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

200233031

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

UIL Numbers: 4941.04-00
511.00-00
512.00-00
514.00-00

Date:

Contact Person:
ID Number:
Telephone Number:

Employer Identification Number: T:ED:B3

Legends

Foundation =
B =
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D =
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Dear Sir or Madam:

This letter responds to the request of counsel for Foundation, dated September 17, 2001, as supplemented and modified by letters dated February 15, and April 10, 2002, for rulings regarding the issue of self-dealing under section 4941 of the Internal Revenue Code ("Code").

FACTS:

Foundation is exempt from federal income tax under section 501(c)(3) of the Code and is classified as a private foundation within the meaning of section 509(a).

Initially, Foundation's directors included B, C, and D. D is B's and was appointed as a director over years ago. C died on year 1. B married E less than a year later, and the remaining directors appointed E as a director to serve with B and D. F, a friend of B and E, was appointed a director over years ago. B died on year 2. Several later, the remaining directors appointed G to fill B's place and serve as a director. G had served for years as B's Accordingly, the current directors are D, E, F and G.

C was married to B at the time of her death. In C's last will and testament, she bequeathed all of her property to B, if he survived, otherwise to Foundation. B signed and timely filed a qualified disclaimer in which he disclaimed his wife's interest in certain community property of their marriage. Consequently, C's interest in the community property of the marriage passed to Foundation.

B thereafter married E, and he was married to her at the time of his death. D and E were appointed independent co-executors ("Co-Executors") of B's estate ("Estate") in accordance with B's will. B's will provides specific bequests to certain named individuals and charities. The will provides that his remaining applicable exclusion amount shall pass to a family bypass trust. The family bypass trust was never funded, however, because there was no applicable exclusion amount remaining. The remainder, and bulk, of the Estate passes to a trust, which qualifies for the unlimited marital deduction under section 2056(b) of the Code ("QTIP Trust").

B's will directs the trustees of the QTIP Trust to distribute the trust's net income to E during her lifetime and so much of the principal of the QTIP Trust as is necessary to provide for E's health, support and maintenance. The QTIP Trust terminates upon E's death. Upon its termination, the Trustees of the QTIP Trust are directed to distribute the remaining trust property, after payment of administrative expenses and taxes, if any, to Foundation. B's will names D and E as co-trustees of the QTIP Trust.

Foundation now owns C's share of the community estate from over twenty years ago, such share being comprised of an undivided one-half interest in the community assets from B's marriage to C. The Estate of B owns the other one-half undivided interest. These assets include numerous real estate holdings and notes receivable. These undivided interests have produced many administrative complications for Foundation. Moreover, it would be difficult for Foundation to sell its undivided interest in such assets to any unrelated third party without suffering significant discounts.

The QTIP Trust would now be entitled to receive B's undivided one-half interest in such properties (50% interest valued at n) as well as B's undivided one-half community share of the assets created with the community of B and E (50% interest valued at o). These assets have been recorded at their fair market value on B's date of death, and a strict trust accounting would

have to be established to properly determine net income (after depreciation, repairs, capital improvements, and other items) available to E as the income beneficiary. Foundation states that this would produce many administrative complexities for the QTIP Trust.

Lastly, E owns her o undivided community one-half interest in the Estate of B with respect to all of the community assets created during their marriage. Foundation states that her interest would likewise produce tremendous administrative complexities and contribute to the economic burden on Foundation and the QTIP Trust caused by ownership of assets in undivided interests. If the exchange set forth herein is not completed, E's undivided ownership property interests will pass to her heirs (her children from a prior marriage). Foundation represents that it is unlikely that E's heirs would be willing to enter into the proposed exchange, as described below, considering the substantial economic benefit inuring to Foundation.

B's will authorizes the Co-Executors to sell or exchange estate property, to enter into transactions with certain individuals or entities, and to make distributions of estate property as follows:

1. Power to Sell or Exchange.

B's will allows the Co-Executors "...to exchange, sell or lease...for cash, property or credit, or to partition, from time to time, publicly or privately, at such prices, on such terms, times and conditions and by instruments of such character...as [the] Executor or Trustee may deem proper, all or any part of the assets of [the] estate and of each trust..."

2. Power to Enter Into Transactions With Certain Individuals/Entities.

B's will allows the Co-Executors "...to enter into any transaction on behalf of [the] estate or of any trust despite the fact that another party to any such transaction may be (i) a trust of which any Executor or Trustee under [the] Will is also a trustee, including any trust established by [the] Will; (ii) an estate of which any Executor or Trustee under [the] Will is also an executor or administrator, including [the] estate; (iii) a business or trust controlled by any Executor or Trustee under [the] Will or of which any such Executor or Trustee or any director, officer or employee of any such corporate Executor or Trustee, is also a director, officer or employee; (iv) any affiliate or business associate of any beneficiary, Executor or Trustee; or (v) any beneficiary, Executor or Trustee under [the] Will acting individually or any relative of such person."

3. Power to Make Distributions.

B's will allows the Co-Executors "...to make divisions or distributions in money or in kind, or partly in each, whenever required or permitted to divide or distribute all or any part of [the] estate or of any trust; to allocate particular assets or portions thereof to any one or more of the beneficiaries of [the] estate or the trusts as [the] Executor or Trustee shall deem to be for the best interests of the beneficiaries of [the] estate and of the trusts without any obligation to make proportionate distributions or to distribute to all beneficiaries property having an equivalent Federal income tax basis..."

Foundation states that the ultimate goal of the proposed transaction is to improve the economic benefits inuring to Foundation, and to eliminate the economic burdens of ownership

of assets in undivided interests. The benefits include the consolidation of title in the properties, thereby greatly increasing the liquidity of such properties in the hands of the Foundation at a favorable price and the elimination of the preceding interest of the QTIP Trust. The burdens include the related complications of administration and management of jointly owned assets, and the determination of trust accounting income required to be distributed by the QTIP Trust, that would otherwise result from the distributions under the terms of B's will and the continued co-ownership of former community property in undivided interests. To obtain these economic benefits and eliminate these burdens, Foundation proposes that the Estate transfer to E a non-recourse note (the "Note") in the amount of p. The Note would be non-recourse, collateralized only by the properties transferred by E to Foundation.

In exchange for the Note, E will release her o community property interest in the assets co-owned with the Estate and her life estate interest in the QTIP Trust valued at q (the "Exchange"). In conjunction with the Exchange, E would be making a gift to Foundation in the amount of r, or the amount by which the value of her combined equitable interests exceeds the value of the non-recourse note she would receive.

It is represented, as modified, that the term of the note shall be H years, payable in monthly installments, with a reasonable rate of interest and with a balloon payment upon maturity. Moreover, Foundation will have the ability to prepay the note in its entirety at any time without penalty.

The Estate owns numerous parcels of rental property (mostly churches and residential properties) and holds several hundred notes receivable from properties sold (the rental properties and the notes receivable are collectively referred to as the "Properties").

Currently, the Estate administers these Properties, collecting the receivables and rents. None of the leases involve payments based upon profits of the occupying tenants. All property maintenance functions (such as lawn maintenance, cleaning services, repairs, and refurbishments) are carried out on a contract basis using unrelated independent contractors. The Estate performs other related collection activities with regard to the Properties, including writing demand letters for delinquent accounts and, if necessary, instituting eviction or foreclosure proceedings. Foundation represents that effectively all (and certainly more than ninety-five percent) of the gross income from these Properties constitutes rents, interest, or other passive income so that administration of these properties by Foundation would not constitute operating a "business enterprise" within the meaning of section 4943 of the Code.

The proposed transaction involves the transfer of the fractional interests in the Properties from the Estate to Foundation. Following the proposed transaction, Foundation represents that: (1) it expects to conduct a plan of orderly liquidation of all these real estate assets; (2) it will not actively engage in the operation of rental properties as an active trade or business; (3) it will not acquire any new properties for resale; and (4) it will not engage in making any new loans other than installment sales related to the sale of real property currently owned (or real property repossessed on foreclosure).

Foundation will continue to collect rents and current payments on notes receivable and invest the money and any proceeds from the sale of real property in a broad-based marketable securities portfolio. Foundation also represents that it will continue to use unrelated independent contractors for all property maintenance.

After obtaining the probate court's approval of this transaction and the conclusion of the administration of the Estate, the remaining properties of the Estate, subject to the liability created by the Note, would be distributed and conveyed to Foundation. Foundation would not assume the Note.

In summary, the total value of all assets passing to Foundation pursuant to the proposed transaction is approximately s. A schedule of the assets was attached to the private letter-ruling request. The schedule shows the total value of the assets of the residuary estate passing to the QTIP Trust is approximately t. The Exchange of E's combined interests, valued at over u, for the p Note would produce an economic advantage (gift) of approximately v to Foundation. Appraisals were included in the private letter ruling request.

As a matter of liquidity, Foundation states that the Exchange should not cause a burden to Foundation because the p non-recourse Note will be collateralized only by the properties transferred by E to the Foundation. Approximately w of the assets passing outright to the Foundation pursuant to the Exchange are installment notes receivable, the monthly proceeds from which will adequately cover the monthly payments due to E under the p non-recourse Note. The consolidation of title to the properties will eliminate the difficulty of dealing with undivided interests (and the discounts) thereby increasing the liquidity to Foundation. Also, Foundation states that the elimination of the economic burden of ownership in undivided interests will also reduce the administrative expenses otherwise incurred, thereby increasing the income available, and thereby improving the liquidity, to Foundation. The transaction just consolidates the title and management of the properties in Foundation. Foundation states that increased capabilities of selling or mortgaging and managing the properties increases the liquidity of Foundation with respect to its overall investment in the properties.

RULING REQUESTS:

You have requested the following rulings:

1. The transfer of the Note from the Estate to E in exchange for all her interests in the Estate and in commutation of her interests in the QTIP Trust and the subsequent conveyance of such properties in the Estate to Foundation, with Foundation taking subject to the liability created by the Note (and secured by the installment notes receivable and real property Foundation receives), will satisfy the requirements of sections 53.4941(d)-1(b)(3) and 53.4941(d)-2(c)(1) of the Foundation and Similar Excise Taxes Regulations ("regulations") and, thus, will not be acts of self-dealing as defined in section 4941 of the Code.

2. Under section 53.4941(d)-2(c)(1) of the regulations, the payment of both interest and principal under the terms of the Note by the Estate and later by Foundation to E will not constitute acts of self-dealing either as direct or indirect acts, as defined by section 4941 of the Code.

LAW:

Chapter 42 of the Code subjects private foundations described in section 509(a) and disqualified persons described in section 4946 to certain excise tax provisions including section 4941.

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

Section 4941(d)(1) of the Code provides, in part, that the term "self-dealing" means any direct or indirect (A) sale or exchange, or leasing, of property between a private foundation and a disqualified person; (B) lending of money or other extension of credit between a private foundation and a disqualified person;...(E) transfer to, or use by or for the benefit of, a disqualified person of the assets of a private foundation.

Section 4946(a)(1) of the Code provides, in part, that the term "disqualified person" means, with respect to a private foundation, a person who is – (A) a substantial contributor to the foundation, (B), a foundation manager, ... or (D) a member of the family of any individual described in subparagraphs (A), (B), or (C).

Section 507(d) of the Code provides that a "substantial contributor" is defined as a person who contributed or bequeathed an aggregate amount of more than $5,000 to the private foundation, if such amount is more than two percent (2%) of the total contributions and 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.

Section 511 of the Code imposes a tax on the unrelated business taxable income of organizations otherwise exempt from federal income tax under section 501(c) of the Code.

Section 512(a) of the Code provides that the term "unrelated business taxable income" means, with certain modifications, the gross income derived by an organization from any unrelated trade or business regularly carried on by it, less allowable deductions.

Section 512(b)(4) of the Code requires a taxpayer to include in gross income from an unrelated trade or business the rental income and the gain or loss from the sale of debt-financed property.

Section 514(b)(2) of the Code defines the term "debt-financed property" as any property which is held to produce income and with respect to which there is an acquisition indebtedness at any time during the taxable year.

Section 514(c)(2)(A) of the Code provides that where property is acquired subject to a mortgage or other similar lien, the amount of the indebtedness secured by such mortgage or lien shall be considered as an indebtedness of the organization incurred in acquiring such property even though the organization did not assume or agree to pay such indebtedness.

Section 514(c)(2)(B) of the Code provides an exception to the above rule and provides that if where property subject to a mortgage is acquired by an organization by bequest or

devise, the indebtedness secured by the mortgage shall not be treated as acquisition indebtedness during a period of 10 years following the date of the acquisition ("Bequest Exception") ...This subparagraph shall not apply if the organization, in order to acquire the equity in the property by bequest, devise, or gift, assumes and agrees to pay the indebtedness secured by the mortgage, or if the organization, makes any payment for the equity in the property owned by the decedent or the donor.

Section 1.641(b)-3(a) of the regulations provides that an estate generally terminates when all the assets have been distributed except for a reasonable amount which is set aside in good faith for the payment of contingent or unascertained liabilities.

Section 53.4941(d)-1(b)(3) of the Foundation and Similar Excise Taxes Regulations excepts certain transactions carried out during the administration of an estate ("the Estate Administration Exception") from the definition of self-dealing. Specifically, section 53.4941(d)-1(b)(3) provides that the term "indirect self-dealing" shall not include a transaction with respect to a private foundation's interest or expectancy in property (whether or not encumbered) held by an estate or revocable trust (including a trust which has become irrevocable on a grantor's death), regardless of when title to the property vests under local law, if:

(i) The administrator or executor of an estate, or trustee of a revocable trust either –

(a) Possesses a power of sale with respect to the property,

(b) Has the power to reallocate the property to another beneficiary, or

(c) Is required to sell the property under the terms of any option subject to which the property was acquired by the estate (or revocable trust);

(ii) Such transaction is approved by the probate court having jurisdiction over the estate (or by another court having jurisdiction over the estate (or trust), or over the private foundation);

(iii) Such transaction occurs before the estate is considered terminated for Federal income tax purposes pursuant to paragraph (a) of section 1.641(b)-3 of the regulations (or in the case of a revocable trust, before it is considered subject to section 4947 of the Code);

(iv) The estate (or trust) receives an amount which equals or exceeds the fair market value of the foundation's interest or expectancy in such property at the time of the transaction, taking into account the terms of any option subject to which the property was acquired by the estate (or trust); and

(v) With respect to transactions occurring after April 16, 1973, the transaction either-

(a) Results in the foundation receiving an interest or expectancy at least as liquid as the one it gave up,

(b) Results in the foundation receiving an asset related to the active carrying out of its exempt purposes, or

(c) Is required under the terms of any option which is binding on the estate (or trust).

Section 53.4941(d)-2(c)(1) of the regulations provides that the lending of money or other extension of credit between a private foundation and a disqualified person shall constitute an act of self-dealing. Further, section 53.4941(d)-2(c)(1) provides that except in the case of the receipt and holding of a note pursuant to a transaction described in section 53.4941(d)-1(b)(3) ("the Estate Administration Note Exception"), an act of self-dealing occurs where a note, the obligor of which is a disqualified person, is transferred by a third party to a private foundation which becomes the creditor of the note.

For purposes of the 95 percent passive gross income exception from the term "business enterprise" under section 4943 of the Code, section 53.4943-10(c)(2) of the regulations provides, in part, that gross income from passive sources includes certain passive modification items under section 512(b), including rents under section 512(b)(3). Any income classified as passive under this exception does not lose its character merely because section 514 (relating to debt-financed income) applies to such income.

ANALYSIS:

E is considered a disqualified person since she is the surviving widow of B (a substantial contributor to the Foundation) and thus, a disqualified person under section 4946(a) of the Code. Also, as E currently serves as a director of Foundation, she will be considered a foundation manager, and thus, a disqualified person.

Foundation represents that:

(i) the Co-Executors of the Estate possess a power of sale with respect to the interests at issue to exchange all assets and the power to reallocate the property to another beneficiary under B's will;

(ii) the transaction will be consummated prior to the termination of the Estate's administration for Federal income tax purposes as provided by paragraph (a) of section 1.641(b)-(3) of the regulations;

(iii) a petition seeking approval of the transaction by the probate court having jurisdiction over this transaction will be filed, and the transaction will not be consummated without prior approval of such court;

(iv) the Estate shall receive an amount which equals or exceeds the fair market value of the property to be sold [such fair market value to be determined pursuant to the provisions of section 53.4941(d) – 1(b)(3) of the regulations]. Specifically, Foundation's expectancy, including the actuarial value of the remainder interest, in the QTIP assets Foundation would receive from the Estate without the proposed transaction would be x, net of E's interest. If the proposed transaction (the Exchange) receives a favorable determination, the Foundation will receive outright ownership of properties valued at y, for a net value of z, after

deducting E's p interest in the Note; and

(v) the Foundation will receive an interest or expectancy interest at least as liquid as the one it surrenders. The non-recourse Note would be collateralized only by the property interests passing to Foundation from the Estate and not Foundation's unrelated liquid assets.

Foundation also represents that the proposed transaction would cause the interests in the real property and installment notes receivable to be transformed from partial undivided ownership to total ownership. This consolidation of ownership will increase the assets' desirability for sale more quickly and without discounts, and thus, cause the assets to be more liquid in the hands of the Estate and later the Foundation. In addition to the divided title problem, the undivided ownership creates administrative complications and additional expense, including but not limited to detailed fiduciary accounting records, on a property by property basis, to distinguish income and expenses from principal receipts and disbursements, in order to account for the economic interests of Foundation and the QTIP Trust. The various problems associated with joint management, such as the allocation of sales price and proceeds from the sales of multiple properties to common buyers during the process of liquidating the underlying properties and the additional expenses associated therewith, would also be eliminated under the proposed transaction. This expense reduction further adds to the increased liquidity achieved by Foundation as a result of the Exchange.

Foundation represents that the undivided joint interests E possesses in the properties with the Foundation require a certain level of cooperation among the parties for the management and ultimate disposition of such properties. If the proposed transaction is not pursued, the Foundation may be required ultimately to deal not with E, who is elderly, but the beneficiaries of E's estate (her children from a prior marriage) in the future. The potential for even further undivided ownership would most likely decrease the liquidity of the underlying assets. The proposed transaction will not only cure present divided title issues and administrative complications for Foundation, but also protect against even greater divided title issues and administrative complications, and the accompanying decreases in liquidity, in the future.

The installment notes receivable account for approximately I percent (approximately w) of the total assets passing to the Foundation in the Exchange (approximately y). Therefore, the non-recourse p Note to E may be completely satisfied through collection of installment notes receivable transferred to Foundation in the Exchange. Thus, the distribution to E of a single note, which consolidates her interest and retains essentially the same collateral, is economically similar to a distribution to her of a consolidated interest in these installment notes. The single note greatly simplifies the Estate's (and Foundation's) administration and management of these properties, and it improves the ultimate value realized by eliminating the undivided interests. At a minimum, the Estate's assets will become no less liquid by virtue of the consolidation of the undivided interests and the distribution of the Note.

Foundation represents that as a result of the proposed transaction, Foundation would obtain a projected economic benefit of r from E and the Estate. This would represent an immediate increase of approximately J percent over the x calculated value of its expected benefit from the Estate.

Also, the distribution of the Note to E in exchange for her community interest in the assets and in commutation of her actuarial interest in the QTIP Trust will still be eligible for favorable treatment under the Estate Administration Exception and will not be detrimentally affected by the commutation of the QTIP Trust.

Section 53.4941(d)-2(c)(1) of the regulations provides that in general, the lending of money or other extension of credit between a private foundation and a disqualified person shall constitute an act of self-dealing. That section further provides that except in the case of the receipt and holding of a note pursuant to a transaction described in section 53.4941(d)-1(b)(3), an act of self-dealing occurs where a note, the obligor of which is a disqualified person, is transferred by a third party to a private foundation which becomes the creditor, except under the Estate Administration Note Exception. Thus, the regulations provide that if the Estate Administration Note Exception applies to a transaction, the transfer and holding of the Note will not be an act of self-dealing. Under the facts and circumstances represented herein, it does not matter that Foundation will be the obligor, rather than the obligee, because the Estate Administration Note Exception applies to the lending of money "between" a private foundation and a disqualified person rather than "to" or "from" one party or the other. Also, it is of significance the note in this instance has a maximum term of short duration and the Foundation has the ability to terminate that short time period by having the ability to prepay the note, in its entirety, without penalty.

RULINGS:

Accordingly, based on the information and representations submitted, we are ruling as follows:

1. The transfer of the Note from the Estate to E in exchange for all her interests in the Estate and in commutation of her interests in the QTIP Trust and the subsequent conveyance of such properties in the Estate to Foundation, with Foundation taking subject to the liability created by the Note (and secured by the installment notes receivable and real property Foundation receives), will satisfy the requirements of sections 53.4941(d)-1(b)(3) and 53.4941(d)-2(c)(1) of the regulations and thus, will not be acts of self-dealing as defined in section 4941 of the Code.

2. Under section 53.4941(d)-2(c)(1) of the regulations, the payment of both interest and principal under the terms of the Note by the Estate and later by Foundation to E will not constitute acts of self-dealing either as direct or indirect acts, as defined by section 4941 of the Code.

This ruling is directed only to the parties that requested it: Foundation, the Estate, D, E, F and G. Section 6110(k)(3) of the Code provides that this ruling may not be used or cited by others as precedent.

This ruling is limited to the applicability of the provisions of sections 4941(d) and 4946 of the Code and does not purport to rule on any facts that were not represented in the ruling request as supplemented or on any changes of those facts. Also, in this ruling, we have not determined whether the methodology you or your independent appraisers are using to

determine fair market values, including interest rates, is proper. We merely have accepted your representations. The ruling does not purport to address any issue under other provisions of the Internal Revenue Code including issues involving the unrelated trade or business provisions under sections 511 through 514.

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,

Robert C. Harper, Jr.

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