INTERNAL REVENUE SERVICE

NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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E.O. Exams Programs and Review
Internal Revenue Service
1100 Commerce Street
MC 4900 DAL
Dallas, TX 75242

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification Number:

Years Involved:

Date of Conference:

Legend:

Q =
R =
S =
T =
U =
U1 =
U2 =
U3 =
U4 =

V =
W =

A =
B =
C =
D =

E =
F =
G =

Date 1 =
Date 2 =

City =

ISSUE:

Whether the loans to R from V, a disqualified person to Q, represent indirect self-dealing.

FACTS:

Description of the parties

A is a trustee of Q, a private foundation. A is also a descendant of a substantial contributor, and is therefore a disqualified person to Q under both section 4946(a)(1)(B) of the Code as Foundation Manager and section 4946(a)(1)(D) for a familial relationship.

V is a publicly traded company. The Class A Common stock of V elects one-third of the total number of directors, treating any fraction thereof as an additional director. The Class B common stock has the right to elect the remaining directors. A owns 1,160,896 shares (35.27%) of Class A common stock and 198,974 shares (99.04%) of Class B common stock of V. A thus owns a controlling interest in V. Due to A's ownership of more than 35% of the total combined voting power, V is a disqualified person to Q under section 4946(a)(1)(E) of the Code.

Ownership of the remaining issued and outstanding shares of Class A common stock is widely held. Ownership of the remaining issued and outstanding shares of Class B stock is held by U, the collective name for the following trusts: U1, U2, U3, and U4. Each of these trusts is for the benefit of one of A's children, which consists of equal shares for B, C, D, and E. The four trusts are governed by a single Trust Indenture and various amendments executed by A. In a private letter ruling, the four trusts were held to be disqualified persons to Q.

A has held positions as chairman of the board, director and CEO of V since approximately 1971. C is the President and Chief Operating officer. D and E are on the Board of Directors. In addition, A receives in excess of $ a year in salary and benefits from V and C receives in excess of $.

R was originally a family-owned entity. As of Date 1, it was owned 50% by Q and 50% by S, a split-interest trust as defined by section 4947(a)(2)(C) of the Code with primarily charitable beneficial ownership. The ownership was unchanged, as of Date 2, when a private letter ruling was requested as to whether R represented an excess business holding. The Service ruled that Q eventually had to reduce its holdings in R below 35%.

As of 1998, ownership of R has been as follows:

Owner	# of Shares Owned	Percentage
S	251	50.2%
Q	170	34.0%
T	79	15.8%
Total	500	100%

T is a tax-exempt organization as described in section 501(c)(3) and is classified as other than a private foundation under section 509(a)(3). T receives a substantial amount of its funding from V. T's Amended Articles of Incorporation provides for a three-member board of directors, currently composed of A as lifetime director, and B and D as the other two directors.

According to the Minutes of R, A received the proxies in a fiduciary capacity from each of Q, S, and T each year for several years for the sole purpose of authorizing him to vote their R shares on their behalf at the annual shareholders meeting in 1999, 2000, 2001 and 2002. A also serves on the board of R and was its chairman in 1999 and 2000.

In 1999, A, F (his spouse) and B (his son), represented 50% of the six-member board of directors. All three are disqualified persons to V. In addition, G, the son of F, was on the board of directors. In 2000, two additional directors were added: D (A and F's daughter) and E (A's son). Both D and E are disqualified persons to V. Since 2000, five of the eight members of the board of directors of R were disqualified persons to Q.

Loan transactions

During 1998, R had three outstanding loans with V. The balance sheet of R shows $ and $ of long term debt owed in 1998 and 1999, respectively. This debt is comprised entirely of loans from V and W, another related corporation. Loans from both V and W are similar with slight variations in their terms. All loans contain some variation of the following:

1. Late payment penalty in the event R fails to make payments when due
2. Acceleration clause if R is deemed in default
3. Ability of maker to increase interest to maximum rate allowed by law in event of default
4. Prohibition against prepayment until after the 5th year (or 7th if a 20 year note)
5. Prepayment penalty of 5% of outstanding principal during first year prepayment allowed, with penalty decreased each additional year

Each loan was a mortgage loan issued to R and secured by real property. Interest rates varied between 8% and 9%.

LAW:

Section 4941(a)(1) of the Internal Revenue Code provides a tax on each act of self-dealing between a disqualified person and a private foundation.

Section 4941(d)(1) of the Code defines self dealing as any direct or indirect: (B) lending of money or other extension of credit between a private foundation and a disqualified person.

Section 53.4941(d)-1(b)(5) of the Foundation and Similar Excise Taxes Regulations provides that an organization is controlled by a private foundation if the foundation or one or more of its foundation managers (acting only in such capacity) may, only by aggregating their votes or positions of authority, require the organization to engage in a transaction which if engaged in with the private foundation would constitute self-dealing. Similarly, an organization is controlled by a private foundation in the case of such a transaction between the organization and a disqualified person, if such disqualified person, together with one or more persons who are disqualified persons by reason of such a person's relationship (within the meaning of section 4946(a)(1) (C) through (G)) to such disqualified person, may, only by aggregating their votes or positions of authority with that of the foundation, require the organization to engage in such a transaction. The "controlled" organization need not be a private foundation; for example, it may be any type of exempt or nonexempt organization including a school, hospital, operating foundation, or social welfare organization. An organization will be considered to be controlled by a private foundation or by a private foundation and disqualified persons referred to in the second sentence of this subparagraph if such persons are able, in fact, to control the organization (even if their aggregate voting power is less than 50 percent of the total voting power of the organization's governing body) or if one or more of such persons has the right to exercise veto power over the actions of such organization relevant to any potential acts of self-dealing.

In section 53.4941(d)-1(b)(8), Example (1) of the regulations, Private foundation P owns the controlling interest of the voting stock of corporation X, and as a result of such interest, elects a majority of the board of directors of X. Two of the foundation managers, A and B, who are also directors of corporation X, form corporation Y for the purpose of building and managing a country club. A and B receive a total of 40 percent of Y's stock, making Y a disqualified person with respect to P under section 4946(a)(1)(E). In order to finance the construction and operation of the country club, Y requested and received a loan in the amount of $ 4 million from X. The making of the loan by X to Y shall constitute an indirect act of self-dealing between P and Y.

In section 53.4941(d)-1(b)(8), Example (6) of the regulations, Private foundation P owns 20 percent of the voting stock of corporation W. A, a substantial contributor with respect to P, owns 16 percent of the voting stock of corporation W. B, A's son, owns 15 percent of the voting stock of corporation W. The terms of the voting stock are such that P, A, and B could vote their stock in a block to elect a majority of the board of directors of W. W is treated as controlled by P (within the meaning of subparagraph (5) of this paragraph) for purposes of this example A and B also own 50 percent of the stock of corporation Y, making Y a disqualified person with respect to P under

section 4946(a)(1)(E). W makes a loan to Y of $ 1 million. The making of this loan by W to Y shall constitute an indirect act of self-dealing between P and Y.

In section 53.4941(d)-1(b)(8), Example (7) of the regulations , A, a disqualified person with respect to private foundation P, enters into a contract with corporation M, which is also a disqualified person with respect to P. P owns 20 percent of M's stock, and controls M within the meaning of subparagraph (5) of this paragraph. M is in the retail department store business. Purchases by A of goods sold by M in the normal and customary course of business at retail or higher prices are not indirect acts of self-dealing so long as the total of the amounts involved in all of such purchases by A in any one year does not exceed $ 5,000.

Rev. Rul. 76-158 held that a private foundation that owned 35% of the voting stock of a corporation, and whose foundation manager personally owned the remaining 65 percent but did not hold a position of authority in the corporation by virtue of being foundation manager, did not control the corporation for purposes of section 4941 of the Code. The private foundation did not have the right to exercise veto power over the actions of the corporation, and had no authority over the corporation's actions other than that represented by its 35% stock ownership.

Moody v. Commissioner, T.C. Memo. 1995-195, involved a similar issue where the court did not find indirect self-dealing. Shearn Moody, Jr., a trustee of the Moody Foundation and a director of Gal-Tex, incurred a large bill at a hotel owned by Gal-Tex, which at the time was owned 50/50 by the Foundation and the Libbie Shearn Moody Trust. Mr. Moody billed the Foundation for the expenses. The Foundation refused to pay, as Mr. Moody failed to substantiate a business purpose for the expenses. Mr. Moody filed for bankruptcy, and the hotel sought to collect in the bankruptcy proceedings, unsuccessfully. The court agreed with the premise that a disqualified person can engage in “indirect" self-dealing with private foundation assets by engaging in transactions with an organization controlled by the private foundation, but held that the Foundation did not control Gal-Tex under the circumstances. Applying section 53.4941(d)-1(b)(5) of the regulations, the court reasoned that the Foundation or its foundation managers acting in such capacity did not control Gal-Tex (reasoning that 50% ownership is ordinarily not enough to constitute control); that Mr. Moody, together with others who are disqualified persons by virtue of their relationship to Mr. Moody (there were none), could not require Gal-Tex to engage in self-dealing only by aggregating their influence with that of the Foundation; that Mr. Moody lacked actual control, or a veto power, over the activities of Gal-Tex; and that, to the contrary, Gal-Tex exercised considerable independence from both Mr. Moody and the Foundation in seeking payment from them. The court also reasoned that failure of an organization to come within the "control" tests of the regulations may not be determinative; there may exist other ways to engage in self-dealing through organizations that are related to the private foundation, though the facts did not support indirect self-dealing in this instance. The court went on to find indirect self-dealing in other transactions involving Foundation grants to charities that used some of the funds for the personal benefit of Mr. Moody (e.g., paying his bankruptcy lawyers for “research projects”).

RATIONALE:

Under the facts presented, we conclude that the loans to R from V, a disqualified person to Q, do not constitute acts of indirect self-dealing under section 4941 of the Code.

Section 4941(d)(1) of the Code generally prohibits lending of money between a private foundation and a disqualified person. It prohibits indirect as well as direct lending. One form of indirect self-dealing is between a disqualified person and an organization controlled by the private foundation. Transactions between a disqualified person and an organization not controlled by the private foundation are not indirect acts of self-dealing in most cases. However, the Code and regulations do not systematically define all manner of "indirect" self-dealing; instead, the facts and circumstances must be considered in each case.

Section 53.4941(d)-1(b)(5) of the regulations provides several tests for determining whether an organization is controlled by a private foundation for purposes of indirect acts of self-dealing, in the first, second, and fourth sentences. Considering the first sentence of section 53.4941(d)-1(b)(5), Q owns less than 50%, a minority interest of R and as such, is unable to force R to enter into any lease arrangement. Also, the facts provided do not indicate that any of Q's foundation managers, in their capacity as foundation managers, had such control. Thus, Q did not control R under this test.

Under the second sentence of section 53.4941(d)-1(b)(5), the disqualified person engaging in the purported act of indirect self-dealing is V. The facts do not indicate that there are any persons who are disqualified persons by reason of an ownership relationship to V. S controls R without the assistance of Q. Thus, Q did not control R under this test.

The fourth sentence of section 53.4941(d)-1(b)(5) references two types of control: control in fact (even if less than 50% voting power), or relevant veto power. The first contemplates a situation where there is no majority owner, but a plurality owner exercising control (see Example (7)), which does not appear to be the case here. Moreover, there are no facts indicating that Q exercises actual control over R. The fourth sentence also indicates that a relevant veto power may be regarded as control; viewed in light of Rev. Rul. 76-158, Q did not control R through veto power.

Based on the foregoing, we find that the loan transactions were not between a disqualified person and an organization controlled by Q. We find that the loans did not otherwise constitute indirect self-dealing on the facts presented.

CONCLUSION:

Based on the foregoing facts, the loans to R from V, a disqualified person to Q, do not constitute acts of indirect self-dealing under section 4941 of the Code.

A copy of this memorandum is to be given to V. Section 6110(k)(3) of the Internal Revenue Code provides that it may not be used or cited as precedent.

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