TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

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Contact Person:

Contact's Identification Number:

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Telephone Number:

Employer Identification Number:

Legend:
F =
S =
T =
X =
Y =
a =

Dear :

This is in reply to trustee T's request for a ruling that T's financial return from the continued use of bank S as a manager of private foundation F's investments in X funds, after T's sale of X funds to bank S, will not be an act of self-dealing under section 4941 of the Internal Revenue Code between disqualified persons under section 4946 of the Code.

Facts

T is a for-profit bank and is a disqualified person under section 4946 of the Code with respect to private foundation F because T is the trustee and foundation manager of F.

F, a charitable trust established pursuant to a decedent's will, is exempt from federal income tax under section 501(c)(3) of the Code, and is a private foundation under section 509(a) of the Code. The trustee of F is bank T.

F's assets are very substantial, amounting to several hundred millions of dollars. T has invested substantial assets in a diversified portfolio of bonds, fixed income securities and common stocks and other equity investments; a smaller portion in alternative investments such as Y and hedge funds; and a very small portion in cash or cash equivalents. T has two advisory boards for grant making, one for each main program; it also has a citizen advisory committee for investment and investment policy.

Prior to date a, T had an investment management division that specialized in investing in Y investments. At that time, the Y investments of the division were very substantial. The division had over 30 clients and 40 different accounts. T invested a portion of the assets of F in X — i.e., two Y funds managed by the Y investment management division. The F assets invested in these funds comprised an insubstantial portion of the assets of the Y investment division — about 3.14 percent. Only about 4.6 percent of the assets of F were invested in the two Y funds. T did not charge F's assets with trustee's fees related to the investments of F assets in the two Y funds, because T in its non-fiduciary capacity has managed the assets and in that capacity received management fees. T represents that the management fees that it charged for F's assets invested in the two Y funds were reasonable.

On date a, T contracted with bank S to sell the Y investment division. Private foundation F's citizen advisory committee has not objected to the continued investment in the X funds now managed by bank S.

Under the contract for the sale of the Y investment division between the banks T and S, for approximately three years after date a (the date of sale), S will receive management fees from all of the Y investments and will pay to bank T, as part of the purchase price for the Y investment division, 30 percent of the fees received from investors in Y that consent to continue the investment in Y. T, in its capacity as trustee of F, has not consented to the continuation of the investment in the X funds. That consent is still pending. Under a separate contract between T and S, T has continued to receive all of the management fees from the X funds, but has paid 70 percent of those fees to bank S for management services. These management fees are the only fees that T is collecting from the X funds at this time. After T has consented to the continuation of F's investment in the X funds which are included in S's Y investment division, the management fees will be paid by F directly to S. At that time, T will begin to charge F's assets invested in the X funds a fee for fiduciary services (reduced from its normal fee and subject to the supervision of the local court). T represents that such fees are fair and reasonable.

If, or to the extent, that T reduces or ends its investments in the sold Y funds, T will receive less money from S under the contract provisions between T and S because, if there are fewer Y assets under management, S will receive less in management fees and the Y management contract will thus be worth less to S. As a result of T's continued investments in the Y funds, including T's investment of F's assets which are now under management by bank S, T will receive a higher purchase price based on the amount of assets (including assets of F) that T continues to invest in the two Y funds.

T has recognized that there is a conflict of interest between its fiduciary duties as manager of F's assets, and the terms of the sales contract under which it will receive a greater sales price if it continues its investments of F assets in the Y funds now managed by S bank. For that reason, T has petitioned the local court having jurisdiction over trusts to obtain a ruling that the continued investment of F's assets in the two Y funds is permissible. The court has not yet issued a ruling.

In both the ruling request and in its petition in the local court, T has represented that the Y investments are made for the long term; that favorable returns are realized only over a lengthy period of years; that the Y interests are illiquid, difficult and expensive to value; and that any premature termination of T's Y investments (including the investment of F's assets) will almost certainly result in T realizing less than true value for its Y assets, including the Y assets of F.

T's ruling request to the Service concerns only whether T is involved in any prohibited self-dealing under section 4941 of the Code with a disqualified person under section 4946 of the Code, by acting on behalf of its trust client, private foundation F, to continue F's investment under the management of bank

S while S is paying T under the contract in relation to the amount of business done for F. This ruling is not contingent on the action of the local court, if any, on the conflict of interest issue.

Requested Ruling

T requests a ruling that T's financial return from the continued use of bank S as a manager of private foundation F's investments in X funds, after T's sale of X funds to bank S, will not be an act of self-dealing under section 4941 of the Internal Revenue Code between disqualified persons under section 4946 of the Code.

Law

Section 501(c)(3) of the Code provides for the exemption from federal income tax of nonprofit organizations organized and operated exclusively for the charitable and/or other exempt purposes stated in that section, provided that no part of the earnings of the organization inures to the benefit of a private individual or company.

Section 509(a) of the Code describes organizations exempt from federal income tax under section 501(c)(3) that are private foundations subject to the provisions of Chapter 42.

Section 4941of the Code imposes an excise tax on any act of self-dealing between a private foundation and a disqualified person as defined in section 4946.

Section 4941 of the Code provides that the term "self-dealing" includes any use of a private foundation's assets for the benefit of any of the disqualified persons under section 4946 of the Code. The prohibition allows a trustee, even as a disqualified person under section 4946, to be paid reasonable compensation for professional trust services provided to the trust.

Section 53.4941(d)-1 of the Foundation and Similar Excise Tax Regulations provides that an act of self-dealing can be a direct or indirect transaction, and it is immaterial to this prohibition whether the transaction results in a benefit to the private foundation.

Section 53.4941(d)-2(f)(2) of the 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 4946 of the Code defines the disqualified persons subject to section 4941, and includes substantial contributors and private foundation managers..

Revenue Ruling 78-77, 1978-1 C.B. 378, holds that there is no act of self-dealing under section 4941of the Code where a private foundation purchased property from a testamentary trust and the banking institution was the trustee of both the purchasing private foundation and the selling testamentary trust. The Ruling held that the purchase is not an act of self-dealing under section 4941 of the Code merely because the banking institution is the trustee of both the private foundation and the testamentary trust because the testamentary trust was not a disqualified person under section 4946 of the Code with respect to the private foundation."

Revenue Ruling 85-162, 1985-2 C.B. 275, indicates that there is no self-dealing under section 4941 where a private foundation, managed by a bank trustee, grants loan money to a charitable purpose project of publicly supported charities which may incidentally pay for services by companies who are customers of that bank that is trustee of the grantor private foundation.

Analysis

Section 4941 of the Code imposes a tax on each act of self-dealing between a disqualified person and a private foundation. The Trust, as a private foundation, is subject to the self-dealing rules under Section 4941 of the Code. T, as trustee of the F, qualifies as a foundation manager under section 4946(b)(1) of the Code, which defines a foundation manager as an officer, director or trustee of a foundation. Therefore, T, as trustee of F, is a disqualified person under section 4946(a)(1)(B) of the Code with respect to the F.

Prior to sale date a, T's charges to F, for managing F's assets in the two Y funds, were payments for investment services and did not constitute an act of self-dealing pursuant to the personal services exception at Section 4941(d)(2)(E) of the Code.

T, as trustee of F's assets, desires to consent to the continuation of the investment of F's assets in the two Y funds, which were sold to S bank together with all of the other assets of T's Y division. Continued investment of F's assets in the two Y funds is prudent and advisable, and premature withdrawal of F's assets from the two funds would have an adverse financial impact on such assets.

However, after consenting to the continued investment, T, in its capacity as the seller of the Y division, will indirectly benefit by receiving a higher purchase price from S bank for the Y division so long as T continues its investment of trust assets in the sold funds, including the assets of F invested in two Y funds.

The investment management fees to be charged to F through its assets invested in the two Y funds if T continues F's investments in the two funds are comparable to fees charged in the industry for like services. S Bank would charge the same fee to its Y investment clients, regardless of the contingent purchase price to be paid to T.

The original payment by the Trust for the Y investment service was within the exception for personal services at 4941(d)(2)(E) of the Code. F will pay similar reasonable fees to S for Y management services. T, as trustee, will continue to be paid its regular compensation by F, regardless of its decision to continue F's investment in the two Y funds. In accordance with section 4941(d)(2)(E), T represents that its compensation as trustee will not be excessive compared to the services rendered to F foundation.

However, like the bank in Revenue Ruling 85-162, T will receive a benefit -- a contingent sales price -- that flows from a business relationship with a separate party (in this case S bank). Such contingent fees are typical in sales of investment management funds. The amount of F assets formerly managed by T's Y division was insubstantial in relation to the total assets sold, and the assets of F invested in the two Y funds is also insubstantial in relation to the total assets of F. So even if the payment by S Bank to T could be indirect self-dealing, the connection is tenuous and would fall within the exception for incidental and tenuous benefits at Reg. §53.4941(d)-2(f)(2).

Ruling

We rule that T's financial return from the continued use of bank S as a manager of private foundation F's investments in X funds, after T's sale of X funds to bank S, will not be an act of self-dealing under section 4941 of the Internal Revenue Code between disqualified persons under section 4846 of the Code.

As a matter of general information, this ruling letter is not intended, and should not be construed, to express any opinion on any other matter beyond section 4941 of the Code. For instance, this section 4941 tax ruling is not intended, and should not be construed, to express any opinion on whether the anticipated state court should, or should not, in the future, approve any potential conflict of interest in the transactions involved here, whether the compensation to be paid by the private foundation for services by T and/or S will turn out to be reasonable in amount, or whether the payments by the S servicing bank to the T trustee bank involve any other federal or state regulations.

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 letter 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 letter, please contact the person whose name and telephone number are shown in the heading of this letter. Because this ruling letter could help to resolve any questions, please keep it in your permanent records.

Sincerely,

Andrew F. Megosh Jr.
Acting Manager, Exempt Organizations
Technical Group 2

Enclosure: Notice 437