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:

M =
M1 =
M2 =
Q =
R =
S =
T =
U =
U1 =
U2 =
U3 =
U4 =

A =
B =
C =
D =

Account 1 =
Account 2 =

Date 1 =
Date 2 =
Year =

a =
b =
c =
d =

ISSUES:

1. Whether M's failure to pay interest on checking accounts held by Q should be treated as self-dealing under section 4941 of the Internal Revenue Code?

2. Whether rent paid by R to M, a disqualified person to Q, for leased office space represents indirect self-dealing under section 4941 of the Internal Revenue Code?

FACTS:

A is a trustee of Q, a private foundation, as well as a descendant of a substantial contributor to Q, and is therefore a disqualified person with respect 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.

M, a bank, is a disqualified person with respect to Q because the majority of interest in M is indirectly owned 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. 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. U owns 50% of the Class A stock and 100% of the Class B stock of M1, which in turn owns 100% of the stock of M2, which itself owns 97.8% of the voting stock of M.

A has generally served as President, Chief Executive Officer, etc. of M from at least the early 80's until the present time, although his exact positions have varied somewhat over time. During 1998, he was Chairman of the Board and a director of M. He was also President and a director of M1 and President of M2. A is currently the Chairman of the Board of M. B, one of A's sons, is a director, as is C, another relative. All three are "disqualified persons" to Q. M has a ten-member Board of Directors, including an employee of the bank.

R, a business corporation, 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 when, as of Date 2, 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	a	50.2%
Q	b	34.0%
T	c	15.8%
Total	d	100%

T is a tax-exempt organization as described in section 501(c)(3) and is currently classified as other than a private foundation under section 509(a)(3). T receives a substantial amount of its funding from M. 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 , , and . A also serves on the board of R and was its chairman in and .

Bank account

Q has had a banking and custodial relationship with the trust department of M for a number of years. The services include the collection of all income and receipts, the payment of all expenses, grants and other disbursements, the preparation of financial statements, and the custody of assets. In Year, Q received a private letter ruling holding as follows:

> The maintaining of a checking account with the Bank is not an act of self-dealing where the banking services are reasonable and necessary to carry out your exempt purposes and the compensation paid to the bank, taking into account the fair interest rate for the use of the funds by the bank, for such services is not excessive.

During , Q maintained a bank account at M, Account 1, which paid interest during at the rate of 2.05%. Large sums of money (i.e. $25,466,523.57 on ; $11,000,000 on) were frequently deposited into this account. These amounts sometimes remained in the account for several days before being reinvested or transferred to other checking accounts.

Account 2 is a Trust Department clearing account that M states is used solely for disbursements on behalf of Q, for grants, expenses and other disbursements. This account received funds transferred from Q's bank account. Deposits in excess of $1 million were frequently made into this account. Most deposits into this account were transfers from Account 1. The funds remained in Account 2 for no more than five days. A typical transaction is described as follows: when a determination is made that a disbursement is needed, funds are transferred from one of Q's bank accounts into Account 2. M then issues a check for such disbursement from Account 2 that same day. Once the funds are transferred from Q's account into Account 2, the funds are no longer included as assets on Q's books. The account typically had a minimum balance well over $l00,000. The balance of Account 2 represents only the total of checks that have been written, but not yet presented for payment. The account did not pay interest during , , and . M began paying interest prospectively in 2001 after the start of the examination and an initial discussion with Q (M states that it did so as a precaution until the issue is resolved).

Historically, M's Trust Department maintained a single clearing account used for disbursements from all of its customer accounts. However, after Q expressed a desire that Q's disbursements be made using checks bearing the Foundation's name and address (rather than M as custodian), the separate clearing account for Q was established.

M wrote a letter to the Office of the Comptroller of the Currency (OCC) in 2003 to verify that such practice is the common practice of national bank trust departments with respect to clearing accounts used by the trust departments to issue trust department checks. The Bank cited the American Bankers Association's Trust Operations Manual (2000) pp. 156-157:

> In some ways a trust checking account works differently than a personal checking account. Instead of making a large deposit and then writing checks against it, the trust organization makes deposits on the same day the checks are written. Rather than the trust organization keeping an unused balance in the account waiting for more checks to be issued, money is deposited into the trust checking account to exactly cover the checks written each day. Thus, balancing is a simpler chore and excess cash is kept elsewhere in interest-bearing form, thereby offering increased investment return for individual accounts.

The OCC responded favorably:

> My understanding of the industry norm is that a bank's trust department typically disburses funds on an as needed basis from a customer's trust or custody account to a non-interest paying demand clearing account. On any given day, a bank typically only transfers sufficient funds into a demand clearing account to cover checks that were written that day. In contrast to the clearing account, excess cash in the customer's trust or custody account is customarily placed in an interest bearing account either at the bank or with a third party (e.g., invested in a money market mutual fund).

In addition, the Asset Management Division of the Comptroller indicated that a "clearing account is a standard demand account outside the Trust Department but in the name of the Trust Department. Once funds have been disbursed from a trust account into the clearing account the funds are no longer treated as assets of the particular trust . . ." The letter went on

to further indicate that the balance in the clearing account is always equal to the total of all unpaid checks and that it is industry practice to disburse funds from a customer's trust account into a non-interest paying demand account.

Office lease

During the time period at issue, R paid rent to M of $ per month, based on two contracts that started March 1, 1992 and March 1, 1998. R has continuously leased space from M since at least some time in 1968. The actual room numbers leased have changed over time. Three rooms are currently being leased compared to only one in 1975. The per month lease payments for through were approximately 18 times greater than the payments in effect for 1/1/1985 through 05/01/1985. Because Q is not a party to the transactions, the issue is whether the lease constitutes an act of indirect self-dealing.

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: (A) sale or exchange, or leasing, of property between a private foundation and a disqualified person; (B) lending of money or other extension of credit between a private foundation and a disqualified person; (C) furnishing of goods, services, or facilities between a private foundation and disqualified person; (D) payment of compensation (or payment or reimbursement of expense 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; and (F) agreement by a private foundation to make any payment of money or other property to a government official (as defined in section 49446(c)), other than an agreement to employ such individual for any period after termination of his government service if such individual is terminating his government service within a 90-day period.

Section 4941(d)(2)(E) of the Code provides generally that payment of compensation by a private foundation to a disqualified person for person services which are reasonable and necessary to carrying out the exempt purposes of the foundation is not self-dealing, if the compensation is not excessive.

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 $.

Section 53.4941(d)-2(c)(4) of the regulations provides that under section 4941(d)(2)(E) of the Code (the “personal services” exception), the performance by a bank or trust company, which is a disqualified person, of trust functions and certain general banking services for a private foundation is not an act of self-dealing, where the banking services are reasonable and necessary to carrying out the exempt purposes of the private foundation, if the compensation paid to the bank or trust company, taking into account the fair interest rate for the use of the funds by the bank or trust company, for such services is not excessive. The general banking services allowed are: (i) Checking accounts, as long as the bank does not charge interest on any over withdrawals, (ii) Savings accounts, as long as the private foundation may withdraw its funds on no more than 30-days notice without subjecting itself to a loss of interest on its money for the time during which the money was on deposit, and (iii) Safekeeping activities.

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:

Issue 1: Whether M's failure to pay interest on checking accounts held by Q should be treated as self-dealing under section 4941 of the Internal Revenue Code?

Section 4941(d)(1) of the Code generally prohibits lending of money between a private foundation and a disqualified person, furnishing of services between a private foundation and disqualified persons, payment of compensation by a private foundation and a disqualified person, and use of private foundation assets by a disqualified person. General banking services and trust functions are permissible where reasonable, taking into account the fair interest rate for use of funds.

Taxpayer has established that the non-interest bearing clearing account arrangement between M and Q during the years in issue was a common business practice for trust departments. On any given day, funds were transferred into the clearing account only in an amount sufficient to cover the checks written that day. When the check was later presented for payment, the funds were withdrawn from the clearing account. The balance was shown to be equal to the amount of the checks outstanding.

Even though Q's accounts generally held large sums of money, the average balance of both accounts combined amounted to less than 0.5% of Q's total assets. While funds held in the accounts were in excess of the $100,000 FDIC-insured limits, Taxpayer represents that such practice has not been uncommon among large organizations. Taxpayer established that under the state law, Q was required to have sufficient funds in an account to cover the total amount of all outstanding checks. In addition, M's access to the funds was the same as with any other depositor with the bank. Further we believe it particularly persuasive that Taxpayer has been paying Q reasonable interest on the accounts since 2000.

Based on the particular facts and circumstances, including Taxpayer's representations, we conclude that M's practices during the years in issue support the conclusion that such services provided by M to Q fell within the exception to self-dealing for general banking services and trust functions described in section 53-4941(d)-2(c)(4) of the regulations.

Issue 2: Whether rent paid by R to M, a disqualified person to Q, for leased office space represents indirect self-dealing under section 4941 of the Internal Revenue Code?

Section 4941 of the Code prohibits indirect as well as direct acts of self-dealing between private foundations and disqualified persons. 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. We think that a case of unreasonable dealing between a disqualified person and an organization in which a private foundation has an interest (short of control) may result in indirect self-dealing.

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 M. The facts do not indicate that there are any persons who are disqualified persons by reason of an ownership relationship to M. M, as Trustee of the majority owner, S, was in a position of authority to force the transaction, but M did not need Q's votes to undertake such action. 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.

We considered whether Q controlled R for the period of the first lease covering the first three months of 1998, because the lease was executed in 1992 when Q had 50% ownership of R. The regulations treat each year of a lease as a separate act of self-dealing (see section 53.4941(e)-1(e)(1) of the regulations), which suggests a year-by-year analysis is more appropriate for considering control than merely when the lease was negotiated and executed. We also note that the Tax Court held 50% ownership insufficient on similar facts. See Moody v. Commissioner, T.C. Memo. 1995-195.

Based on the foregoing, we find that the lease transaction was not between a disqualified person and an organization controlled by Q. However, we lack sufficient information to determine whether the leases otherwise constituted indirect self-dealing between Q and M. The rents between the parties appear to have risen dramatically over the course of years. Also significant in this regard are that R is beneficially owned primarily by charitable interests (including but not limited to Q), and the dealings between R and M are not at arm's length (given A's pervasive influence over both R and M). If the amounts paid by R to M are clearly excessive, then we think the leases would constitute indirect acts of self-dealing. Obtaining information on the fair rental value of the leases is necessary to resolve this issue. We recognize that the self-dealing rules of section 4941 were intended to avoid IRS determinations of reasonableness, but we consider the issue unavoidable for certain indirect self-dealing questions as we have here.

CONCLUSION:

1. M's failure to pay interest on the clearing account held by Q is not an act of self-dealing under section 4941 of the Internal Revenue Code as if falls within a specific exception provided by section 53-4941(d)-2(c)(4) of the regulations. Section 53-4941(d)-2(c)(4) provides a specific exception to the self-dealing rules for the performance of certain trust functions and certain general banking services. The facts presented indicate that it is a common business practice by trust departments to use non-interest bearing clearing accounts to disburse funds from a trust.

2. Rent paid by R to M, a disqualified person to Q, for leased office space does not represent indirect self-dealing under section 4941 of the Code on the ground that Q controlled R. The facts indicate that there was no control over R by Q. We lack sufficient facts to determine whether the rent paid by R to M otherwise constituted an indirect act of self-dealing.

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

-END-