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

Significant Index Nos.: 4941.04-00
4943.04-03
4944.03-00
4945.04-00

Date: SEP 21 1999

Contact Person:

ID Number:

Telephone Number:

OP:E:EO:T:3

Employer Identification Number:

Legend:

M =
B =
X =
Y =
N =
T =
xx =
yy =
zz =
aa =

Dear Sir or Madam:

This is in response to a request for a private letter ruling, dated July 28, 1998, as modified by a letter dated September 7, 1999, submitted on your behalf by your authorized representatives, concerning the federal tax consequences of the proposed transactions described below.

The information provided indicates that you (the "Foundation") have been recognized as exempt from federal income tax as an organization described in section 501(c)(3) of the Internal Revenue Code, and are a private operating foundation described in sections, 509(a) and 4942(j)(3) of the Code. The Foundation's purposes are to promote nature preservation and conservation and its activities include the operation of nature reserves and other protected areas on certain ecologically significant real property owned by the Foundation.

The Foundation's real property, along with privately owned contiguous real property (together, the "Land"), was formerly owned by M (the "Company"), a corporation. The Company, in turn, was owned by certain descendants of B (the "Family").

The Company granted to the County of X an Open Space Easement covering substantially all of

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the undeveloped portions of the Land (the "Easement"). The Easement was granted for the express purpose of providing an opportunity for, and to encourage access by, the public to substantial portions of the Land for scenic, open space and recreational purposes and to preserve portions of the Land for the protection of wildlife, plants and unique geological sites.

The shareholders of the Company donated all of the issued and outstanding Class A Common Stock of the Company to the Foundation. Subsequently, all of the Class A Common Stock of the Company was redeemed in exchange for certain assets of the Company , most of which was subject to the Easement. The Company continues to own much of the Land that does not belong to the Foundation.

The state of Y (the "State"), holds title to substantially all of the submerged lands adjacent to the Land (the "Submerged Lands"). Although Y has an informal policy that such lands are normally leased (if at all) to the owners of the adjacent uplands, there is no formal rule or regulation granting the owners of the uplands such priority. The Company's lease of the Submerged Lands expired. Because of the interrelationship between the Submerged Lands and the Foundation's property, both in terms of the preservation of the biotic and aquatic communities on the Land and the fulfillment of the Foundation's responsibility for managing and maintaining public access to the open space areas of the Land, the Foundation was concerned about the management of the Submerged Lands

In order to increase the chances of success in obtaining the lease, the Company's financial resources were made available to the Foundation and the State as a guarantor of the Foundation's performance of the terms and conditions of the lease through the Company's execution of a joint bid with the Foundation. The Company and the Foundation were successful in obtaining the lease for a fifteen-year term. In the lease (the "Submerged Lands Lease") the State of Y

Subsequently, the Company and the Foundation entered into a separate agreement (the "Submerged Lands Agreement") to allocate the burdens and benefits of the Submerged Lands Lease.

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N, (the "Manager") was engaged by the Foundation to provide the services required by the Submerged Lands Lease pursuant to a property management and service agreement (the Management Agreement"). The Manager was unrelated to the Foundation, the Company, or the Family. The terms of the Management Agreement provided that the Manager (i) perform all of the personal management services required by the Submerged Lands Lease and (ii) pay to the State the rent due under the Submerged Lands Lease, in exchange for (iii) the obligation of the Foundation to pay to the Manager a management and service fee equal to xx% of the gross fees realized from the Submerged Lands Lease. From the Foundation's point of view, the economic effect of the arrangement was that the Foundation was paid yy% of the gross fees realized from the Submerged Lands Lease after N collected the fees from the public.

As part of its mission, the Foundation operates on its land. were operated pursuant to the Foundation's obligations to do so under the terms of a Memorandum of Understanding pursuant to the Open Space Easement with the County. The Foundation and N entered into a Management Agreement to provide the services necessary to manage the variou The fees paid b with respect to the located on property subject to the Easement were approved by the County. The fees paid with respect to are set at comparable rates. The fees paid for are set by the Foundation. The Management Agreement was similar in structure to the Management Agreement in that N was responsible for performance of all of the management services needed to operate the N was also obligated to make the expenditures required under the Memorandum of Understanding. The Management Agreement further provided that N was entitled to a fee based on a percentage of the gross license fees and gross sales at the which over time has averaged zz%. Thus, the economic effect of the Management Agreement was that the Foundation was paid approximately aa% of the gross fees realized from the .

In , the owner of N conveyed his desire to retire and terminate all of the services provided by his company as soon as reasonably possible. This decision was motivated in part by his determination that it was not profitable to continue the operations of his company. Notwithstanding the owner's decision, the Foundation was (and is) obligated under the terms of the Submerged Lands Lease and the Memorandum of Understanding Pursuant to Open Space Easement to continue to provide the services performed by N. The Foundation examined alternatives to engaging N. Due to the remote location of the Land and the lack of profit potential in the two agreements, no unrelated contractor was sufficiently interested in assuming N's duties under the agreements to make a formal proposal. The Foundation had previously attempted to use unpaid volunteers to perform some of the management services (prior to the execution of the Management Agreement), but the services proved to be too labor intensive for volunteer staffing and thus, the use of volunteers to perform the services provided by N was deemed impractical. Finally, the Foundation concluded that the capital investment and additional (paid) employees which would be necessary to replicate N's operations would be extremely expensive and would place a heavy administrative burden on the Foundation's existing management.

In addition to the services provided to the Foundation, N conducted a variety of other business activities on the Land, including the operation of various facilities under lease from the Company. In , the Company addressed the need to replace N by forming T as a wholly owned subsidiary to acquire N's assets and assume the operations of N. So that there would be no interruption in service, the Company proposed that T be allowed to perform the services previously provided by N to the Foundation, and on , T began performing all of such services. Since then, its interim financial statement shows that T is operating at a loss.

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Because the services were, and are, necessary to carry out the exempt purposes of the Foundation, the Foundation proposes to establish a limited liability company (LLC) to perform the Services. The Foundation and T will be the two members of the LLC. The Foundation's membership interest will hold voting control over the LLC. The Foundation will contribute no capital to the LLC, but will assign its rights to service under the Submerged Lands Lease and its rights to service under the Memorandum of Understanding to the LLC. T will be obligated under the Operating Agreement of the LLC to contribute whatever capital and services are necessary to perform its functions. The Foundation's membership interest will be entitled to a preferred return on income generated from the LLC (i.e., vv% of the fees generated from and aa% of the fees generated from , which will put the Foundation in the same financial position that it was under the former agreements with N. T's membership interest will have no preferred return; instead, T will be entitled to distributions of net profits or losses which result from the LLC's operations. Should the Foundation desire to dissolve the LLC, the Foundation will retain its rights under the Submerged Lands Lease and the Memorandum of Understanding and T will be entitled to retain whatever capital it contributed to LLC.

The LLC will be treated as a partnership for federal tax purposes. The LLC will not engage in any legislative or political campaign activity within the meaning of section 170(c)(2)(D) of the Code. The members will receive cash or property distributions and allocations of LLC's gains and losses in accordance with section 704(c), and there will be no transaction involving the LLC which would properly be characterized as a sale or exchange of property between partners under section 707(a)(2)(B). Neither member will engage in any transaction with the LLC other than in the capacity as a member.

Members of the Family are substantial contributors to the Foundation, and hence are disqualified persons with respect to the Foundation under section 4946(a)(1)(A) of the Code. The Company is a corporation more than thirty-five percent (35% of the total combined voting power of which is owned, within the meaning of section 4946(a)(3), by persons (members of the Family) described in section 4946(a)(1)(A)-(D). Hence it is a disqualified person with respect to the Foundation under section 4946(a)(!)(E). T is a wholly-owned subsidiary of the Company. The LLC will be a disqualified person with respect to the Foundation under section 4946(a)(1)(F) of the Code.

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

Section 4941 of the Code imposes a tax on each act of self-dealing, directly or indirectly, between a disqualified person and a private foundation.

Section 4941(d)(1)(A) of the Code provides that the term "self dealing" includes any sale or exchange, or leasing, of property between a private foundation and a disqualified person.

Section 4941(d)(2)(C) of the Code provides that the furnishing of goods, services, or facilities by a disqualified person to a private foundation shall not be an act of self-dealing if the furnishing is without charge and if the goods, services, or facilities so furnished are used exclusively for purposes specified in section 501(c)(3).

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

Section 4943(d)(3)(A) of the Code provides that the term "business enterprise" does not include

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a functionally related business (as defined in Section 4942(j)(4)).

Section 4942(j)(4)(A) of the Code defines the term "functionally related business" as including a trade or business which is not an unrelated trade or business (as defined in section 513).

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

Section 4944(c) of the Code provides that "program related investments," the primary purpose of which is to accomplish one or more of the purposes described in section 170(c)(2)(B), and no significant purpose of which is the production of income or the appreciation of property, shall not be considered as investments which jeopardize the carrying out of exempt purposes.

Section 4945 of the Code imposes a tax on taxable expenditures.

Section 4945(d) of the Code defines a "taxable expenditure" as including any amount paid or incurred by a private foundation for any purpose other than one specified in section 170(c)(2)(B).

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 53.4944-3(a) of the regulations provides that a "program related investment shall not be classified as an investment which jeopardizes the carrying out of exempt purposes of a private foundation A "program related investment" is an investment which possesses the following characteristics:

(i) The primary purpose of the investment is to accomplish one or more of the purposes described in section 170(c)(B);

(ii) No significant purpose of the investment is the production of income or the appreciation of property; and

(iii) No purpose of the investment is to accomplish one or more of the purposes described in section 170(c)(2)(D).

Section 53.4945-6(e)(1) of the regulations provides that a grant to a an organization that is not described in section 501(c)(3) will not be a taxable expenditure if the making of the grant itself constitutes the making of a program-related investment.

Because the Foundation's charitable mission requires the Foundation to make its lands available to members of the public who visit the Land for recreation and education, the control over the Submerged Lands provided by the Submerged Lands Lease and the access it allows are critical to the accomplishment of the Foundation's charitable purposes. Therefore, the LLC's operation of would not constitute an unrelated trade or business under section 513 of the Code, but would constitute a functionally related business.

Pursuant to the terms of the Submerged Lands Agreement, the joint lease by the Company and the Foundation is in substance a lease by the Foundation with a guarantee by the Company of the Foundation's performance of its obligations. Because the Company does not realize any economic benefit from the Submerged Lands Lease, the Submerged Lands Lease does not result in the exchange

of money or property by a disqualified person to a private foundation. The guarantee is, in effect, the provision of a service at no charge. Under section 4941(d)(2)(C) of the Code, the provision of services by a disqualified person to a private foundation at no charge is not an act of self-dealing.

Although the formation and operation of the LLC will involve the transfer to , and use by, a disqualified person (the LLC) of an asset of the Foundation (its contractual rights under the agreements pertaining to , the benefit received by any disqualified persons from the Foundation's assets will be incidental to the benefits received by the Foundation from its participation in the LLC. Under section 53.4941(d)-2(f)(2) of the regulations, such formation and operation will not result in self-dealing.

Moreover, since the primary purpose of the Foundation's investment in the LLC is to accomplish the charitable purposes of the Foundation and not made to produce income or to engage in political campaigning or legislative activities, it is not a jeopardizing investment within the meaning of section 4944 of the Code since it is a program related investment. The investment is not a taxable expenditure within the meaning of section 4945 since it is a program related investment.

Accordingly, we rule as follows:

1. The participation by the company in the joint lease of the Submerged Lands is for tax purposes the furnishing of services by the Company to the Foundation without charge, and the services so furnished are used exclusively by the Foundation for tax exempt purposes, and therefore the participation by the Company in the joint lease is not an act of self-dealing under section 4941(d)(2)(C) of the Code.

2. The contribution by the Foundation to the LLC of the rights to service the contribution of services and capital by T to the LLC, and the operation of the LLC will not constitute acts of self-dealing under section 4941 of the Code.

3. The Foundation's membership interest in the LLC constitutes a holding in a "functionally related business" under section 4943(d)(3(A) of the Code and does not constitute an excess business holding.

4. The contribution by the Foundation to the LLC of the rights to service is a program-related investment by the Foundation which does not jeopardize the carrying out of any of its exempt purposes, and therefore does not constitute a jeopardy investment under section 4944 of the Code.

5. The contribution by the Foundation to the LLC of the rights to service does not constitute a taxable expenditure under section 4945 of the Code.

This ruling is directed only to the organization that requested it. Section 6110(k)(3) of the Code provides that this ruling may not be used or cited by others as precedent.

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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,

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