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TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

Date: MAY 12 2004

Contact Person:

Uniform Issue List Numbers: 514.06-00
4941.04-00
4945.04-00

Contact's Identification Number:

Telephone Number:

Employer Identification Number:

Legend:

M =
A =
B =
C =
D =
X =
Y =
Z =
x =

Dear Sir or Madam:

This is in response to a letter dated April 1, 2003, and subsequent correspondence, from M's authorized legal representatives, who have requested certain rulings on M's behalf. Generally, these rulings concern the applicability of sections 514, 4941 and 4945 of the Internal Revenue Code to loan proceeds from real property.

M is an organization that is described in section 501(c)(3) of the Code and is classified as a private foundation under section 509(a). A and B were husband and wife who established M during their lifetimes. However, M was not funded while B was alive. Upon the death of B, all her estate, which consisted primarily of real property, went to M as a result of A's disclaimer of his interest in B's estate. A, C and D were the initial directors of M at the time it received these assets. Subsequently, A died, and a substantial portion of his estate, including three partnerships that are the subject of this ruling request, was transferred to M.

Prior to A's death, as part of his longstanding business relationship with C and D, A invested in the X and Y partnerships with C and D. The partnerships comprise approximately one-half of M's assets. In addition, three apartment buildings, Z, were transferred to M.

M received a private letter ruling from the Internal Revenue Service that the indebtedness encumbering various assets transferred to M as a result of A's death (including the three partnerships) would not constitute "acquisition indebtedness" within the meaning of section 514(c)(2) of the Code for a period of ten years following the date of acquisition of the partnerships by M. Thus, for ten years following the date of acquisition of such property by M, income received from the partnerships did not constitute unrelated business taxable income under section 512(a)(1).

X owns an apartment complex (the X property); Y owns an apartment complex (the Y property); and M is the sole owner of three apartment buildings (the Z property). X, Y and M will borrow from an independent, third-party institutional lender approximately 60% of the current fair market value of the X property, the Y property and the Z property on a nonrecourse basis secured by first deeds of trust encumbering the respective properties. After such borrowing, X and Y will distribute their respective shares of the proceeds to their partners on a pro rata basis. M will use its share of the loan proceeds to make grants to publicly supported organizations described in section 501(c)(3) of the Code.

Total proceeds from the borrowing described above are expected to amount to $x. M will use these amounts to fund (1) its normal grants, (2) the grants it will make during the next several years and (3) possibly special grants approved by M's directors.

Various individuals and entities are disqualified persons with respect to M, which has paid the Internal Revenue Service the user fee required for this ruling request.

Law and Analysis:

Section 511(a) of the Code generally imposes a tax on the unrelated business taxable income (as defined in section 512) of organizations described in section 501(c).

Section 512(a)(1) of the Code provides that the term "unrelated business taxable income" means 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 allowable deductions which are directly connected with the carrying on of the trade or business, both computed with the modifications provided in section 512(b).

Sections 512(b)(3) and (5) of the Code provide, in part, that there shall be excluded from the computation of unrelated business taxable income all rent from real property and gains from the sale of property.

Section 512(b)(4) of the Code provides, in part, that notwithstanding sections 512(b)(3) and (5), in the case of debt-financed property as defined in section 514, there shall be included as an item of gross income derived from an unrelated trade or business the amount ascertained under section 514(a)(1).

Section 514(a) of the Code provides for the inclusion in gross income derived from an unrelated trade or business a percentage of the income derived from debt-financed property.

Section 514(b)(1) of the Code provides that the term "debt-financed property" means any property which is held to produce income and with respect to which there is an acquisition indebtedness (as defined in subsection (c)) at any time during the taxable year (or, if the property was disposed of during the taxable year, with respect to which there was any acquisition indebtedness at any time during the 12-month period ending with the date of such disposition).

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

Sections 4941(d)(1)(D) and (E) of the Code provide that the term "self-dealing" means any direct or indirect payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person; and the transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation.

Section 53.4941(d)-2(f)(2) of the Foundation and Similar Excise Taxes Regulations provides 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.

Section 4945(a) of the Code imposes a tax on each taxable expenditure as defined in section 4945(d).

Section 4945(d)(5) of the Code provides that a "taxable expenditure" is any amount paid or incurred by a private foundation for any purpose other than one specified in section 170(c)(2)(B).

M's payment of the user fee to the Internal Revenue Service for this ruling request concerning itself, but involving other parties and their interests in X and Y, does not constitute an act of self-dealing under section 4941 of the Code or a taxable expenditure under section 4945. Any possible benefit accruing to any disqualified persons is merely incidental or tenuous within the meaning of section 53.4941(d)-2(f)(2) of the regulations and therefore is not an act of self-dealing. The cost of the user fee is not a taxable expenditure, because such payment is not for a purpose other than one specified in section 170(c)(2)(B). Also, M's payment of the user fee will not be considered the payment of compensation for purposes of sections 4941 or 4945. Furthermore, X's and Y's borrowing of funds and distributing of the loan proceeds to their partners on a pro rata basis will not constitute an act of self-dealing under section 4941 or a taxable expenditure under section 4945.

Although the proceeds received by M are borrowed funds, the loans, in the aggregate or individually, do not constitute "debt-financed property" under section 514(b)(1) of the Code. Here, M will distribute such borrowed funds to organizations that are described in section 501(c)(3), and such amounts will not constitute property which is held to produce income. Under these circumstances, the loan proceeds do not constitute "debt-financed property" as defined in section 514(b). However, any income derived by M from the investment of the loan proceeds prior to their distribution to organizations described in section 501(c)(3) would constitute unrelated debt-financed income under section 514(a).

Conclusions:

Based on the foregoing, we rule that:

1. M's payment of the cost of obtaining the rulings set forth in this ruling request does not constitute an act of self-dealing for purposes of section 4941 of the Code or a taxable expenditure for purposes of section 4945, and the payment of such costs will not be considered additional compensation for purposes of section 4941 and 4945.

2. Proceeds received by M from the X, Y and Z loans, in the aggregate or individually, do not constitute "debt-financed property" under section 514(b)(1) of the Code where M distributes such amounts to organizations that are described in section 501(c)(3). Under these circumstances, the loan proceeds do not constitute "debt-financed property" because they are not property held to produce income. However, any income derived by M from the investment of the loan proceeds prior to their distribution to organizations described in section 501(c)(3) would constitute unrelated debt-financed income under section 514(a).

3. If X borrows funds that are secured by the X property and distributes the loan proceeds to its partners on a pro rata basis, neither the X loan nor the distribution will constitute an act of self-dealing under section 4941 of the Code or a taxable expenditure for purposes of section 4945.

4. If Y borrows funds that are secured by the Y property and distributes the loan proceeds to its partners on a pro rata basis, neither the Y loan nor the distribution will constitute an act of self-dealing under section 4941 of the Code or a taxable expenditure for purposes of section 4945.

This ruling is based 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 M's authorized representative. A copy of this letter should be kept in M's permanent records.

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

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

Sincerely,

(signed) Marvin Friedlander

Marvin Friedlander
Manager, Exempt Organizations
Technical Group 2