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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Contact Person:

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Identification Number:

Telephone Number:

Fax Number:

Employer Identification Number:

Legend

A =
B =
C =
D =
x =
z =
xx =

Dear :

We have considered your ruling request, dated September 8, 2003, regarding whether participation by B in A's securities lending program will involve an act of self-dealing as defined in section 4941(d) of the Internal Revenue Code of 1986, as amended.

FACTS

B is a tax-exempt organization and private foundation as described in section 501(c)(3) and section 509(a) respectively of the Code. A serves as Investment Trustee of B. To participate in the securities lending program, B engaged A as its agent to provide securities lending services.

The purpose of B is to make grants to organizations for programs that improve the quality of life for the residents of C, with a particular emphasis on programs that support children, the elderly, the arts, healthcare, medical research, education and religious organizations.

D died in June and B's primary source of funding has been contributions from her estate. As of the close of its fiscal year, B's assets totaled x. These assets consists principally of equity and fixed income securities, along with cash and cash equivalents. During that year, B paid over z in grants to more than different tax-exempt organizations and government instrumentalities.

Pursuant to the terms of B's trust instrument, an Administrative Trustee and an Investment Trustee administer B. D initially held these positions. As provided by the successor trustee provisions in section 4.2 of the trust instrument, A has served as Investment Trustee since D's death. Four individuals, who act by majority vote in making decisions, have held the position of Administrative Trustee following D's death. None of these individuals is affiliated with A. The Administrative Trustee has also appointed officers and agents to assist the Administrative Trustee with its functions.

Articles VI and VII of the trust instrument set forth the various Trustee powers and responsibilities and accordingly divide the Trustee functions between the Administrative Trustee and Investment Trustee. The functions of the Investment Trustee are limited to the investment of B's assets and related functions as provided in Article VI of the Trust instrument. By contrast, pursuant to Article VII of the Trust instrument, the Administrative Trustee is specifically charged with the conduct B's exempt function. Powers and responsibilities of the Administrative Trustee include: (a) making all decisions relating to B's grants and charitable distributions; (b) making management and operational decisions regarding office space, the employment and compensation of agents and employees, and other business matters; and (c) preparing and maintaining records that are not prepared and maintained by the Investment Trustee. In the event of any uncertainty concerning which Trustee is charged with any power or responsibility, the disputed power or responsibility is deemed to be within the charge of the Administrative Trustee.

A is organized as a and provides general banking, investment management and trust administration services. As Investment Trustee, A has those powers and responsibilities with respect to B that are enumerated in section 6.1 of the trust instrument, including: (a) providing for the custody of A's assets and the production and collection of investment income; (b) managing and investing A's assets that are not managed by an investment manager chosen by the Administrative Trustee; (c) preparing and maintaining records and accounts; and (d) making charitable and other disbursements as directed by the Administrative Trustee. The Investment Trustee's compensation for performing these functions is negotiated with and approved by the Administrative Trustee.

The trust instrument provides no specific language authorizing or requiring the Trustee to engage in securities lending activities. However, sections 8.1 and 8.2 of the instrument do give the Investment Trustee broad authority and flexibility in making trust investments, including an authorization in subsection 8.1(h) to invest in any investment medium that is not prohibited under the private foundation excise tax rules. These sections also incorporate the standard that

trust investments are viewed within the context of the entire investment portfolio and within an overall portfolio investment strategy.

In Article IX of the trust instrument, the Investment Trustee and Administrative Trustee are specifically directed not to perform any of the prohibited acts applicable to private foundations under chapter 42 of the Code, including engaging in any act of self-dealing as defined in section 4941(d) of the Code.

To generate additional income for B's charitable activities, the Administrative Trustee, on the recommendation of its own investment consultant, has proposed that B engage the services of a bank to loan securities within the B's investment portfolio to third-party borrowers. After reviewing various options, the Administrative Trustee has proposed that A provide these securities lending services to B through A's securities lending program (the "Program"). The Administrative Trustee has approved using A's Program based on a number of factors, including A's experience with securities lending, its competitive fees, and the fact that A serves as custodian of B's assets and performs other functions for B. Through participation in the Program, a substantial portion of the B's equity securities will be available to be loaned to third-party borrowers as discussed in more detail below. B currently does not plan to loan fixed-income securities, although it may do so in the future.

Securities lending is an activity commonly performed by banks as a service to institutional investors such as tax-exempt organizations, to allow them to generate additional income on their investment portfolio with minimal risk to the portfolio. A's Program is typical of securities lending programs offered by banks. Each borrower participating in A's Program ("Borrower") is a large bank or other financial institution. A and its affiliates are not permitted to be Borrowers.

To participate in the Program, B will execute a Securities Lending Authorization Agreement ("Agency Agreement") appointing A as its agent for purposes of lending its securities. The Agency Agreement gives A the power to lend securities owned by B to Borrowers pursuant to a securities Borrowing Agreement entered into between A and each Borrower. As lender, B will approve the types of its securities available to be loaned under the Program. B will also approve the list of Borrowers, which will be designated on Schedule A to the Agency Agreement.

As a protection to B in lending its securities, sections 3 and 4 of the Agency Agreement require that collateral must be received from each Borrower in exchange for each loan. B will designate on Schedule B to the Agency Agreement the types of collateral (typically cash, U.S. Government securities and letters of credit) that A is authorized to accept, and the types of permissible investments of cash collateral. A will hold all collateral and cash collateral investments in segregated accounts for the benefit of its lending clients. The collateral will be required to be a market value equal to at least 100% of the market value of the borrowed

securities, as determined each business day that the loans remain in effect. Accordingly, if on any business day the market value of the collateral is less than the aforementioned required value, A will demand additional collateral from the Borrower to make the market value equal to the required value. As provided in section 6 of the Agency Agreement, a Borrower is also required to pay A, for B's account, amounts equal to and in substitution for distributions such as cash or stock dividends and interest payments made on loaned securities during the term of the loan.

Pursuant to section 5 of the Agency Agreement, A retains the right (as further specified in the Borrowing Agreement) to terminate a loan of securities at any time, whereupon the Borrower must deliver the securities to A for B's account in less than five business days from the notice of termination. Section 5 correspondingly gives B the right to direct A to terminate the loan at any time in whole or in part. If the Borrower should fail to deliver the securities, A is given the right to purchase equivalent securities using the collateral received from the Borrower, and the Borrower is responsible for the costs of purchasing such securities. As additional protection, the Agency Agreement in section 16 provides for A to indemnify B under certain circumstances if A is unable to recover the borrowed securities.

By lending its securities, B will receive revenue consisting of (a) income derived from the investment of cash collateral received during the loan period and (b) loan premiums or fees paid by Borrowers pursuant to the Borrowing Agreement. This revenue will be credited to the B's account on a monthly basis. As compensation for its services, A will be permitted to deduct from the account a fee equal to a percentage of the net revenue received by B. The fee percentage contemplated is a fee split whereby A will receive a 40 percent split of the lending revenue for its services as lending agent, and B will receive the remaining 60 percent of such revenue. You have represented that this 40percent/60 percent fee split is a standard industry rate charged by A and other banks that offer similar securities lending services. In the first 12 months of B's participation in the Program, it is estimated that the net revenue generated from the securities loans will be approximately xx.

RULING REQUESTED

You have requested a ruling that the participation by B in A's securities lending Program, as described above, will not involve an act of self-dealing as defined in section 4941(d) of the Code.

LAW

Section 4941 of the Internal Revenue Code imposes an excise tax on any direct or indirect act of self-dealing between a private foundation and a disqualified person with respect to the foundation. The tax is imposed on the disqualified person and, in certain situations, a tax

is also imposed on the foundation manager or managers participating in the self-dealing act or acts.

Section 4941(d)(1) of the Code provides, in part, that the term self-dealing includes a direct or indirect: (A) sale or exchange, or leasing, of property between a private foundation and a disqualified person; (C) furnishing of goods, services or facilities between a private foundation and a disqualified person; (D) payment of compensation (or payment or reimbursement of expenses) by a private foundation to 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 4941(d)(2) of the Code enumerates certain exceptions to the foregoing rules. As one exception, section 4941(d)(2)(E) provide that, except in the case of a government official as defined in section 4946(c), 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 53.4991(d)-2(c)(4) of the Foundation and Similar Excise Tax Regulations provides that the performance by a bank or trust company, which is a disqualifies person, of trust functions and certain general banking services for a private foundation is not an act of self-dealing where the banking services are reasonable and necessary to carrying out the exempt purposes of the private foundation, if the compensation paid to the bank or trust company is not excessive. The general banking services allowed by this subparagraph are: (1) checking accounts so long as the bank does not change interest on withdrawals; (2) savings accounts, as long as the foundation may withdraw its funds on no more than 30-days notice without subjecting itself to a loss of interest on its money for the time during which the money was on deposit; and (3) safekeeping activities.

Section 53.4941(d)-3(c)(1) of the regulations provides that the payment of compensation (and the payment or reimbursement of expenses) by a private foundation to a disqualified person for the performance of personal services which are reasonable and necessary to carry out the exempt purposes of the private foundation shall not be an act self-dealing if such compensation (or payment or reimbursement) is not excessive. For purposes of this subparagraph the term "personal services" includes the services of a broker serving as agent for the private foundation, but not the services of a dealer who buys for the private foundation as principal and resells to third parties. For the determination whether compensation is excessive, see section 1.167-7 of the regulations. Section 1.162-7 of the regulations provides that the determination of whether compensation is reasonable and not excessive is made looking at prevailing industry standards, that is, whether the compensation or fees are similar in amount to those paid for comparable services by like enterprises under similar circumstances.

Section 53.4941(d)-3(c)(2) of the regulations, Example (2), states that C, a manager of a private foundation X (and hence a disqualified person with respect to X), owns an investment counseling business. Acting in his capacity as an investor counselor, C manages X's investment

portfolio for which he receives an amount which is determined not to be excessive. The payment of such compensation to C shall not constitute an act of self-dealing.

Section 4946(a)(1)(B) of the Code defines the term "disqualified person" to include, among others, a foundation manager.

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.

ANALYSIS

The term disqualified person is defined in section 4946 of the Code. Based on this definition, it is possible that given the Investment Trustee's responsibilities under the Trust instrument, the Investment Trustee, which is A as discussed above, may be considered to be a disqualified person with respect to B.

However, even if A deemed to be a disqualified person, B's participation in the securities lending Program will not involve an act of self-dealing by virtue of the self-dealing exception set forth in section 4941(d)(2)(E), supra. In this regard, two sections of the regulations promulgated in connection with section 4941(d)(2)(E) of the Code provide a basis for demonstrating that self-dealing does not exist in this situation: (a) the provision of securities lending services by A involves "trust functions" and "general banking services" performed for reasonable compensation to carry out B's exempt purpose as permitted by section 4941(d)-2(c)(4) of the regulations; and (b) A's role in the Program is limited to that of providing personal services, as an agent for B, in furtherance of B's exempt purpose as permitted by section 49411(d)-3(c)(1) of the regulations.

The performance by a bank or trust company that is a disqualified person of trust functions and certain general banking services for a private foundation is not self-dealing if the trust functions and banking services are reasonable and necessary to the foundation's exempt purpose, and the compensation, taking into account the fair interest rate for the use of funds by the bank or trust company, is not excessive. Section 53.4941(d)-2(c)(4) of the regulations.

Section 53.4941(d)-3(c)(1) of the regulations provides an exception from self-dealing for payment of reasonable compensation for personal services rendered by a disqualified person in carrying out the exempt purpose of a private foundation. This provision is related to the trust functions/ banking services exception in section 53.4941(d)-2(c)(4), supra. In fact, banking services are referenced and described as personal services in section 53.4941(d)-3(c)(1) of the regulations and in Example (3) following of this section of the regulations.

The payment of compensation to a foundation manager for its investment services rendered to a private foundation qualifies as compensation for personal services. Section 53.4941(d)-3(c)(2) of the regulations, Example (2).

Pursuant to section 53.4941(d)-3(c)(1) of the regulations, qualified personal services include the services of a broker serving as agent for a private foundation, but not the services of a dealer who buys from the foundation as principal and resells to third parties. This prohibition on principal-to-principal transactions is consistent with the self-dealing prohibitions under section 4941(d)(1) of the Code, which generally prohibit sales, exchanges, and also prohibit the transfer to or use by a disqualified person of a private foundation's income or assets.

In arranging securities loans for B, A will be acting only as an agent for B and will not be buying or selling securities (or otherwise engaging in transactions) with the B on a principal-to-principal basis. A's role as agent will include performing a number of services on behalf of B, including acting as broker in arranging securities loans, monitoring Borrowers, managing and investing collateral and other amounts received from Borrowers, and the distributing revenue into one or more of B's accounts maintained by A. None of these functions involves A engaging in a transaction with the B in a manner prohibited under section 4941(d). Importantly in this respect, A and its affiliates will not be Borrowers of B's securities under the Program, and no other disqualified persons within the meaning of section 4946 of the Code will be a Borrower.

A's role as agent of the Trust is also evidenced by the controls the Agency Agreement gives B over A with respect to B's participation in the Program. B will approve the list of Borrowers of B's securities as well as the type of collateral received in exchange for securities loans. B may also direct A to terminate the loan at any time. Finally, B may terminate its engagement of A as agent at any time by B's power to terminate the Agency Agreement at any time.

Therefore, A's role in the Program will be as an agent providing trust functions and other personal services that are reasonable and necessary to carrying out the exempt purposes of B, as permitted by section 4941(d)(2)(E) of the Code, and the regulations thereunder. Moreover, any compensation received by A for such services is reasonable in accordance with section 4941 standards.

RULINGS

Accordingly, based on the law and analysis, we rule the participation by B in A's securities lending Program will not involve an act of self-dealing as defined in section 4941(d) of the Code.

This ruling is based on the understanding that there will be no material change in the facts upon which it is based. Any changes that may have a bearing on your tax status should be

reported to the Service. This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described.

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

Because this letter could help resolve future questions about your federal tax responsibility, please keep a copy of this ruling in your permanent records. If your have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

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Sincerely yours,

Michael Seto
Manager, Exempt Organizations
Technical Group 1