TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

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Date: FEB 3 2003

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LEGEND:

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Dear Sir or Madam:

Dear Sir or Madam:

This is in response to a ruling request dated March 7, 2002, submitted on your behalf by your authorized representatives. You are seeking rulings on whether the excise tax provisions of Chapter 42 of the Internal Revenue Code are violated by a proposed investment as more fully set forth below.

FACTS:

X is a trust created and funded by A, who currently serves as the sole trustee. A funded X on the date of its creation with a, and, since its creation, X has not received any other contributions. To date, X's funds have been invested solely in money market accounts. X has been recognized as exempt from federal income tax under section 501(c)(3) of the Code and as a private foundation under section 509(a).

Y is a limited partnership that acts as the general partner of and an investor in Z, an investment partnership whose limited partners are unrelated to X. The management, control and operation of Y is vested exclusively in its general partner, W. The current limited partners of Y are A, U, (a corporation wholly owned by A, his wife and children), B, C, D, and relatives of, and private foundations created by, each of B, C, and D.

W, the general partner of Y, is a wholly-owned subsidiary of V, a business trust that has elected to be treated as an association taxable as a corporation for federal income tax purposes. V has also made elections under sections 1362(b)(3) and 1362(a) of the Code to be an S corporation and to treat W as a qualified subchapter S subsidiary. The beneficial interests in V (and thus, indirectly in W) are owned, b by A, c by D, d by B, and e by C. These individuals (hereinafter the "Investment Advisors") are sophisticated fund managers who provide services only on behalf of Z. Each of the four manages a portion of Z's assets, for the most part independently of the others.

Z is a limited partnership organized to act as an investment partnership. The management, control and operation of Z is vested exclusively in Y its sole general partner. As of January 1, 2002, Y holds g of the capital interest in Z. The remaining capital interests in Z are held in various percentages by h, all of whom are limited partners who are not related to X, Y, or any other partner of Y.

Z has over I in assets under management invests solely in publicly-traded securities, including publicly-traded derivatives, and does not acquire more than j% of the securities issued by any one issuer. At any given time, Z's investment portfolio may consist of portions of 60 to 70 different companies, representing four to six different sectors of the market. Z's investing strategy makes use of a variety of sophisticated investment techniques, including puts, calls, straddles, margin purchases, and short (as well as long) positions. From its inception, Z has had an annualized return of k. As a result of its risk hedging practices, Z has at the same time been able to achieve those returns while performing with less volatility that the S&P 500.

Y receives two forms of compensation from Z, a quarterly management fee (the "Management Fee") and a special allocation of profits (the "Special Allocation").

The quarterly Management Fee paid by Z to Y is equal to l of the value of the assets under management on behalf of the limited partners as of the beginning of each calendar quarter. The entire amount of the Management Fee is remitted by Y to its own general partner, W. In turn, W, the wholly owned subsidiary of V, is responsible for all net costs and expenses of Y attributable to Y's activities as general partner of Z. Any net profits or losses from the provision of services to Z for which the Management Fee is intended compensation thus accrues solely to the owners of W, the Investment Advisors, by virtue of their ownership of V.

The Special Allocation is part of the overall allocation provisions in Z's Partnership Agreement. Under those provisions, Z's partners (general as well as limited) first receive an allocation of gain (whether realized or unrealized) until the total gain allocation to them represents a cumulative m return on their investment in Z for each semi-annual period beginning on January 1 or July 1, of each year. The gains allocated to Y are in turn allocated by Y to the partnership interests of the Investment Advisors, who together decide how such gains should be allocated among themselves.

The remaining income of Y represents the gains (whether realized or unrealized) allocated to Y by Z in proportion to Y's ownership interest in Z. Those gains are in turn allocated among partners of Y in proportion to their respective ownership interests.

Neither the Z Partnership Agreement nor the Y Partnership Agreement requires Y to invest in Z. Nevertheless, in fact Y invests all of its assets with Z and plans to do so for the foreseeable future.

For the limited partner, the economic effect of investing funds in Y, therefore, is the same as direct investment in Z, except that investments in Z made through Y do not bear the burden of the Management Fee or the Special Allocation. The limited partners of Y in effect receive the benefit of the Investment Advisors' expertise free of charge.

On the other hand, except for the Investment Advisors, the limited partners of Y do not share in either the Management Fee or the Special Allocation that Y receives from Z for the investment and management services that the Investment Advisors provide through W. All expenses and liabilities of Y related to the management of Z are the responsibility of W. The net effect is that the limited partners of Y other than the Investment Advisors have an investment in Z but they have no interest in the investment advisory and management business that the Investment Advisors operate through Y and W.

X wishes to avail itself of the services of the Investment Advisors. Because the Investment Advisors provide services only to Z, X can only obtain these services through an investment in Z. However, Z will not permit a direct investment by X because of security law concerns. A direct investment in Z would also cause X to incur the burden of the Management Fee and the Special Allocation.

For those reasons, X proposes to invest, most, if not all, of its current assets in Z by acquiring a limited partnership interest in Y, which will in turn, invest the funds received from X in Z. By investing in Z through Y, X will obtain the benefit of the services of the Investment Advisors without incurring the burden of the Management Fee or the Special Allocation.

X's proposed investment in Z will not create any economies of scale or any other benefit for Y, Z, or any other investor in either Y or Z. In particular, X's proposed investment will not benefit the Investment Advisors personally in any way.

Section 1-II of the Fourth Amendment to Y's Partnership Agreement states:

> Notwithstanding any other provision of the Partnership Agreement, the Partners agree that the Partnership shall refrain from the following actions and that any such action purported to be taken on behalf of the partnership shall be void and of no effect:
>
> > (i) any transaction involving a Limited Partner that is a private foundation under section 509(a) of the Code that would constitute a direct or indirect act of self-dealing under section 4941 by such private foundation; and
> >
> > (ii) any other action with respect to Partnership assets attributable to the Capital Contributions of a Limited Partner that is such a private foundation that would constitute a direct or indirect act of self-dealing under section 4941 of the Code by such private foundation.

You represent that, by way of example and not limitation, the following types of transactions will not occur with respect to X's proposed investment in Y once the investment has been made:

> (1) No portion of X's proposed investment will be sold, exchanged, or leased to Y or a disqualified person who is a partner in Y;
>
> (2) No portion of X's proposed investment will be loaned to or extended as credit to Y or to a disqualified person who is a partner in Y;
>
> (3) No portion of X's proposed investment will be used to furnish goods, services or facilities to Y or a disqualified person who is a partner in Y;
>
> (4) No portion of X's proposed investment will be used to pay compensation to or reimburse the expenses of Y or a disqualified person who is a partner in Y; and
>
> (5) No portion of X's proposed investment will be transferred to, or used by or for the benefit of, Y or a disqualified person who is a partner in Y.

The subsequent operation of Y pursuant to the above representations, with respect to X's proposed investment in Y, once made, will therefore not constitute either a direct or indirect act of self-dealing.

Under Y's Partnership Agreement, X will be entitled to receive and withdraw the profits earned on its investment at least annually. In addition, X will have the opportunity twice a year to withdraw its investment. These rights are identical to those granted to limited partners in Z, so that X will have the same rights in that respect that it would have if it invested directly in Z.

LAW:

Section 4941 of the Code imposes an excise tax on acts of self-dealing between a disqualified person and a private foundation.

Section 4941(d)(1) defines self-dealing to include any direct or indirect:

A) sale or exchange or leasing of property between a private foundation and a disqualified person;

B) lending of money or other extending of credit 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;

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)(E) of the Code provides generally that 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 53.4941(d)-1(a) of the Foundation and Similar Excise Taxes Regulations provides that it is immaterial whether a self-dealing transaction results in a benefit or detriment to the private foundation. Self-dealing does not, however, include a transaction between a private foundation and a disqualified person where the disqualified person status arises only as a result of such transaction.

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 53.4941(d)-3(c)(II) of the regulations provides that 'personal services' include 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. This paragraph

applies without regard to whether the person who receives the compensation (or payment or reimbursement) is an individual. The portion of any payment which represents payment for property shall not be treated as payment of compensation (or payment or reimbursement of expenses) for the performance of personal services for purposes of this paragraph.

In section 53.4941(d)-3(c)(2), Example (2) of the regulations, 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.

Section 4943 of the Code imposes an excise tax on any "excess business holdings" of a private foundation.

Section 4943(c) of the Code defines an "excess business holding" as any interest in a "business enterprise" held in excess of 20% of the business's voting stock or profits interest reduced by any such stock or interest held by disqualified persons.

Section 4943(d)(3)(B) of the Code provides that the term "business enterprise" does not include a trade or business at least 95% of the gross income of which is derived from passive sources.

In S. Rep. No., 552, 91st Cong., 1st Sess. [41] (1969), the Senate Finance committee stated the following regarding the meaning of "business holding" under section 4943 of the Code:

> ..."[S]tock in a passive holding company is not to be considered a business holding, even if the holding company is controlled by the foundation. Instead, the foundation is to be treated as owning its proportionate share of the underlying assets of the holding company. The committee also made it clear that passive investments generally are not to be considered business holdings. For example, the holding of a bond issue is not a business holding, nor is the holding of stock of a company which itself derives income in the nature of a royalty to be treated as a business holding."

Section 4944(a)(1) of the Code imposes an excise tax on the investment of any amount by a private foundation in such a manner as to jeopardize the carrying out of any of its exempt purposes.

Section 53.4944-1(a)(2) of the regulations provides that an investment shall be considered to jeopardize the carrying out of the exempt purposes of a private foundation if it is determined that the foundation managers, in making such investment, have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment, in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes.

Section 4946(a)(1) of the Code provides that a disqualified person, with respect to a private foundation, includes:

(A) a substantial contributor (including a creator of a trust)

(B) a foundation manager

(C) an owner of more than 20% of a corporate, partnership, or trust substantial contributor

(D) a family member (including a child or grandchild) of an individual described above

(E) a corporation of which persons described above own more than 35% of the total combined voting power

(F) a partnership in which persons described in (A)-(D) own more than 35% of the profits interest

(G) a trust or estate in which persons described in (A)-(D) hold more than 35% of the beneficial interest

Section 4946(a)(3) of the Code requires that for purposes of determining the ownership of a corporation, there shall be taken into account indirect stockholdings which would be taken into account under section 267(c) of the Code, as modified by the definition of members of family under section 4946(d).

Section 4946(a)(4) of the Code requires that for purposes of determining the profits or beneficial interests in a partnership or trust, the rules of constructive ownership under section 267(c) of the Code, as modified by the definition of members of family under section 4946(d), be taken into account.

Section 4946(b)(1) of the Code defines the term "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) and any employee of the foundation having the authority or responsibility to act on behalf of the foundation.

Section 4946(d) of the Code provides that, for purposes of section 4946(a)(1), the family of an individual shall include only his spouse, ancestors, children, grandchildren, great-grandchildren, and the spouses of children, grandchildren, and great-grandchildren.

ANALYSIS

You have represented that B, C, and D have not made any financial contribution to X and that none of them serves as a trustee of X. They do not own more than twenty percent (20 %) of the stock, profit interests or beneficial interest of any substantial contributor to X. Finally, they are not a family member of a substantial contributor, a trustee, or owner of more than twenty percent (20%) of a substantial contributor.

B, C, and D are shareholders in Y but none own more than a sixteen percent interest. As Investment Advisors, B, C, and D each make investment decisions with respect to a portion of Z's investment portfolio, and as such, they would control some portion of X's investments so long as X retained any investment in Z through Y. They would not, however, have any control over X's decision to withdraw from or continue to invest with Y.

X's relationship with B, C, and D is that of an investor with an investment advisor. Conversely, B, C, and D do not exercise any control or authority over X other than that of an investment advisor. Accordingly, B, C, and D are not disqualified persons with respect to X within the meaning of section 4946(a)(1) of the Code.

Since Y is a disqualified person with respect to X because A and his family together will own directly or indirectly more that 35% of the profits interests in Y prior to X's proposed investment with Y, a sale or exchange between X and Y would constitute an act of self-dealing under section 4941(d)(1)(A) of the Code. However, X's proposed acquisition of a limited partnership interest in Y is in substance a "co-investment arrangement" by X in Y along with other partners of Y, not a sale or exchange between X and Y or between X and the other partners of Y. This arrangement is more properly characterized as involving services in the nature of "brokerage and portfolio services" performed for X by Y.

The purpose of X's acquisition of a partnership interest in Y is to permit X to make an investment in Z that it could not otherwise make, and to allow it to make such an investment on a more favorable basis than it could if it could invest in Z directly. This arrangement will also give X essentially the same rights as a direct investment in Z. No disqualified person will benefit from X's investment, by reducing their administrative expenses or in any other way. Accordingly, neither the initial acquisition of a limited partnership interest in Y by X nor any subsequent additional investments in Z or withdrawals from Z made by X through Y will constitute acts of self-dealing under section 4941 of the Code.

You have represented that Z is not a business enterprise because all of its income is passive income. Therefore X's proposed investment in Y is viewed as an investment in Z for purposes of section 4943 of the Code, and that investment will not be characterized as a holding in a business enterprise.

The investment by X of substantially all of its assets in one company might ordinarily be viewed as a jeopardizing investment due to a lack of diversification. However, under the facts and circumstances presented, X's proposed investment in Y may be viewed as an investment in Z and through Z, in the underlying securities held by Z. The securities held by Z are sufficiently diversified so that the indirect investment by X would meet the requisite standard of care and prudence which would not jeopardize the carrying out of X's exempt purposes.

RULINGS:

Based on the information submitted and the representations made therein, we rule as follows:

1. B, C, and D are not disqualified persons with respect to X.

2. (a) X's acquisition of a limited partnership interest in Y, thereby effecting an indirect interest in Z , will not be an act of self-dealing within the meaning of section 4941 of the Code.

   (b) Additional investments by X in Y to permit additional indirect investments in Z, or withdrawals from Y to enable withdrawals from Z, will not be acts of self-dealing within the meaning of section 4941 of the Code.

3. The subsequent operation of Y, as set forth in this request, will not give rise to any act of self-dealing within the meaning of section 4941 of the Code on the part of X.

4. X's limited partnership interest in Y will not be an interest in a "business enterprise" within the meaning of section 4943 of the Code.

5. X's acquisition of a limited partnership interest in Y will not constitute a jeopardizing investment under section 4944 of the Code solely because such limited partnership interest may constitute a significant portion of X's assets.

These rulings are directed only to the organization that requested them. Section 6110(k)(3) of the Code provides that they may not be used or cited as precedent.

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

Sincerely,
(signed) Robert C Harper, Jr

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