TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

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Dear Sir:

This letter is in response to your letter dated December 8, 2000, and subsequent correspondence, requesting rulings under section 4941 of the Internal Revenue Code.

X was executed on July 8, 1987 by A as settlor, A's wife, B, as co-trustee along with C as the other co-trustee. X is a charitable remainder trust. The Service issued a ruling that X meets the requirements of a charitable remainder unitrust under section 664 of the Code. As a

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section 664 trust, X is also a split-interest trust described in section 4947(a)(2), subject to section 4941 but not subject to section 4943.

S and its subsidiaries are an affiliated group of corporations which file a consolidated federal income tax return. S was incorporated in Delaware in 1967. It is a closely held company and has only one class of stock outstanding, which is common voting stock.

A died in 1988 and left a Last Will and Testament, which was admitted to probate. Z, A's estate, remains open and before the jurisdiction of the probate court. The Will provides that after the distribution of certain specific bequests, the entire residuary estate will pass to X. Z currently owns e percent of the stock of S issued and outstanding.

B and C were appointed independent co-executors of Z. C is a trustee of X, as previously mentioned, and is President and a director of S. B is a trustee of X and is also the income beneficiary of X. B is a shareholder of S, owning f percent of the total issued and outstanding shares, and she is also director (Chairman of the Board) and chief executive officer of S. Both B and C receive substantial salaries from S as officers and employees. Most of the remaining shares of S stock are held by S's ESOP. C has a minimal stock interest in the ESOP of l percent.

Z owns a note payable by T, an indirect wholly owned subsidiary of S. The note was acquired in g with an original principal amount of a payable in quarterly installments on a h-year amortization schedule with a maturity date of i. The current balance on the note is b. Since the note becomes due and payable on i, T wishes to extend the maturity date of the note and to obtain additional funds. Z is willing to extend the maturity date and loan T additional funds. Accordingly, it is proposed that Z exchange the existing note and provide an additional loan of c in cash for a new note with an original principal balance of d. Interest on the note will be set at fair market value. You represent that the interest to be charged would be comparable to what a third party commercial financier would charge after arm's length negotiations. The new note will require payments of interest only until i, then level quarterly installments on a h-year amortization schedule, with all unpaid principal and interest due on j. All other terms and conditions of the new note will remain the same as with the old note. The new note will pass to X when Z closes.

Z has remained in existence for a long period of time due to discussions and negotiations over a contingent liability. Prior to his death, A entered into a lease agreement with a public charity. Subsequently, the property was assigned to corporate entities, but the charity required A to remain a guarantor on the lease. Following the death of A, the charity insisted that the executors of the estate affirm the lease obligation under the guaranty agreement. The executors have been unsuccessful in repeated efforts to obtain release from the lease guaranty. However, an accommodation has been reached which will allow assets in Z to be distributed to X subject to the review and approval of the probate court.

B is an income beneficiary of X and is age m. Based on actuarial computation, B's interest in X is k.

The following rulings have been requested:

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1. Z's exchange of the old note plus the proposed loan of additional cash for the new note will not be a direct or indirect act of self-dealing; and

2. The holding of the new note by Z and ultimately by X will not constitute direct or indirect self-dealing.

LAW

Section 4947(a)(2) of the Code provides in substance that in the case of a trust which is not exempt from tax under section 501(a), not all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B), and which has amounts in trust for which a deduction was allowed under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522, certain chapter 42 rules will be applicable to such split-interest trusts, including section 4941.

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

Section 4941(d)(1) of the Code provides that the term "self-dealing" means any direct or indirect-

(B) lending of money or other extension of credit between private foundation and a disqualified person or

(E) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation.

Section 4946 of the Code define the term disqualified person to include

(A) a substantial contributor, as described in section 507(d)(2)

(B) a foundation manager

(D) a member of the family of an individual described in subparagraph (A), (B), or (C).

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

Section 53.4946-1(h) of the Foundation and Similar Excise Taxes regulations define members of the family to include a spouse.

Section 53.4946-1(a)(4) of the regulations provides generally that for purposes of determining a 35 percent interest in a trust, a person's beneficial interest in a trust shall be determined in proportion to the actuarial interest of such person in the trust.

Section 53.4941(d)-3(c)(1) of the regulations provides, in general, that under section 4941(d)(2)(E), the payment of compensation by a private foundation to a disqualified person for

the performance of personal services which are reasonable and necessary to the carry out of the exempt purpose of the private foundation shall not be an act of self-dealing if such compensation is not excessive.

Section 53.4941(d)-2(f)(2) provides, in part, that the fact that a disqualified person receives an incidental or tenuous benefit from the use by a foundation of its income or assets will not, by itself, make such use an act of self-dealing.

ANALYSIS

For Z to be defined as a disqualified person, disqualified persons must hold more than a 35 percent beneficial interest. Section 4946(a)(1)(G). B's beneficial interest in Z is k percent based on actuarial calculations. Thus, Z is not a disqualified person as to X and is not subject to section 4941 taxation.

S is not a disqualified person since the interests of B and C in S combined do not exceed 35 percent. Section 4946(a)(1)(E) of the Code.

Under the holdings of Rockefeller, 572 F. Supp. 9 (E.D. Ark., 1982), *aff'd* 718 F.2d 290 (8th Cir. 1983), cert. den., 466 U.S. 962 (1984), and Reis Estate v. Commissioner, 87 T.C. 1016 (1986), the assets of an estate in which the private foundation is entitled upon distribution is considered the assets of such private foundation. Thus, it is conceivable that the loan from Z to S is an act of indirect self-dealing if the loan benefits a disqualified person such as B and C.

The argument for indirect self-dealing is that the loan benefits B and C, disqualified parties under section 4946(a)(1)(B). B is also a disqualified person under section 4946(a)(1)(D). One could argue that B and C benefit from the loan made to T and the credit extension granted to T because (1) the funds from such loan support the salaries being paid to them as officers of S and; (2) enhances the value of the corporation in which each holds an interest directly (B) or through the ESOP (C).

The payment of salaries, if made directly by X would not be an act of self-dealing if the salaries paid were reasonable and necessary. Section 53.4941(d)-3(c)(1) of the regulations, supra. We do not see that a different rule would apply in the case of salaries paid by a business entity controlled by X through S. For purposes of this ruling, we are assuming that the salaries paid to B and C are not excessive.

Another indirect self-dealing assertion could be made that the loan T benefits B and C since both are S shareholders. However, the ownership interest of X in S dwarfs the interest of B and C. X holds a beneficial interest, through Z, in more than substantially all of the stock of S. X has a ready source of cash in Z, in which it will have full possession when Z closes, and which it wants to extend to T for business reasons. We do not believe that X should be precluded from using this accessible source of funds to enhance important business and investment assets (S and T) merely because current use of the funds, funds ultimately passing to X, may incidentally benefit B or C. Under the circumstances, if X borrowed the funds from a third party commercial financier, X could be in a section 514 of the Code debt financed situation that could jeopardize its section 664 status.

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The incidental or tenuous exception under section 53.4941(d)-2(f)(2) of the regulations has been the subject of revenue rulings. In Rev. Rul. 80-310, 1980-2 C.B. 319, a private foundation made a grant to a university to establish an educational program in manufacturing engineering. The program benefited a disqualified person corporation in an incidental and tenuous manner as one of many manufacturing businesses that would benefit from employees or future employees who are or were students in the program. The Revenue Ruling analogized the situation with example (1) of section 53.4941(d)-2(f)(4) of the regulations. The example describes a grant made to a city for the purpose of alleviating slum conditions in a city neighborhood, A substantial contributor to the private foundation which made the grant was located in the same neighborhood where the grant was to be used. The example held that the general improvement of the area only constituted an incidental and tenuous benefit to the disqualified person.

Similarly, in the instant situation, the loan by Z to T enhances X's S business interest, and only incidentally or tenuously benefits B and C.

Finally, we note that X, though subject to section 4941 pursuant to section 4947, is not a section 501(c)(3) private foundation. Rather it is a split-interest trust treated as a private foundation for some purposes. B has a financial interest in X as income beneficiary which is excepted from self-dealing by virtue of section 53.4947-1(c)(ii). To the extent that one may say that the loan/credit extension benefits B's interest in S, it is her beneficial interest in an asset of X that is being used for this purpose. Her actuarial value in X is k percent. To the extent that there is a benefit to B, it may be said that it is her own funds that are providing that benefit.

We conclude that the benefit from the loan, to the extent that such may be considered a benefit to B and C because of compensation and ownership interests in S, is merely an incidental or tenuous benefit within the meaning of section 53.4941(d)-2(f)(2) of the Regulations.

Accordingly, based on the very particular facts of this case, we hold as follows:

1. Z's exchange of the note plus the proposed loan of additional cash for the new note will not be a direct or indirect act of self-dealing; and

2. The holding of the new note by Z and ultimately by X will not constitute a direct or indirect act of self-dealing.

This ruling is limited to the applicability of section 4941 of the Code and does not purport to rule on any facts that were not presented in the ruling request as supplemented. Also, in this ruling, we are not determining whether the methodology you are using to determine fair market interest values is proper. We merely have accepted your representations that the proposed transactions will reflect fair market value. We are assuming that salaries received by B and C from S are necessary and not excessive although we express no opinion as to whether the salaries are, in fact, reasonable and not excessive.

We are sending a copy of this ruling letter to your authorized representative listed on the power of attorney on file with this office.

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This ruling is directed only to B, C, X and S. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,

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

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