q’s activities to be considered a “business enterprise” within the meaning of section 53.4943-10(a)(1) of the regulations, the activity must be regularly carried on for the production of income from the sale of goods or the performance of services and constitute an unrelated trade or business under section 513 of the Code. Section 513(c) defines “trade or business” as any activity which is carried on for the production of income from the sale of goods or performance of services. Thus, in order to constitute a business enterprise, the activity must be both a “trade or business” and unrelated to the exercise or performance of M’s charitable purposes. Section 512(a)(1) provides that “unrelated business taxable income” is the gross income derived from an unrelated trade or business as defined in section 513. “Unrelated business taxable income” is to be calculated with the modifications provided in section 512(b). Section 512(b) excludes dividends, interest, royalties, rents, and gains or losses on the sale of certain property from the calculation of unrelated business taxable income.

Q holds investments in the form of securities and unimproved real estate, and its income from these holdings is in the form of dividends, interest, and rents. Thus, Q is not engaged in any activity which constitutes a “business enterprise” within the meaning of section 53.4943-10(a)(1) of the regulations: (1) Q is not engaged in any activities carried on for the production of income from the sale of goods or performance of services, and, therefore, its activities do not constitute active trades or businesses within the meaning of section 513 of the Code, and (2) section 512(b) specifically excludes from the calculation of unrelated business taxable income the types of income which Q receives (i.e., dividends, interest, and rents). Q’s activities are neither trades or businesses nor are they unrelated to M’s exempt purpose. The activities are not unrelated to M’s exempt purpose because the income generated from those activities is specifically excluded from “unrelated business taxable income” by section 512(b). Therefore, M holds no interest in a “business enterprise” through Q and consequently has no “excess business holdings” within the meaning of section 4943(c)(1) of the Code and section 53.4943-3(a)(1) of the regulations.

Section 4943(c)(3) of the Code and section 53.4943-3(c) of the regulations provides that the permitted holdings of a private foundation and all disqualified persons with respect to the private foundation in any partnership constituting a business enterprise is limited to twenty percent. As discussed above, Q is not a business enterprise and thus should be treated as a passive investment with respect to M. As such, M and all disqualified persons with respect to M are not precluded from owning interests in Q in excess of the twenty percent limitation imposed by section 4943. Section 4943(d)(1) of the Code and section 53.4943-8(a)(1) provide that in computing a private foundation's ownership in a business enterprise owned by a partnership, the partnership's interest in any business enterprise is treated as constructively owned by the partners. Thus M's investment in Q will not constitute an excess business holding under section 4943 provided Q limits its investment in any business enterprise to the twenty percent limitation imposed by section 4943(c)(3) of the Code and section 53.4943-3(c) of the regulations.

4. Section 4944 Taxes on Investments That Jeopardize Charitable Purposes

Section 4944(a) 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.

Section 53.4944-1(a)(2)(i) of the regulations provides that 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. The determination as to whether an 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.

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 which is gratuitously transferred to a private foundation.

Section 53.4944-1(a)(2)(iii) of the regulations provides, in pertinent part, that for purposes of section 4944 of the Code, a private foundation which changes the form or terms of an investment (regardless of whether 53.4944-1(a)(2)(ii) applies to such investment) will be considered to have entered into a new investment on the date of such change. Accordingly, a determination as to whether such change in the investment jeopardizes the carrying out of the foundation's exempt purposes shall be made at such time.

The transfer of the 33.3 percent limited partnership interest in Q by R to M will be without consideration and thus constitute a gratuitous transfer within the meaning of section 53.4944-1(a)(2)(ii)(a) of the regulations. Therefore, M's limited partnership interest in Q will not be considered a jeopardizing investment under section 4944 of the Code. Because section 53.4944-1(a)(2)(i) provides that the determination as to whether an investment is a jeopardizing one is to be made at the time of the initial investment, or gratuitous transfer in this case, it is conceivable that M's limited partnership interest in Q would never become a jeopardizing investment because it was not classified as one initially. However, section 53.4944-1(a)(2)(iii) provides that regardless of the application of section 53.4944-1(a)(2)(ii) to a gratuitous transfer, if a private foundation changes the form or terms of an investment, it will be considered to have entered into a new investment on the date of such change for purposes of determining whether or not such investment is a jeopardizing one under section 53.4944-1(a)(2)(i).

Although M many never change the terms or form of its investment in Q due to the restriction on it as a limited partner, M concedes that the makeup of the underlying assets in the partnership will change from time to time at the direction of the general partners. M also concedes that its trustees, also general partners of Q, are aware of the restriction on a private foundation's ability to hold investments which may jeopardize the private foundation's ability to carry out its exempt purposes. However, the duties and responsibilities of C, D, and E to Q are separate and apart from those duties and responsibilities they owe to M in their capacity as trustees, and it would not be reasonable to require the general partners to manage Q while simultaneously constraining their actions in such capacity just because they are trustees of M. For purposes of determining whether an investment is a jeopardizing one, changes in the underlying assets of that investment by Q should not be considered as a change in the "form or terms of an investment" by M for purposes of section 53.4944-1(a)(2)(iii). Therefore, even though the makeup of the underlying assets in Q will change from time to time, M's investment in Q will not constitute a jeopardizing investment provided M itself does not change the form or terms of that investment.

<u>Conclusion</u>:

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

1. M will not recognize the interest in Q held by R for purposes of calculating its minimum investment return under section 4942 of the Code until such interest is actually or constructively received by M pursuant to section 53.4942(a)-2(c)(2)(i) of the regulations. For this purpose, M will not be in constructive receipt of the interest in Q during a reasonable period for R's administration. Such period of administration shall include the time necessary to obtain guidance on the several issues outlined in this ruling request where such request is reasonable in consideration of M's desire to comply with the private foundation rules contained in section 4941, 4943, and 4944 of the Code.

2. After receiving the 33.3 percent limited interest in Q from R, M shall take such interest into account in calculating its minimum investment return for purposes of section 4942 of the Code. In doing so, M will value its interest in Q on an annual basis in accordance with section 53.4942(a)-2(c)(4)(iv)(a) of the regulations by employing commonly accepted methods of valuation per section 53.4942(a)-2(c)(4)(iv)(c). Insofar as Q's assets consist of shares of listed securities issues, such assets shall be valued monthly on the basis of market quotations or in accordance with section 4942(e)(2)(B), if applicable.. Additionally, the valuation of the partnership interest may be made by individuals without regard to whether such individuals are disqualified persons with respect to M.

3. Because the value of Q is related to the value of its underlying assets, the real estate must be appraised in order to determine the value of M's interest in Q. In this regard, application of the five-year valuation rule contained in section 53.4942(a)-2(c)(4)(iv)(b), if elected by M, is appropriate where such application would accomplish the rule's intended purpose of alleviating

M from the burden and cost of conducting annual appraisals on the real estate.

4. The act of N, as trustee of P, of assigning its interest in the Put Agreement with Q to N, as lender, to secure a loan to pay the Estate's estate tax liability did not constitute a direct or indirect act of self-dealing under section 4941 of the Code with respect to R or M where neither R nor M has an expectancy interest in the assets of P or the Estate, namely the 66.4 percent partnership interests in Q. The Loan Agreement and the Put Agreement are structured in such a way that no disqualified person would benefit from the use of R's or M's assets because partnership assets were not pledged as security for the loan.

5. Co-ownership of Q by M and P, and, later, after P distributes the Q limited partnership interests to its beneficiaries, co-ownership by M and its trustees, C, D, and E, will not constitute direct or indirect acts of self-dealing under section 4941 of the Code where such co-investment arrangements do not constitute a use by, or for the benefit of, disqualified persons of the income or assets of M. Payment of compensation by Q to its general partners, disqualified persons with respect to M, does not change this result where M does not control Q within the meaning of section 53.4941(d)-1(b)(5) of the regulations, and therefore Q's paying reasonable compensation to its general partners will not be treated as an indirect act of self-dealing solely because of the ownership interests of those individuals in Q. Furthermore, the act of Q's paying reasonable compensation to its general partners will not constitute an act of self-dealing where M's act of compensating those individuals directly would not constitute a direct act of self-dealing by virtue of section 4941(d)(2)(E) of the Code. Likewise, Q's compensating members of the real estate management committee, disqualified persons with respect to M, does not constitute an indirect act of self-dealing where M could compensate those individuals directly without violating section 4941(d)(1)(D) by virtue of section 4941(d)(2)(E).

6. M will hold a limited partnership interest in Q which will hold investments in real estate and securities in trades or businesses. Q will not directly engage in the active conduct of a trade or business, and M, as limited partner, cannot participate in the management of the partnership and has no right or authority to act for or bind the partnership or its partners. As such, M's investment in Q represents a passive investment, not a trade or business. Thus, by definition, M's investment in Q does not constitute an investment in a business enterprise and therefore does not represent an excess business holding under section 4943 of the Code. Alternatively, Q is excepted from treatment as a business enterprise by meeting the holding company exception contained in section 53.4943-10(c) of the regulations. In either case, application of the constructive ownership rule of section 53.4943-8(d) allows M and its disqualified persons to own up to a twenty percent interest in any business enterprise through Q. Therefore, M will not be liable for the tax on excess business holdings under section 4943 of the Code with regard to its investment in Q provided Q keeps its investment in any one business enterprise within the twenty percent limitation provided by section 4943(c)(3) of the Code and section 53.4943-3(c) of the regulations.

7. Because M's investment in Q represents a gratuitous transfer from R's settlor, B, the investment will not constitute a jeopardizing investment within the meaning of section 4944 of the Code. Furthermore, M's investment in Q will not be considered a jeopardizing investment provided M does not change the form or terms of that investment. For this purpose, changes in the underlying investments of the partnership by Q in the ordinary course of managing its investments will not constitute a change in the form or terms of the investment by M.

These rulings are made on the understanding that there will be no material changes in the facts upon which it is based.

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

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

This ruling letter is directed only to the organization that requested it. Section 6110(k)(3) of the Code provides that they may not be used or cited 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,

Mary Jo Salins
Acting Manager
Exempt Organizations
Technical Group 2