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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION JAN 14 2003

Significant Index No.
4941.00-00

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Legend:
M=
N=
O=
P=
Q=
R=
S=
T=
U=
V=

Dear Sir or Madam:

This is in response to a request for a ruling, as supplemented and modified, under section 4941 of the Internal Revenue Code submitted on M's behalf by M's authorized representative as modified. M has requested a ruling involving O's services to partnership N.

M has been recognized as exempt under section 501(c)(3) of the Code and classified as a private foundation described in section 509(a). M's trustees and substantial contributors include Q, R, and S. Q and R are husband and wife. S is the son of Q and R. Q, R, and S are members of the T family and are disqualified persons with respect to M within the meaning of section 4946. M has assets currently in a diversified portfolio of marketable securities. M also has investments in rental real estate and other securities.

U has been recognized as exempt under section 501(c)(3) of the Code and classified as a private foundation described in section 509(a). Q, R, and S serve as officers and foundation managers for U.

O is a limited liability company treated as a partnership for federal tax purposes that is engaged in the business of providing full service real estate management services. O purchases and manages real estate for its own account as well as a variety of T family investment vehicles. O's members are S and P.

P is a corporation. P is 100% owned by Q, R, and S. P is a disqualified person under section 4946(a)(1)(E) of the Code with respect to M.

M states that through the T family's interests in various corporations, partnerships, and limited liability companies, the T family owns and operates properties located in various states. M states that employees of O and P manage the T family's real estate portfolio. Services provided by O and P employees include the following: (1) property management (2) billing and collection of rents (3) accounting (4) compliance; (5) leasing activity and lease negotiations (6) risk management (7) cash management (8) debt management and (9) supervision of outside professionals and contractors.

N is a limited liability company incorporated under state law. As originally requested by M, M, U, and O are the members of N, M will have no voting control over N, O will own a 20% profits interest in N, N will be controlled and managed by O, M will hold a 65% profits interest in N and U will have a 15% profits interest in N. As represented below, there are proposed changes to these original representations.

N's gross income will be derived from rents from real property, interest and dividend income, and net capital gains from the sale of investment property. It is represented that more than 95% of the gross income of N will be derived from such passive sources.

N's articles of incorporation provide that its members shall manage N. The articles further provide that the articles may be amended, restated or modified from time to time by members holding more than 50% of the votes held by members then entitled to vote, consent to or otherwise decide any matter

submitted to the members, as determined pursuant to the operating agreement of N.

N's members will invest funds in N for purposes of acquiring additional real estate holdings. M originally represented that V, another section 501(c)(3) private foundation related to Q, R, and S, may also invest with M, O, and U in the acquisition of certain real estate investments in future years.

M has modified its representations. M now represents that M will not co-invest its assets with the assets of disqualified persons in N.

O will manage and supervise the operations of N. O will provide the following services, for M, in managing N: (a) identification and analysis of potential real estate acquisitions (b) contract negotiations (c) cash management (d) debt management including budgeting (e) negotiation of financing (f) review of loan agreements and expenditures (g) accounting (h) supervision of property operations and inspections (I) advertising (j) leasing and lease negotiations (k) goodwill relations with tenants and communities (l) interface with municipalities and compliance with new ordinances (m) collections of rents (n) supervision and administration of risk management program (o) supervision of personnel and human resources including hiring, firing, administration of employee benefit programs and personnel policies (p) supervision and administration of legal and tax services and other incidental and ancillary activities associated with the ownership of passive rental real property.

M has submitted supplemental information indicating that O may also perform services related to the disposition of property. It is represented that O will not perform maintenance, repair, janitorial, cleaning, landscaping or other operational services and capital improvement services for N, but will arrange through third party contractors the performance of such services. M has submitted supplement information indicating that O may perform supervision of capital improvement services.

M states that N will compensate O solely from the revenue and assets of N. O will receive compensation for the services described above in connection with the management of properties acquired by N. M represents that compensation provided to O would constitute reasonable compensation and be comparable with the customary practices within the industry.

M has submitted a supplemental statement of facts indicating that the Service has issued a ruling concluding that the merger and transfer of V's assets into M will be treated as a termination of V's private foundation status pursuant to section 507(b)(2) of the Code. Such transfer will not be subject to termination tax imposed by section 507(c) of the Code.

M has made the additional representations indicating that M and U will hold a combined profits interest in N of approximately 50%. Unrelated third parties will hold the balance of the profits interest.

M has provided a supplemental statement of facts indicating that M and other tax-exempt organizations will be passive investors in N with no participation in N's management.

Section 501(c)(3) of the Code provides, in part, that an organization is exempt from Federal income tax if it organized and operated for charitable and educational purposes, and if no part of the net earnings of the organization inures to the benefit of any private shareholder or individual.

Section 4941(d)(1)(D) of the Code provides 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.

Section 4941(d)(1)(E) of the Code states that the term "self dealing" means any direct or indirect 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)(E) of the Code provides that except in the case of a government official (as described in section 4946(c)), the payment of compensation (and the 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 4946(a)(1) of the Code defines a disqualified person to include with respect to a private foundation, a foundation manager and substantial contributors.

Section 4946(b)(1) of the Code states that the term "foundation manager" includes a trustee of a foundation having the authority or responsibility over the activities of the foundation.

Section 4946(a)(1)(E) and (F) of the Code, respectively, provide that the term disqualified person includes a corporation of which persons described in subparagraph A, B, C, or D own more than 35 percent of the total combined voting power and a partnership in which persons described in A, B, C, or D own more than 35 percent of the profits interest.

Section 53.4941(d)-1(b)(4) of the Foundation and Similar Excise Taxes Regulations provides that a transaction between a private foundation and an organization which is not controlled by the foundation (within the meaning of

subparagraph (5) of this paragraph), and which is not described in section 4946(a)(1)(E), (F), or (G) because persons described in section 4946(a)(1)(A), (B), (C), or (D) own no more than 35 percent of the total combined voting power or profits or beneficial interest of such organization, shall not be treated as an indirect act of self-dealing between the foundation and such disqualified persons solely because of the ownership interest of such persons in such organization.

Section 53.4941(d)-1(b)(5) of the regulations provides that for purposes of this paragraph, 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, for purposes of this paragraph, 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. For purposes of this paragraph, 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.

Section 53.4941(d)-1(b)(7) of the regulations provides that the term 'indirect self-dealing' shall not include a transaction involving one or more disqualified persons to which a private foundation is not a party, in any case in which the private foundation, by reason of section 4941(d)(2), could itself engage in such a transaction. Thus, for example, even if a private foundation has control (within the meaning of subparagraph (5) of this paragraph) of a corporation, the corporation may pay to a disqualified person, except a government official, reasonable compensation for personal services.

Section 53.4941(d)-3(c)(1) of the regulations provides that under section 4941(d)(2)(E), except in the case of a Government official (as defined in section 4946(c)), the payment of compensation by a private foundation to a disqualified person for the performance of personal services which are reasonable and necessary to carry out the exempt purpose of the private foundation shall not be an act of 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 from the private foundation as principal and resells to third parties. For the determination whether compensation is excessive, see Sec. 1.162-7 of this chapter (Income Tax Regulations). This paragraph applies without regard to whether the person who receives the compensation (or payment or reimbursement) is an individual.

Examples 1 and 2 of section 53.4941(d)-3(c) of the regulations provides as follows:

Example (1). M, a partnership, is a firm of 10 lawyers engaged in the practice of law. A and B, partners in M, serve as trustees to private foundation W and, therefore, are disqualified persons. In addition, A and B own more than 35 percent of the profits interest in M, thereby making M a disqualified person. M performs various legal services for W from time to time as such services are requested. The payment of compensation by W to M shall not constitute an act of self-dealing if the services performed are reasonable and necessary for the carrying out of W's exempt purposes and the amount paid by W for such services is not excessive.

Example (2) C, a manager of private foundation X, owns an investment counseling business. Acting in his capacity as an investment counselor, C manages X's investment portfolio for which he receives an amount which is determined to be not excessive. The payment of such compensation to C shall not constitute an act of self-dealing.

N has elected to be treated as a partnership for federal income tax purposes. Therefore, N will be treated as a partnership for purposes of section 4946 of the Code in order to determine whether the self-dealing provisions of section 4941 are applicable.

Since O is a disqualified person with regards to M, services provided by O to N, an entity in which M previously held at least a 65% profits interest and which has no disqualified person co-investors, may constitute self-dealing under section 4941 of the Code. M has provided supplemental information indication that M and U will hold a combined profits interest of 50% in N. Unrelated third parties will hold the balance or remaining 50% profits interest in N.

The personal service exception of section 53.4941(d)-3(c)(1) of the regulations addresses this concern. The services to be provided by O include a range of professional and managerial financial and real estate investment services, including negotiating real estate purchase contracts, financing terms, and cash management services which are comparable to the broker, lawyer, and investment management examples in the regulations. Under the facts and circumstances, O's services to N are personal services following section 53.4941(d)-1(b)(7) of the regulations. O can receive reasonable compensation for personal services provided by O to N.

M represents that N is an investment partnership that holds interests in real estate. N's gross income will be derived from rents from real property, interest and dividend income, and net capital gains from the sale of investment property. Thus, N derives more than 95 percent of its income from passive sources pursuant to section 53.4943-(10)(c)(1) and (2). Therefore, N is not a "business enterprise" within the meaning of section 4943(d)(3)(B) of the Code.

Based on the above, we rule that services rendered by O to N, in respect to assets allocable to M, constitute personal services and, therefore, N may compensate O under the self-dealing exception under section 4941(d)(2)(E) of the Code so long as the services are reasonable and necessary and the compensation is not excessive.

This ruling is limited to the applicability of section 4941(d)(2)(E) of the Code to issue ruled herein. The ruling is based on the understanding that there will be no material changes in the facts upon which it is based. This ruling does not purport to rule on any other issue or Code section not addressed herein.

This ruling is directed only to M, N, O, P, Q, R, S, U, and V. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely yours,

(signed) Robert C Harper, Jr

Robert C. Harper, Jr.
Manager, Exempt Organizations
Technical Branch 3