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

Date: OCT 21 2002

Contact Person:

Identification Number:

Telephone Number:

T:ED:B4

Employer Identification Number:

Legend:
B:
C:
D:
E:
x:

Dear Taxpayer:

We have considered B's ruling request dated January 16, 2002, concerning the application of section 4941 of the Internal Revenue Code to B's payment of compensation to a disqualified person.

FACTS

B is a charitable trust created under the laws of the State of C. B is exempt from Federal income tax under section 501(a) of the Internal Revenue Code as an organization described in section 501(c)(3) and is a private foundation within the meaning of section 509(a).

B was created to distribute trust income and principal to charities exempt from taxation under section 501(c)(3) and to make direct distributions for any charitable purpose described in section 501(c)(3).

D is the sole contributor of the assets owned by B and is a "substantial contributor" within the meaning of sections 4946(a)(2) and 507(d)(2) of the Code. D and two of his family members are trustees of B. The fourth trustee is not a family member of D. The trustees have each assumed all of the numerous duties imposed on a trustee by the laws of C. B employs two officers to oversee its management and administrative affairs.

D is the sole proprietor of E, a business organized to provide investment advisory services which include investment strategy, research, implementation and management

services. E provides its services to B and to investments owned by D individually and by trusts for D's benefit or the benefit of D's family members. E is a "disqualified person" with respect to B because D is a substantial contributor to B, a foundation manager of B and D is the sole proprietor of E.

B and E will enter into a contract for investment advisory services. B indicates the agreement contains specific terms of the investment advisory service, all of which are of a type of personal service that are frequently contracted for by a charitable foundation. The agreement also provides a method for calculating the amount of compensation to be paid by B to E.

On an annual basis, B will obtain fee schedules from at least three independent companies who provide professional investment advisory services that are comparable to the services provided by E. The industry practice is to calculate fees based upon the fair market value of portfolio assets under management. B will average the fees schedules from each of the surveyed investment advisory companies and apply the average schedule rate to the fair market value of B's investment portfolio managed by E. The fair market value of the investment portfolio will be valued at the end of each quarter and the average schedule rate will be divided by four. The resulting fees will be paid quarterly in arrears. In the event of a significant contribution or distribution, the value of the investment portfolio will be the average daily balance for the quarter. A significant contribution or distribution is defined as an amount equal to x percent or more of the investment portfolio valued as of the end of the previous quarter.

B's investment portfolio will include investments that incur sub-advisement fees. The amount of compensation to E under the contract will not be reduced by any sub-advisement fees incurred. The investment advisory services provided by E do not include investment custody services, brokerage transaction fees on the buying and selling of securities, or accounting fees. These services are not normally considered within the scope of investment advice and are not included in the services of the surveyed companies whose fee schedules are used to calculate the compensation rate.

B represents that all fees to be charged by E to B for services are reasonable for the services rendered, in accordance with industry practice, and consistent with local laws governing fiduciaries.

RULING REQUESTED

B requests a ruling that:

The payment of compensation for investment advisory services, as calculated under the Investment Management Fee Agreement between B and E would not be a prohibited act of self-dealing under section 4941 of the Code.

LAW

Section 501(c)(3) of the Code provides, in part, an exemption from federal income tax for a corporation organized and operated exclusively for charitable, scientific or educational purposes provided no part of the corporation's net earnings inure to the benefit of any private shareholder or individual.

Section 509(a) of the Code provides that, unless specifically excepted, a domestic or foreign organization described in section 501(c)(3) is a private foundation and subject to the annual excise taxes of Chapter 42.

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

Section 4941(d)(1)(D) of the Code provides that the term "self-dealing" includes 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 provides that the term "self-dealing" includes 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 the payment of compensation by a private foundation to a disqualified person for personal services which are reasonable and necessary to carry out the exempt purpose of the foundation shall not be an act of self-dealing if the compensation is not excessive.

Section 53.4941(d)-1(a) of the Foundation and Similar Excise Taxes Regulations provides that for purposes of section 4941, the term "self-dealing" means any direct or indirect transaction described in section 53.4941(d)-2 of the regulations. For purposes of this section it is immaterial whether the transaction results in a benefit or detriment to the private foundation.

Section 53.4941(d)-3(c)(1) of the regulations provides that the payment of compensation (and the payment or reimbursement of expenses, including reasonable advances for expenses anticipated in the immediate future) 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 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 [illegible] foundation as principal [illegible] foundation but not the services of a dealer who buys from the private foundation and resells to third parties.

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Example (2) of section 53.4941(d)-3(c)(1) of the regulations [illegible] person of private foundations X who manages X's investment portfolio [illegible] determined to be not excessive. The example concluded that the payment [illegible] compensation is not an act of self-dealing.

Section 4946(a)(1) of the Code describes a disqualified person [illegible] manager as that term is described in section 4946(b).

Section 4946(b) of the Code defines a foundation manager as: [illegible] trustee of a foundation (or an individual having powers or responsibilities [illegible] officers, directors, or trustees of the foundation), and with respect to any [illegible] the employees of the foundation having authority or responsibility with [illegible] failure to act).

Section 4946(a)(1)(E) of the Code describes a disqualified person as including a corporation of which persons described in section 4946(a)(1)(A), (B), (C), or (D) own more than 35 percent of the total combined voting power.

Section 4946(a)(1)(F) of the Code describes a disqualified person as including a partnership in which persons described in section 4946(a)(1)(A), (B), (C), or (D) own more than 35 percent of the profits interests.

Section 1.162-7(b) of the Income Tax Regulations provides that "It is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances."

ANALYSIS

D and E are "disqualified persons" with respect to B under section 4946 of the Code. B's proposal to compensate E for personal services will not constitute self-dealing under section 4941(d)(1)(E), if the compensation is reasonable and necessary to carry out the exempt purposes of B and is not excessive.

B's investment advisory service agreement with E includes a provision to calculate E's compensation. The agreement provides that B will annually average the rates of three independent service providers offering comparable services as E. B will compensate E based upon this average rate. B has represented that the average rate used to compensate E is reasonable for the services rendered and in accordance with industry practice.

Given the nature of the services provided by E, and based on B's representations that the method of calculating the fees is reasonable, the fees are comparable to fees charged by similar organizations for similar services, and the fees are not excessive, the compensation arrangements meet the requirements of section 4941(d)(2)(E) of the Code and section 53.4941(d)-3(c)(1) of the regulations.

RULING

Based upon the representations B submitted, under the facts described above, E's compensation for investment advisory services, under the Investment Management Fee Agreement between B and E would not be a prohibited act of self-dealing under section 4941 of the Code

This ruling is limited to the applicability of the personal service exception to self-dealing on the proposed B and E compensation arraigements under section 4941(d)(2)(E) and section 53.4941(d)-3(c)(1) of the regulations. No opinion is expressed on the federal income or excise tax consequences of the transaction under any other section of the Code.

Because this ruling could help resolve future questions about your federal income tax status, you should keep it in your permanent records.

This ruling is directed only to B, D and E. Section 6110(k)(3) of the Code provides that it 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,

Gerald V. Sack

Gerald V. Sack
Manager, Exempt Organizations
Technical Group 4