



TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

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

Number: **200620034**  
Release Date: 5/19/06

SE:TE:EO:RA:T:PE

Date: February 23, 2006

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Legend:

B --  
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Dear \_\_\_\_\_ :

This is in response to your ruling request as to whether the redemption of certain limited partnership units and related transactions that will occur upon the death of X will constitute acts of direct or indirect acts of self-dealing under section 4941 of the Code.

M is exempt from tax under section 501(c)(3) of the Code and classified as a private foundation under section 509(a). The directors of M are X, Y and Z. M's mission is to provide funds to certain charitable organizations that are tax exempt under section 501(c)(3).

N is a limited partnership engaged in the management and distribution of publicly traded funds. The primary unit holders of N are P, B, C, and D. P is a holding company that is 99% owned by X. B and C are X's sons.

N manages and distributes certain publicly traded mutual funds known as R. Q holds a

general partnership interest in N. B serves as the chairman and CEO of Q, which is the general partner of N. C is the president of N. Approximately \_\_\_\_\_ of N limited partner units are owned, either directly or indirectly by X, B and C. P is a holding company and has a interest in N and real estate.

X is the founder of N and serves as its senior research advisor and serves as the chairman and CEO of P. Y is married to X. X's will provides that after the payment of debts, administration expenses and after certain bequests of tangible personal property and residential real estate, X's residuary shall be paid to the trustee of a revocable trust agreement with X as settlor and an unrelated individual as trustee.

S provides that after X's death, after the payment of his debts, administration expenses, and taxes, the trust will be distributed to two marital trusts for the lifetime benefit of Y if she survives X. The marital trusts are designed to qualify for the estate tax marital deduction under section 2056(b)(7) of the Code. Upon Y's death, and after payment of any applicable administration expenses and taxes, the remaining assets of the marital trusts, up to a defined pecuniary amount, will be divided into separate shares for the benefit of X's living descendants. All remaining trust assets in excess of the pecuniary bequests will be distributed outright to M, a private foundation formed and funded by X.

X's estate is expected to have sufficient assets other than P's shares to fully fund the pecuniary bequests. Accordingly, X's estate plan should cause his P shares to pass to M after the deaths of X and Y. M would then indirectly own units in N through P.

X, B and C desire to have all N units owned by members of X's family or person employed by N. X, B, and C are also concerned about the potential section 4941 self dealing problems that might arise by M indirectly owning interests in N as well as the taxes imposed under section 4943 of the Code for excess business holdings. Accordingly N, P and X have entered into a "Redemption Agreement" whereby the N units currently owned by P, as well as any N units owned directly by X, would be redeemed for fair market value upon X's death.

Under the terms of the Redemption Agreement, the purchase and sale of the N units are binding on X's estate and S. The transactions under the Redemption Agreement will be completed before X's estate is considered terminated for federal income tax purposes under section 1.641(b)-3 of the regulations or before S is considered subject to section 4947 of the Code.

The purchase price of N units purchased under the Redemption Agreement would be the higher of the unit formula price provided under the N agreement or the finally determined estate tax value of the N units. The formula price is based on a combination of N's assets under management and a multiple of N's adjusted earnings as measured at the time of purchase. Historically, the unit formula price has been used in situations where a limited partner is prohibited from assigning his or her N units under the terms of the N agreement and must sell the units back to either N or the general partner. In addition the formula price has been used in connection with N's employee unit options and unit appreciation rights. The formula price has also been used in recent sale transactions between the partners. X's estate and or S will receive an amount that equals or exceeds the fair market value of M's interest or expectancy in

N units at the time of the transaction, taking into account the terms of the Redemption Agreement.

The purchase price of the N units purchased under the Redemption Agreement will be paid at closing with a combination of cash and a promissory note (Note). The executor of X's estate and S trustee will seek approval from the probate court having jurisdiction over the applicable entities or entity to sell the N units under the Redemption Agreement. The cash will equal the lesser of T or the purchase price, and the Note will equal the purchase price less the cash payment. The formula price of the N units currently owned by P is V as of August 31,

The initial principal value of the Note will be adjusted retroactively to reflect any increase in the value of the N units for federal estate tax purposes at the time such values have been finally determined.

The Note will be payable in ten equal annual installments beginning one year after the closing and can be pre-paid at any time. The Note will bear interest at the then effective applicable federal rate. The note repayment is subject to a Debt Service Limitation. The limitation provides that the total interest and principal payments due for any year under the note shall not exceed 150% of the pro rata cash flow of the redeemed units. Pro rata cash flow is the percentage interest in N represented by the redeemed units times the amount of available cash, as defined in the N Agreement. Available cash is defined as 70% of N's net book income, excluding death benefits under key man life insurance, or such lesser amount as is approved by 80% in interest of the general partner and voting limited partner units., calculated on the basis of the four calendar quarters most recently ended prior to the date as of which the pro rata cash flow is determined. Payments deferred under the debt service limitation are due on the next payment date, again subject to the debt service limitation. Notwithstanding the debt service limitation, all interest or principal on the note must be paid no later than 25 years after the redemption date.

The note and its repayment proceeds will be distributed to the Marital Trusts during Y's life time. After Y passes away, or upon X's death if he survives Y, the remaining balance on the Note and any remaining repayment proceeds will be distributed to M after payment of the pecuniary bequests and any properly payable debts, administration expenses and taxes.

If the note is in default, the redemption agreement and note contain commercially reasonable protections to the note holder. Specifically, the note will become immediately due and payable at the option of the holder, and the outstanding balance will bear a default interest rate equal to 3% over the initial interest rate. In addition, during the term of any default, N is prohibited from making any dividends, distributions, or loans to its partners as well as other restrictions listed in the Redemption Agreement.

Following the redemption of the N units from P, it is expected that P would be liquidated and its net assets distributed to its shareholders according to their respective interests. Because X owns 99% of P, it is expected that the 1% shareholder would be paid in cash from the sale and the estate's share would consist of the note and any other remaining assets.

You are seeking the following rulings:

1. The redemption of the N units and subsequent liquidation of P will not constitute acts of direct or indirect acts of self dealing under section 4941 of the Code to B,C, P and X.
2. The receipt, holding, collection and distribution of the Note or the net proceeds of the Note by the Estate, S, marital trusts or M will not cause the redemption or the holding of the Note to become a direct or indirect act of self-dealing under section 4941 of the Code.
3. Payments on the note while it is held by Estate, S, Marital Trusts and or M will not result in direct or indirect acts of self dealing under section 4941 of the Code.

#### Law

Section 4941(a)(1) of the Code imposes a tax on acts of self-dealing between a disqualified person as defined in section 4946(a)(1) and a private foundation.

Section 4941(d)(1) of the Code provides, in part, that the term “self dealing” , means any direct or indirect sale or exchange of property or the extension of credit between a foundation and a disqualified person.

Section 4946(a)(1) defines the term “disqualified persons” with respect to a private foundation as including a substantial contributor to the foundation, a foundation manager, and an owner of more than 20 percent of the total combined voting power of a corporation which is a substantial contributor to the foundation. It also includes a member of the family of any individual described above. It also includes a corporation, partnership, trust, or estate in which persons described above hold more than 35 percent of the beneficial interest therein.

Section 4946(b) defines the term foundation manager as including an officer, director, or trustee of a foundation or an individual having powers or responsibilities similar to those officers, directors, or trustees of the foundation. Section 4946(d) states that the term family with respect to any individual that is a disqualified person includes the spouse, children of and grandchildren of the disqualified person.

Section 507(d)(2)(A) of the Code defines a substantial contributor as any person who contributed or bequeathed an aggregate amount of more than \$5,000 to a private foundation, if such amount is more than 2 percent 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. In the case of a trust, the term substantial contributor also means the creator of the trust.

Section 53.4941(d)-1(a) of the Foundation and Excise Tax regulations provides that for the purposes of section 4941, the term “self-dealing” means any direct or indirect transaction described in section 53.4941(d)-2 of the regulations. Section 53.4941(d)-1(b)(1) of the regulations states that indirect self-dealing includes any transaction between a disqualified person and an organization controlled by a private foundation.

Section 53.4941(d)-1(b)(3) of the regulations 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 vest under local law, if:

- (i) The administrator or executor of an estate or trustee of a revocable trust either:
  - (a) possess 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 to be terminated for Federal Income tax purposes pursuant to paragraph (a) of section 1.641(b)-3 of this chapter(or in the case of a revocable trust, before it is considered to be subject to section 4947);
- (iv) The estate (or trust) receives an amount which equals or exceeds the fair market of the foundation's interest or expectancy in such property at the time of the transaction taking into account the terms of any option 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(a)(2) of the regulations provides that the transfer of real or personal property by a disqualified person to a private foundation shall be treated as a sale or exchange if the foundation assumes a mortgage or similar lien which was placed on the property prior to the transfer, or takes subject to a mortgage or similar lien which a disqualified person placed on the property within the 10 year period ending on the date of the transfer. For purposes of this subparagraph, term "similar lien" shall include, but is not limited to, deeds of trust and vendors' liens, but shall not include any other lien if such lien is insignificant in relation to the fair market value of the property transferred.

Section 53.4941(d)-2(c) 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. Thus, for example, an act of self dealing occurs where a third party purchases property and assumes a mortgage, the mortgagee of which is a private foundation, and subsequently the third party transfers the property to a disqualified person who either assumes a liability under the mortgage or takes the property subject to a mortgage. Similarly, 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, is transferred by a third party to a private foundation which becomes the creditor under the note.

Section 4947(a) of the Code provides that certain trusts which are not exempt under section 501(a) of the Code are treated as private foundations and subject to the excise taxes imposed by Chapter 42.

Section 4947(a)(2) of the Code provides that trusts, which are not exempt 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, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2) or 2522 are subject to the provisions of section 507, 508(e) and to the extent applicable, 4941, 4943, 4944, 4945 in the same manner as if such trusts were private foundations.

Section 53.4947-1(b)(2)(ii)(A) of the regulations provides that when an estate from which the executor or administrator is required to distribute all of the net assets in trust for charitable beneficiaries, or free of trust to such beneficiaries, is considered terminated for Federal income tax purposes under section 1.641(b)-3(a). The estate will be treated as a charitable trust under section 4947(a)(1) between the date on which the estate is considered terminated under section 1.641(b)-3(a) and the date of the final distribution of all of the net assets is made to or for the benefit of the charitable beneficiaries.

Section 53.4947-1(b)(2)(iii) provides that a split-interest trust in which all of the unexpired interests are charitable remainder interests and in which the charitable beneficiaries have become entitled to distribution of corpus in trust or free of trust shall continue to be treated as a split interest trust under section 4947(a)(2) until the date on which final distribution of all the net assets is made. However, if after the expiration of any intervening interests the trust is considered terminated for Federal income tax purposes under section 1.641(b)-3(b), the trust will be terminated as a charitable trust under section 4947(a)(1), rather than as a split-interest trust under section 4947(a)(2) between the date on which such final distribution of all of the trust assets is made to or for the benefit of the charitable remainder beneficiaries.

#### Rationale

X is a disqualified person with respect to M as described in section 4946(a)(1) of the Code, by being a substantial contributor to M as described in section 507(d)(2)(A) of the Code. Y is a disqualified person with respect to M within the meaning of section 4946(a)(1) by being the wife of X. B and C are disqualified persons with respect to M, because they are the children of X. N, P,S are disqualified persons with respect to M, because more than 35% of their beneficial

interests are being held by B,C, and X.

The redemption agreement between N, P, and X would be considered a sale or exchange of property for purposes of section 4941, because the transaction is between X, a disqualified person and P and N, organizations that are disqualified persons with respect to M as described in section 53.4941(d)-1(b)(1) of the regulations.

Following the redemption of the units by P, it will be liquidated and its net assets distributed to its shareholder according to their respective interests. M has an expectancy in P. The redemption to P will be for a combination of cash and a note, and ultimately distributed to M. The potential holding of the note according to the terms of the redemption would be an act of self-dealing as described in section 53.4941(d)-2(c) of the regulations, unless it falls within the "estate" exception.

A transaction will not be subject to the self-dealing rules described in section 4941 if the transaction involves situations that take place during the administration of an estate or revocable trust as described in section 53.4941(d)-1(b)(3) of the regulations. Section 53.4941(d)-1(b)(3) has been satisfied in this situation because the executor of X's estate and the S have a power of sale with respect to the P stock and N units; and they will seek approval from the probate court having jurisdiction over the applicable entity or entities to sell N units under the redemption agreement; the transactions under the redemption agreement will be completed before the X estate is considered terminated for federal income tax purposes under section 1.641(b)-3 of the Code or before S is considered subject to section 4947 of the Code; X's estate and S will receive an amount that equals or exceeds fair market value of M's interest or expectancy in the N units at the time of the transaction, taking into account the terms of the redemption agreement; and the sale of the N units under the redemption agreement is required under the terms of that agreement, and that agreement will be legally binding on X's estate and S.

Furthermore the transfer of the note or the net proceeds to the estate of X, S, marital trusts or M in exchange for the N units is not considered an act of self dealing under section 53.4941(d)-2(c) of the regulations because the note may be transferred to M during the administration of X's estate.

Based on the following we rule as follows:

1. The redemption of the N units and subsequent liquidation of P will not constitute acts of direct or indirect acts of self dealing under section 4941 of the Code to B, C, P and X.
2. The receipt, holding, collection and distribution of the Note or the net proceeds of the Note by the Estate, S, marital trusts or M will not cause the redemption or the holding of the Note to become a direct or indirect act of self-dealing under section 4941 of the Code.
3. Payments on the note while it is held by Estate, S, Marital Trusts and or M will not result in direct or indirect acts of self dealing under section 4941 of the Code.

This ruling will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, *Notice of Intention to Disclose*. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

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

Steven B. Grodnitzky  
Acting Manager,  
Exempt Organizations  
Technical Group 1

Enclosure  
Notice 437