WestVirginiaUniversity
THE RESEARCH REPOSITORY @ WVU

Law Faculty Scholarship

WVU College of Law

Winter 2017

Is Consistency the Hobgoblin of Little Minds? Co-Investment under Code Section 4941

Elaine Waterhouse Wilson

Follow this and additional works at: https://researchrepository.wvu.edu/law_faculty

Part of the Tax Law Commons

IS CONSISTENCY THE HOBGOBLIN OF LITTLE MINDS? CO-INVESTMENT UNDER CODE SECTION 4941

Elaine Waterhouse Wilson*

I. INTRODUCTION 394
II. THE SELF-DEALING RULES AND PRIVATE FOUNDATION CO-INVESTING 398
A. The Reality of Foundation Investing 398
B. Private Foundation Alternative Investment Allocations 402
C. Foundation Investments Managed by Family Offices 406
D. Securities Law Issues and the Family Office 407
III. PRIVATE FOUNDATIONS AND CHAPTER 42 412
A. Private Foundations, Generally 412
B. The Private Foundation Excise Taxes 413
C. Code Section 4941's Excise Tax on Self-Dealing 418
1. Disqualified Persons 418
2. Acts of Self-Dealing 420
3. Exceptions to Acts of Self-Dealing 421
4. Indirect Acts of Self-Dealing 422
D. Investing Along with Disqualified Persons Under Code Section 4941: The PLRs 423
1. The 2001 PLR 424
2. The 2003 PLR 425
3. The 2004 PLR 429
4. The 2005 PLR 431
5. Investing After the 2005 PLR 433
IV. INVESTING IN PARTNERSHIPS: TAX AND PROPERTY LAW APPROACHES 434
A. State Law Treatment of Partnerships 434
1. General Partnerships 434
2. State Laws Governing Limited Partnerships 437
B. Subchapter K of the Internal Revenue Code 440
V. SHOULD THEORETICAL CONSISTENCY BE A GOAL OF THE TAX LAW? 443
A. Consistency Within a Code 444
B. Consistency Between State Property Law and Federal Tax Law 446
C. Toward Achieving Consistency 448
D. Living with the Dissonance: A Possible Safe Harbor 450
VI. CONCLUSION 452

---

* Associate Professor of Law, West Virginia University College of Law. Many thanks to my research assistants, Zachary McCoy, Christopher L. Bauer, Kelsey Jonas, Jackson Butler, and Allisyn Monteleone, who worked tirelessly and without whom this article would not have been finished. I am especially grateful for the time and comments of Joan MacLeod Heminway on the securities and partnership portions of this article. Thanks to those friends, mentors, and colleagues that suffered through this process with me, especially Joshua Fershee, Atiba Ellis, Jena Martin, Valarie Blake, and Kendra Huard Fershee. Finally, the author would like to thank the Bloom Fund (officially, the Kanawha County Class Action Settlement 2009 Charitable Trust) for its support of this research project.

A foolish consistency is the hobgoblin of little minds, adored by little statesmen and philosophers and divines. With consistency a great soul has simply nothing to do. He may as well concern himself with his shadow on the wall. Speak what you think now in hard words, and to-morrow speak what to-morrow thinks in hard words again, though it contradict everything you said to-day.
-Ralph Waldo Emerson

I. INTRODUCTION

Every year, the Internal Revenue Service (IRS) issues a Priority Guidance Plan—a list of regulatory projects that will receive priority attention over the coming fiscal year.[1] Many of the items on the Priority Guidance Plan are carry-over projects—guidance that the IRS intended to issue in the prior fiscal year, but did not finish (or sometimes, even start). Some of the projects on the Plan, however, are completely new. A review of these new projects often provides insight into what the IRS is seeing on a regular basis, and the IRS' regulatory direction.[2]

In the Exempt Organization section of the 2013-2014 Priority Guidance Plan, the following project appeared for the first time[3]: "Guidance under § 4941 regarding a private foundation's investment in a partnership in which disqualified persons are also partners." The project reappeared in the 2014-2015 Priority Guidance Plan[4] and again in the 2015-2016 Priority Guidance Plan.[5] The 2016-2017 Priority Guidance Plan, released on August 15, 2016, continues to list this project.[6]

The appearance of a regulatory project regarding partnership investments under the private foundation self-dealing rules of Code[7] Section 4941 came as an unwelcome surprise to many practitioners. The IRS issued a series of private letter

---

[1] I.R.S., *Priority Guidance Plan*, http://www.irs.gov/uac/Priority-Guidance-Plan (last updated July 18, 2016) [hereinafter the 2016-2017 Plan or 2016-2017 Priority Guidance Plan].

[2] *Id.*; *see, e.g.*, Dominick Schirripa, *IRS's 2015-16 Priority Guidance Plan Is a Mix of the Old and the New on EGT Topics*, EST. TAX BLOG (Sept. 3, 2015), http://www.bna.com/irss-201516-priority-b17179935562/; *Treasury Department and IRS Issue Priority Guidance Plan*, MORGAN LEWIS (Aug. 26, 2013), https://www.morganlewis.com/pubs/tax-exempt_lf_2013-2014priorityguidanceplanissued_26aug13.

[3] *Compare* DEP'T OF THE TREASURY, 2013-2014 PRIORITY GUIDANCE PLAN (2013), https://www.irs.gov/pub/irs-utl/2013-2014_pgp.pdf *with* DEP'T OF THE TREASURY, 2012-2013 PRIORITY GUIDANCE PLAN (2012), https://www.irs.gov/PUP/pub/irs-utl/2012-2013_pgp.pdf (no reference to Code Section 4941).

[4] DEP'T OF THE TREASURY, 2014-2015 PRIORITY GUIDANCE PLAN 10 (2014), https://www.irs.gov/pub/irs-utl/2014-2015_pgp_initial.pdf (Exempt Organizations, Item 10).

[5] DEP'T OF THE TREASURY, 2015-2016 PRIORITY GUIDANCE PLAN 9 (2015), https://www.irs.gov/pub/irs-utl/2015-2016_pgp_initial.pdf (Exempt Organizations, Item 7).

[6] DEP'T OF THE TREASURY, 2016-2017 PRIORITY GUIDANCE PLAN (2016) (Exempt Organizations, item 10).

[7] Unless otherwise indicated, references to the "Code" mean the Internal Revenue Code of 1986, as from time to time amended.

rulings (PLRs) addressing this issue in the early 2000s, which seemed to bless such partnership arrangements, at least under some circumstances.[8] After the last PLR in the series was released, the IRS made little further noise regarding this issue. Private foundations and their advisors quietly relied on the PLRs and set up their investment structures accordingly.[9] Investing happened.

When the Code Section 4941 regulatory project first appeared on the 2013-2014 Priority Guidance Plan a decade (or more) after the PLRs, private foundations now had to review their existing investment structures with a troubled eye.[10] Were the structures that were set up in reliance on the PLRs still valid, assuming they ever were? What exactly was the IRS targeting? Would it be necessary to unwind such arrangements? Would they be grandfathered? Should a private foundation be proactive in advance of the guidance from the IRS? Such a brief statement of a potential future project has caused great consternation among many private foundations (and their advisors).

So what was the investment structure that caught the eye of the IRS and which now causes such unease? A private foundation is a subset of charitable organizations exempt from income tax under Code Section 501(c)(3).[11] Because a private foundation is usually funded and controlled by a single donor or family, it is subject to a series of excise taxes designed to regulate its behavior, found in Chapter 42 of the Code. These excise taxes, passed in 1969, include a number of prohibitions and limitations on the investment activities of private foundations. This specifically includes a strict prohibition on transactions with parties related to the private foundation, known as disqualified persons. This prohibition, found in Code Section 4941, applies to all transactions with disqualified persons, [12] even if the transactions are at or below fair market value or otherwise in the foundation's best interest.[13]

The question then becomes whether investment structures designed primarily to allow private foundations and their disqualified persons to invest jointly in certain alternative investments violate the self-dealing prohibition of Code Section 4941. In its most basic form, a private foundation becomes a partner

---

[8] *See* discussion *infra* Section III.D (discussing I.R.S. Priv. Ltr. Rul. 200148069 (July 17, 2001); I.R.S. Priv. Ltr. Rul. 200318069 (Feb. 3, 2003); I.R.S. Priv. Ltr. Rul. 200420029 (Feb. 19, 2004); and I.R.S. Priv. Ltr. Rul. 200551025 (Sept. 28, 2005).

[9] I.R.C. § 6110(k)(3) (West 2015); M. Elizabeth Magill, *Agency Choice of Policymaking Form*, 71 U. CHI. L. REV. 1383, 1391–92 (2004) (while private letter rulings may not be relied upon as authority in court, they are commonly used to provide guidance to practitioners in creating legal structures).

[10] Grace Allison, *2013-14 Priority Guidance Plan Has a Surprise for Private Foundations*, AMERICANBAR.ORG (Oct. 5, 2013), http://www.americanbar.org/content/dam/aba/publishing/rpte_ereport/2013/5_october/te_allison.authcheckdam.pdf; *see also* Dominick Schirripa, *For Exempt Organizations, IRS Priority Guidance Plan Feels a Lot Like Groundhog Day*, EST. TAX BLOG (Oct. 1, 2014), http://www.bna.com/exempt-organizations-irs-b17179895389/.

[11] See the definition of a private foundation *infra* Part III.A.

[12] For the definition of a disqualified person, see *infra* Part III.C.

[13] *See generally* I.R.C. § 4941(d) (West 2015); *see also* the discussion of the private foundation excise taxes and specifically the self-dealing excise tax of Code Section 4941 *infra* Part III.C.

in a partnership in which one of the private foundation's disqualified persons is also a partner. In many cases, the partnership itself is a disqualified person as a result of the ownership of the partnership by disqualified persons.[14] By way of example, a private foundation and two of its trustees might wish to enter into a private equity fund, but none of the three of them have sufficient liquid assets to meet the fund's minimum contribution requirement. They might, however, aggregate their funds in a partnership in order to meet minimum investment requirement, with the partnership making the investment in the fund.[15] This arrangement raises the question of whether the private foundation is engaged in an act of self-dealing prohibited by Code Section 4941 because it involves the sale or exchange of property between a private foundation and a disqualified person or a use of the private foundation's assets by a disqualified person.[16]

The PLRs allow such an arrangement, on the notion that when a private foundation invests in a partnership, it is not entering into a transaction of any kind with either the partnership itself or the other partners.[17] Rather, the IRS treats the partners as if they are merely investing side-by-side, or, in the language of PLR 200318069, they were merely in a "co-investment arrangement." Under this analysis, the IRS treats the partners as if they own a proportionate share of the underlying partnership assets directly.[18] As a result, there is no transaction between the private foundation and either the other partners or the partnership itself, and therefore, there can be no act of self-dealing.

Some have questioned whether it is wise to rely on these PLRs.[19] The notion that there is no transaction between the private foundation and the other

---

[14] *See, e.g.*, I.R.S. Priv. Ltr. Rul. 200318069 (Feb. 3, 2003) (private foundation to invest in the general partner of a hedge fund along with its primary funder/foundation manager, and an entity owned by the primary funder, his wife and their children; because the owners of the general partner were all disqualified persons, the general partner itself was a disqualified person).

[15] Such a structure might separate securities law issues, as discussed *infra* Part II.D.

[16] I.R.C. § 4941(d)(1)(A), (E) (West 2015).

[17] *See* I.R.S. Priv. Ltr. Rul. 200318069 (Feb. 3, 2003).

[18] Both I.R.S. Priv. Ltr. Rul. 200318069 (Feb. 3, 2003) and I.R.S. Priv. Ltr. Rul. 200420029 (Feb. 19, 2004) cite to the legislative history of the private foundation excise taxes (namely, the Senate Finance Committee report accompanying the 1969 legislation (citing S. REP. NO. 91-522, at 41 (1969)), stating that in the case of the stock of a passive holding company (which is not treated as a business enterprise for purposes of I.R.C. § 4943), "the foundation is treated as owning its proportionate share of the underlying assets of the holding company." H.R. 13270, S. 42, 91st Cong. (1969). The flaw in this argument is that the legislative history quoted is for Code Section 4943 and not Code Section 4941. *Compare* I.R.C. § 4943 (West 2015) *with* I.R.C. § 4941 (West 2015). Code Section 4943's look through rule is necessary to prevent a private foundation from placing excess business holdings in a corporate holding company and using that as a blocker to circumvent the limitations in the statute. While I.R.S. Priv. Ltr. Rul. 200551025 (Sept. 28, 2005) does not cite to this same language, it does discuss the partnership at issue as "joint or co-investments." I.R.S. Priv. Ltr. Rul. 200551025 (Dec. 23, 2005).

[19] Matthew J. Gries, Independent Foundations Legal Update, Southeastern Council of Foundations 2013 Annual Meeting (Nov. 14, 2013), http://www.secf.org/assets/site/AnnualMeeting/2013/Presentations/14.20.pdf ("Relying on these PLRs is not without risk because (i) PLRs are not precedential and (ii) these PLRs present very little analysis (and rely on substance over form principles).").

partners or the partnership when the foundation contributes capital to the partnership seems directly to contradict the common understanding of partnership property interests for both state law and federal tax law purposes.[20] Is the inherent dissonance between this series of PLRs and fundamental notions of partnership interests under state law and Subchapter K part of the reason why the IRS is revisiting the issue of private foundation co-investments? Assuming for the moment that such theoretical dissonance exists, should the IRS care? Is consistency the hobgoblin of little minds, or does it actually add to our understanding of the tax code?

At first glance, this question may appear to be a technical question that affects only a handful of large family foundations. It implicates, however, a number of significant legal issues, ranging from state partnership law to the securities laws to the income tax laws. Additionally, this technical question raises the issue of the role of the legislators and regulators in considering consistency within the codes that they write and interpret, and the expectation of consistency that may be held by the judicial branch. Finally, it implicates current trends in philanthropy, such as the increased investment by endowments in private equity and the move to for-profit philanthropy vehicles, as evidenced by the Chan Zuckerberg Initiative.

This Article begins with an introduction to private foundation investing, including investments in alternative assets, the use of family offices in investing, the increased incidence of investment with affiliated parties, and basic securities law issues. With this background, Part III of the Article describes the private foundation excise taxes, generally, and specifically Code Section 4941's excise tax on acts of self-dealing. Part III also analyzes the Internal Revenue Service's current treatment of investment structures that allow private foundations to invest in alternative investments along with its affiliated parties as co-investments so as to avoid violating the Code Section 4941 self-dealing prohibition. The IRS' current treatment of co-investment partnerships is then compared to how other parts of the Code (namely, Subchapter K) and state partnership law approach issues of co-investment in Part IV. As Part IV will demonstrate, there appears to be an inconsistency between the PLRs on the one hand and the Subchapter K and state law approaches to partnership co-investment on the other; in response, Part V will

---

In this presentation, Ruth Madrigal, Attorney-Advisor, Office of Tax Policy of the Department of the Treasury (Sept. 20, 2013) is quoted as saying: "Many of you are aware that there have been PLRs over the years in this area, and sometimes this is referred to as 'co-investing.' And TE/GE has received PLR requests in this area more recently, and we think this is an area that would benefit from some additional guidance and guidance of general applicability, things that folks could all rely on. So we are looking into this area, and we intend to do some work on it," citing *ABA Transcript: Transcript of the September 20, 2013, ABA Tax Section's Exempt Organizations Committee Meeting*, 72 EXEMPT ORG. TAX REV. 567, 569 (Dec. 2013).

[20] Douglas M. Mancino and Ofer Lion, Co-Investing by Private Foundations and Disqualified Persons, 23 TAX'N OF EXEMPTS, Nov.-Dec. 2011, at 3 (recognizing that the investment in a partnership involves a sale or exchange, but otherwise supporting the IRS' line of reasoning in the PLRs on substance over form principles).

discuss whether consistency is necessary or if it can be sacrificed to achieve other goals. The Article concludes with a suggestion for the outlines of a regulatory safe harbor that could harmonize the IRS' treatment of partnership co-investment with state law and Subchapter K—or at least, maybe, the dissonance can be minimized to acceptable levels.

II. THE SELF-DEALING RULES AND PRIVATE FOUNDATION CO-INVESTING

A. The Reality of Foundation Investing

The self-dealing rules of Code Section 4941 can create significant landmines for private foundation investing.[21] The manner in which a private foundation manages its investment activities varies by the size of the foundation.[22] For large independent foundations, the foundation's investments may be handled by an inside Chief Investment Officer,[23] supported by an outside firm that may be affiliated with or recommended by one or more foundation managers.[24] For smaller foundations, investments are typically handled by the foundation managers directly or by hiring an outside investment advisor.[25] For larger family foundations, investing is significantly more complicated: often the investments for the entire family and all affiliated entities are run centrally, which may include the involvement of a family office.[26] Whether by coordination or happenstance,

---

[21] James L. Kronenberg, *Investing Private Foundation Assets: It's Not Your Father's Portfolio...or Your Sister's...or Yours*, BESSEMER TRUST, (Feb. 21, 2016), https://www.bessemertrust.com/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/Public/Published/Our%20Approach/Pdfs/12_28_07_InvestPrivFound.pdf (last visited Feb. 21, 2016) ("Some assume that investing for a private foundation is just like investing for individuals, only it's easier because a private foundation is tax-exempt. Actually, there are many legal constraints, both fiduciary and tax, that are unique to private foundation investing.").

[22] *Id.*; FOUND. SOURCE, ANNUAL REPORT ON PRIVATE FOUNDATIONS (2015) [hereinafter 2015 FOUND. SOURCE]. According to Foundation Source, of the 91,000 private foundations in existence, 66% have assets below $1.0 million. *Id.*

[23] By way of example, the Foundation Financial Officers Group is an industry group that typically consists of financial and investment professional employees of private foundations with assets in excess of $200.0 million in assets in a diversified investment programs that engage outside investment managers to manage assets. *FFOG Membership Application*, FOUND. FIN. OFFICERS GROUP, *FFOG Membership Application*, https://ffog.site-ym.com/general/register_member_type.asp (last visited Feb. 21, 2016). A family office or management company that provides financial or investment services to anyone other than the donor and the donor's family and private foundation is not eligible for membership. *Membership Eligibility*, FOUND. FIN. OFFICERS GROUP, *Membership Eligibility*, http://www.ffog.org/?page=MembershipEligibilit (last visited Feb. 21, 2016).

[24] *See* COUNCIL ON FOUNDATIONS-COMMONFUND, STUDY OF INVESTMENT OF ENDOWMENTS FOR PRIVATE AND COMMUNITY FOUNDATIONS, COUNCIL ON FOUND-COMMONFUND, Aug. 48 (2014) [hereinafter COMMONFUND STUDY].

[25] *See generally id.* at 50.

[26] Private foundations use direct alternative managers at a higher rate than community foundations,

foundation investments often end up in the same place as the individual investments of affiliated individuals, businesses, or family trusts.[27]

The private foundation excise taxes significantly complicate the process of investing private foundation assets through investment entities that involve related parties. Clearly, a private foundation must analyze each investment opportunity for compliance the self-dealing rules of Code Section 4941. In addition, the excess business holdings rules of Code Section 4943[28] and the Code Section 4944 tax on jeopardizing investments[29] significantly limit the ability of private foundations to invest in alternative asset classes. Taken together, the private foundation excise taxes place a heavy compliance burden on any foundation that wishes to engage in any type of sophisticated investment strategy.

As a result of the compliance burdens and prohibitions imposed by these excise taxes on private foundation, some donors have moved away from the traditional private foundation format as a vehicle to centralize management of charitable giving.[30] This movement resulted in the rise of both the supporting

---

reflecting a 44% portfolio allocation versus 25% for community foundations in the study group. Private Foundations with assets over $500 million used three times as many direct alterative investment managers as community foundations of the same size. *Id.* at 52.

[27] *Id.* at 34–36. The Commonfund Council on Foundations 2014 study found that private foundations tend to have small investment committees than community foundations, noting that "in particular, for family foundations as a subset of private foundations, these committees typically comprise the founder, family members, close advisers and selected associates from philanthropic or business organizations." *Id.* at 35. The fund also found that "while private foundations tend to have more diversified portfolios with significantly larger allocations to alternative investment strategies [than community foundations]—suggesting that they would likely have proportionately more investment professionals on their investment committees than do community foundations—the opposite is in fact true." *Id.* at 36.

[28] Code Section 4943 prohibits the private foundation from owning significant equity interests in operating businesses in which disqualified persons are also invested. *See generally* I.R.C. § 4943.

[29] Code Section 4944 limits the ability of the private foundation to invest in certain assets that might endanger the private foundation's charitable purpose. *See generally* I.R.C. § 4944.

[30] For the typical comparison of private foundations to public charities and donor advised funds prior to 2006, *see* Craig Wruck & Helen Monroe, *Family Foundations: Donor Advised Funds and Supporting Organizations as Alternatives to Private Foundations*, PLANNED GIVING DESIGN CTR. (July 14, 1999), http://www.pgdc.com/pgdc/family-foundations-donor-advised-funds-and-supporting-organizations-alternatives-private-foundations, and Victoria B. Bjorklund, *Charitable Giving to a Private Foundation and the Alternatives, the Supporting Organization and the Donor Advised Fund*, NAT'L CTR. ON PHILANTHROPY & L. (1999), http://www1.law.nyu.edu/ncpl/pdfs/1999/Conf1999_Bjorklund_Final.pdf.

organization[31] and the donor advised fund (or DAF).[32] Prior to 2006, supporting organizations and DAFs were generally governed by the same administrative and investment rules applicable to all public charities (not the more stringent rules applicable to private foundations.). When Congress saw the increased use of supporting organizations and DAFs as ways to have a charitable entity that looked like a private foundation while avoiding the imposition of the Chapter 42 excise taxes, it passed significant reforms as part of the Pension Protection Act of 2006.[33]

---

[31] A supporting organization is a specific type of public charity, described in Code Section 509(a)(3). *See generally* I.R.C. § 509(a)(3) (West 2015); Mark Rambler, *Best Supporting Actor: Refining The 509(a)(3) Type 3 Charitable Organization*, 51 DUKE L.J. 1367, 1368 (2002). Generally, public charities are not subject to the oversight of the Chapter 42 excise taxes on the presumption that the general public and a broad spectrum of donors are overseeing the charity in a manner that is not present with a private foundation. *See id.* at 1367–68. A supporting organization is granted public charity status not because it has a broad range of donors, but because it has a governance relationship with another public charity, and that public charity has an interest in providing the oversight that would otherwise be provided by the general public. Thus, a supporting organization can be funded by a single individual, family, or company, and still obtain public charity status. *See generally* Jeffrey D. Davine, *Everything You Ever Wanted to Know About Type 3 Supporting Organizations*, PLANNED GIVING DESIGN CTR. (June 26, 2000), http://www.pgdc.com/pgdc/everything-you-ever-wanted-know-about-type-3-supporting-organizations. A supporting organization is prohibited from providing support to organizations other than the public charity with whom it is affiliated; however, selecting a supported organization with a broad charitable mission (such as a community foundation) allowed a supporting organization to function as if were a private foundation. The supporting organization came under fire as circumventing Chapter 42, and as a result, supporting organizations came under scrutiny as part of the Pension Protection Act of 2006. *See generally* Rambler, at 1383.

[32] For the current definition of a DAF, *see* I.R.C. § 4966(d)(2) (West 2015); note, however, that Congress enacted Code Section 4966 in 2006. Prior to 2006, there was no statutory or regulatory definition of a DAF, although the regulations under Code Section 170 discuss the "component parts of a community trust" for public charity calculation purposes. Treas. Reg. § 1.170A-9(f)(11)(ii) (as amended in 2011). Generally, DAFs were segregated funds held by a charity pursuant to an agreement with a donor, in which the donor reserved certain advisory rights. Bjorklund, *supra* note 30, at 41–42. Because the assets held in the DAF were treated as gifts to the charitable organization, a charitable organization could maintain its public charity status because it could treat the funds in the DAFs as public support. Treas. Reg. § 1.170A-9(f)(11). At the same time, the gift management agreements between the sponsoring charity and the donor afforded the donor sufficient input and information as into the charitable giving process such that the DAF could functionally mimic the control retained by a private foundation. As a result, a DAF can function as a private foundation substitute, while affording the donor the income tax deduction given to gifts to public charities and the flexibility to operate free from the strictures of the private foundation excise taxes. *See* Wruck & Monroe, *supra* note 30. Moreover, because DAFs were not subject to the excess business holdings rules of Code Section 4943 prior to 2006, a donor could transfer family business assets (such as the stock in a family company) without limitation. Bjorklund, *supra* note 30. For a further discussion of current concerns regarding DAFs, *see* Roger Colinvaux, *The Rise of the Donor Advised Fund: Congress Should Respond with a Payout for Some DAFS and New Rules for Noncash Contributions* (Catholic Univ. of Am. Columbus Sch. of Law Legal Studies Research, Paper No. 2677297, 2015), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2677297 (providing more information on the current concerns regarding donor advised funds).

[33] The Pension Protection Act of 2006, Pub. L. No. 109–280, 120 Stat. 780 (2006), was signed into law on August 17, 2006 [hereinafter, PPA]. The Act expanded the reach of the Code Section 4943 excess business holdings excise tax and some parts of the Code Section 4945 excise tax on distributions for non-charitable purposes to DAFs (as well as supporting organizations). The Code

Under this new legislation, Congress subjected DAFs and supporting organizations to Code Section 4943's excise tax on excess business holdings.[34] While Congress did not go as far as to apply all of Code Section 4941's self-dealing rules to supporting organizations and DAFs, it did strengthen the excess benefit transaction rules (the public charity analog to Code Section 4941) as applied to those entities.[35]

As the Pension Protection Act made it more difficult to utilize the supporting organization and the DAF to avoid the private foundation excise taxes, more philanthropists turned to a completely different structure: the for-profit entity with a charitable purpose.[36] Although not the first to adopt this approach, Mark Zuckerberg and his wife, Priscilla Chan recently made headlines when they announced the formation of the Chan Zuckerberg Initiative, LLC, a for-profit entity dedicated to pursuing social goals.[37] After the announcement of its creation (on Facebook, of course), the Initiative quickly came under fire for being a for-profit entity.[38] One of the apparent rationales for foregoing the traditional private foundation format was that the Initiative could invest free from the restrictions

---

Section 4941 prohibition on self-dealing, however, was not extended to DAFs or supporting organizations. Finally, the PPA added a provision to Code Section 4942 that limits the ability of a private foundation to treat a distribution to a supporting organization as a qualifying distribution for purposes of meeting its annual minimum distribution requirement. *See* I.R.C. § 4941(2)(g)(4) (West 2015).

[34] For a brief discussion of Code Section 4943, *see supra* note 28.

[35] The public charity rules regarding self-dealing under Code Section 4958 are more lenient than the Code Section 4941 rules applicable to private foundations, in that they allow for arms' length transactions. The PPA added specific provisions to Code Section 4958 for DAFs and supporting organizations. *See* I.R.C. §§ 4958(c)(2), (3) (West 2015). For DAFs and supporting organizations, grants, loans, compensation, and "similar payments" are treated as automatic excess benefits, thereby imposing a prohibition on such transaction that would mirror the treatment such transactions would have received under Code Section 4941. I.R.C. §§ 4958(c)(1). In addition, the PPA added two additional excise taxes applicable to DAFs: Code Section 4966, which prohibits (but does not define) taxable distributions, and Code Section 4967, which taxes prohibited benefits given to a DAF's related parties. *See generally* I.R.C. §§ 4966, 4967 (West 2015).

[36] For an in depth discussion of the for-profit entity as a philanthropic vehicle, including a case study of Google.org, see Dana Brakman Reiser, *For-Profit Philanthropy*, 77 FORDHAM L. REV. 2437, 2465 (2009).

[36] *See e.g.* Susanna Poon, *LLC vs. Foundation: Which Is the Better Option for Philanthropists?*, FAM. OFF. EXCHANGE BLOG, https://www.familyoffice.com/insights/llc-vs-foundation-what-philanthropists-best-option (last visited July 26, 2016).

[37] *See* Mark Zuckerberg, *A Letter to Our Daughter*, FACEBOOK (Dec. 1, 2015), https://www.facebook.com/notes/mark-zuckerberg/a-letter-to-our-daughter/10153375081581634. After the initial criticism of the Initiative, Mark Zuckerberg followed up with an additional Facebook post to explain the structure of the organization, highlighting the need to be able to invest with flexibility. *See* Mark Zuckerberg, FACEBOOK (Dec. 3, 2015), https://www.facebook.com/zuck/posts/10102507695055801?fref=nf; *See generally* Josh Constine, *The Chan Zuckerberg Initiative's Chief of Staff Reveals Plan for Big-Bet Philanthropy*, TECHCRUNCH.COM (Dec. 11, 2015), http://techcrunch.com/2015/12/11/the-chan-zuckerberg-initiative/.

[38] *See* Martin Levine, *Chan Zuckerberg LLC: No Tax Breaks + No Accountability = What Exactly?* (Dec. 7, 2015), https://nonprofitquarterly.org/2015/12/07/chan-zuckerberg-llc-are-no-tax-breaks-plus-no-accountability-good-for-the-public/.

imposed by the private foundation excise taxes,[39] including the investment restrictions of Code Sections 4941 and 4943,[40] as well as the political and lobbying restrictions of Code Section 4945.[41]

At least until 2006, for-profit entities, DAFs and supporting organizations avoided (in varying degrees) the imposition of the private foundation excise taxes. At least in the case of the for-profit entities such as the Chan-Zuckerberg Initiative, the donors are not entitled to a charitable income tax deduction upon funding the entity, as the assets of the entity are not irrevocable dedicated to charitable purposes. As a result, one might argue that there is no reason to regulate such a vehicle in the same manner as the private foundation, despite the founders' stated intention to use it to further charitable causes. Others argue that the confluence of business and charity raises issues regarding the proper role (and regulation) of each sector.[42] On the other hand, transfers to both the DAF and the supporting organization do generate assets irrevocably dedicated to charity and an income tax deduction. As a result, the general public should be concerned about investment restrictions on private foundations if donors are utilizing alternative vehicles in order to avoid the discipline of these regulatory excise taxes.[43]

B. Private Foundation Alternative Investment Allocations

For those families that retain the traditional private foundation form for their charitable giving, the next step is to invest the foundation's assets in a manner that is consistent with the private foundation excise taxes as well as state law.[44] Over at least

---

[39] Mark Zuckerberg, FACEBOOK (Dec. 3, 2015), https://www.facebook.com/zuck/posts/10102507695055801?fref=nf; Jessica Guynn, *Mark Zuckerberg: Why Chan Zuckerberg Initiative Is an LLC*, USA TODAY (Dec. 4, 2015), http://www.usatoday.com/story/tech/2015/12/03/mark-zuckerberg-explains-corporate-structure-chan-zuckerberg-initiative/76749162/; Martin Levine, *Chan Zuckerberg LLC: No Tax Breaks + No Accountability = What Exactly?*, NONPROFIT QUARTERLY (Dec. 7, 2015), https://nonprofitquarterly.org/2015/12/07/chan-zuckerberg-llc-are-no-tax-breaks-plus-no-accountability-good-for-the-public/ (quoting Jack Blum of Tax Justice Network USA); Reiser, *supra* note 36, at 2453–54 (reciting similar concerns for the selection of a for-profit entity form for Google.org).

[40] In addition, the jeopardizing investment excise tax of Code Section 4944 would have been applicable.

[41] Code Section 4945 imposes an excise tax on a private foundation's taxable expenditures, which is defined to include lobbying and political activities. *See* I.R.C. §§ 4945(d)(1), (2) (West 2015).

[42] For a good discussion of the issue of for-profit philanthropy compare Eric A. Posner & Anup Malani, *The Case for For-Profit Charities*, (Univ. of Chi. Law & Econ., Olin Working Paper No. 304, 2006), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=928976; with Brian Galle, *Keep Charity Charitable*, 88 TEX. L. REV. 1213 (2012); Benjamin Moses Leff, *The Case Against For-Profit Charity*, 42 SETON HALL L. REV. 819 (2012); and Reiser, *supra* note 36, at 2472 ("The for-profit philanthropy model does not just push or question the boundaries the law has placed on philanthropy. It ignores the map altogether.").

[43] See, for example, the debate that occurred at a recent forum hosted by Boston College: *The Rise of Donor Advised Funds: Should Congress Respond?* (Nov. 11, 2015), https://www.bc.edu/schools/law/newsevents/events/philanthropy-forum/events/donor-advised-funds-program-.html.

[44] A full discussion of the state law fiduciary duty issues that arise in private foundation investing is beyond

the past decade, studies have shown that private foundations have steadily increased the allocation of their portfolios to alternative investments.[45] An alternative investment is typically an asset that is not publicly traded and is not a "traditional investment" in stocks, bonds, or cash.[46] As a result, private foundations increasingly invest in limited partnerships or LLCs as investment vehicles,[47] such as hedge funds,[48] private equity funds,[49] or real estate investment trusts.[50]

---

the scope of this paper, but see generally Susan N. Gary, *Is it Prudent to Be Responsible? The Legal Rules for Charities that Engage in Socially Responsible Investing and Mission Investing*, 6 NW J.L. & SOC. POL'Y 106 (2011); and Susan N. Gary, *Fiduciary Duties and ESG Investing*, ASS'N GOVERNING BOARDS U. & CS. TRUSTEESHIP MAG. (Dec. 2015), http://agb.org/trusteeship/2015/novemberdecember/fiduciary-duties-and-esg-investing.2015 (discussing the full fiduciary duty issues that arise in private foundation investing).

[45] According to the Foundation Source 2015 Report, the private foundations in its survey (which consisted of 769 of its foundation clients, all of whom had under $50.0 million in assets) averaged 15.6% of their portfolios in alternative investments in 2014, up from 15.2%. Even the smallest private foundations in the survey—those with under $1.0 million in assets—averaged an alternative investment allocation of 5.5% in 2014. 2015 FOUND. SOURCE, *supra* note 22, at 13. In Foundation Source's first Private Foundation Report in 2012, it found that by the end of 2011, allocations to alternative strategies remained steady during the study period at roughly 14% of assets under management, however, the number of foundation between $1.0 million and $10.0 million using alternative investment strategies rose from 41.6% at the end of 2007 to 60.1% at the end of 2011. FOUND. SOURCE, FIRST ANNUAL REPORT ON PRIVATE FOUNDATIONS 3 (2012) [hereinafter 2012 FOUND. SOURCE]. It further found that use of alternative investments increased for foundations of all sizes between 2007 and 2011, with a marked increase for foundations with assets between $1 and $10 million. Foundations that received little to no new funding tended to establish and pursue more aggressive allocation strategies, as all future growth would come from investment returns. *Id.* at 24. The Commonfund Council on Foundations 2014 Study, the study sample for which generally contains larger private foundations, shows an alternative investment allocation of 44% for 2014, up from 42% in 2013. In contrast, community foundation allocations went down from 27% to 25% over the same time period. COMMONFUND STUDY, *supra* note 24, at 17, 34-35 ("[B]oth types of foundation have over time significantly increased their allocations to alternative investment strategies and, to a lesser degree, to international equities. Both have correspondingly reduced their allocations to domestic equities and fixed income.")

[46] *See* EWELINA SOKOLOWSKA, THE PRINCIPLES OF ALTERNATIVE INVESTMENTS MANAGEMENT: A STUDY OF THE GLOBAL MARKET 1–2 (2014) ("In a broad sense, [alternative investments] are defined as investment products, which fall outside the circle of traditional investments such as stocks, bonds, or other money market instruments . . . .").

[47] *See* Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 19 (2008) (noting the rise of the demand for private equity due to smaller institutions, family offices and high net-worth individuals); David A. Weisbach, *The Taxation of Carried Interests in Private Equity*, 94 VA. L. REV. 715, 721 n.8 (2008) (citing a study by the Private Equity Council that found that 7.7% of private equity fund investors are tax-exempt organizations other than pension funds, while 6.8% are family offices and 10.%%.% are wealthy individuals).

[48] *See id.* at 726. ("Traditional hedge funds engage in arbitrage—they attempt to find subtle mispricings in securities and enter into long and short position to take advantage of the mispricings without exposing themselves to risk. They typically purchase public securities and hold them only for a short period."). *Id.* at 726.

[49] *See id.* at 721 (Private equity funds are investment funds that purchase equity positions in private businesses. If the fund invests in new companies, it is referred to as a venture capital fund. If the fund invests in existing companies—usually companies that require restructuring prior to resale—it is referred to as a leveraged buyout fund.); For more on the basic workings of private equity funds, see *id.* at 720–27.

[50] Code Section 856 defines a Real Estate Investment Trust as a "corporation, trust or association" that meets various requirements, including a requirement that most of its income come from real

By way of example, a traditional private equity fund might be organized as a limited partnership.[51] The fund's sponsors and investment managers, often through some type of entity, act as the general partner of the partnership. The fund's investors become limited partners to the extent of their capital contributions—possibly in their individual capacities, or through their own family entities. In some cases, the investment managers participate in the fund as limited partners directly in addition to their participation through the general partner.[52] The fund typically compensates the investment managers in two ways, often referred to colloquially as the "two and twenty."[53] First, the general partner receives a management fee, which is equal to a set percentage (traditionally, 2%) of the invested capital.[54] In addition, the general partner also takes an incentive fee (called a "carried interest" or a "carry"), which is a percentage (traditionally, 20%) of fund profits.[55] These fees are in addition to the share of profits that might be allocable to capital contributions of the general partner, if any, and the individual limited partnership investments of the fund managers.[56]

The typical equity fund has a number of limitations. An investment in a private equity fund is usually fairly illiquid. The fund usually prohibits the limited partners from withdrawing their investments for a significant period of time.[57] Thus, an investor in a private equity fund must take into account this lack of liquidity for cash flow purposes, which can be problematic for a private foundation that is required to distribute five percent of the fair market value of its assets annually.[58] The private foundation must find other sources for the cash needed to make these required distributions. In addition, in order to deal with the federal securities law, an equity fund often limits the number of parties investing in the fund, and requires those parties to have a certain level of investment sophistication, as discussed in further detail below.[59]

---

estate-related activities, dividends and interest. *See* I.R.C. § 856(c) (West 2015). According to the first Foundation Source Report, most foundation alternative investments in their study were limited partnership interests, real estate and other real property, although there was some growth in precious metals. 2012 FOUND. SOURCE, *supra* note 22, at 17.

[51] *See* Fleischer, *supra* note 47, at 8. Hedge funds or private equity funds can be set up as LLCs that are taxed as partnerships for federal tax purposes. *Id.*

[52] Weisbach, *supra* note 47, at 7-9; Fleischer, *supra* note 47, at 8.

[53] *See* Fleischer, *supra* note 47, at 1, 8.

[54] Weisbach, *supra* note 47, at 8; Fleischer, *supra* note 47, at 1.

[55] Fleischer, *supra* note 47, at 1, 8; Weisbach, *supra* note 47, at 1 n.11. Traditionally, the manner in which the 20% carried interest is calculated differs between hedge funds and private equity funds. *Id.* at 723 n.11.

[56] Fleischer, *supra* note 47, at 8 ("The GP also contributes some of its own capital to the fund so that it has some 'skin in the game.").

[57] *See Hedge Funds: Sauce for the Goose... and the Gander?*, FED. STREET ADVISORS 4, 6 (July 2007), http://www.federalstreet.com/guest_docs/Hedge_Funds_and_Foundations.pdf [hereinafter FED. STREET ADVISORS].

[58] I.R.C. § 4942(a), (e).

[59] FED. STREET ADVISORS, *supra* note 57, at 6. For a more detailed discussion of securities law issues see *infra* Section II.D.

Some commentators have decried this move toward alternative investments in the exempt organization space.[60] Certain alternative investments can increase the amount of risk in the portfolio beyond that which was typically seen as appropriate for charitable organizations.[61] As described above, alternative investments also cause significant illiquidity in the charity's portfolio, which can impact its ability to make distributions or expenditures for charitable purposes. Alternative investments often lack significant transparency—many hedge funds do not make their investment holdings public, sometimes even to the limited partners—which can cause difficulties in evaluating investment performance and measuring asset value.[62] Finally, alternative investments should take more time and attention to oversee than traditional investments, demanding the additional attention of foundation managers and incurring additional investment cost.[63]

Increased risk is not always inappropriate, however. If the charity's investments are structured to recognize and balance this risk, alternative investments can have an appropriate place in a diversified portfolio. Some types of alternative investments, such as a well-run hedge fund, can actually reduce portfolio risk if done correctly.[64] Structuring a portfolio to accommodate or decrease risk and to maintain sufficient liquidity to support a charity's expenditures requires some degree of professional expertise in nonprofit investing.[65]

---

[60] Much of this debate has centered around college and university endowments and public pension funds. *See, e.g.*, Barry Ritholtz, *The Shame of Alternative Investments*, BLOOMBERGVIEW (June 24, 2014, 8:25 AM), http://www.bloombergview.com/articles/2014-06-24/the-shame-of-alternative-investments.

[61] Code Section 4944 imposes an excise tax on "jeopardizing investments," which lists puts, calls, straddles, warrants, short sales, trading on margin, commodity futures and oil and oil and gas investments (technique often utilized by hedge funds and private equity funds) as requiring close scrutiny. Treas. Reg. § 53.4944-1(a)(2) (as amended in 1973). The Foundation Source indicated that after the market decline of 2008, many foundations moved to less aggressive investment strategies; however, those foundations "that did not received infusions of new capital after 2008 were more likely to invest their assets aggressively (with heavier equity allocations)." 2012 FOUND. SOURCE, *supra* note 45, at 4. After 2011, alternative investment growth "ticked up slightly" as foundations continued to recover from 2008, but the study found that larger foundations allocated about 15% of their assets to alternative investments, "due in part to the fact that larger foundations (or their funders) have greater access to private equity and other alternative investments." *Id.* at 16.

[62] *See* Stuart McCrary, Berkeley Research Group, *Commentary: Exploring Hedge Fund Transparency*, WESTLAW J., Aug. 2014, http://www.thinkbrg.com/media/publication/471_McCrary_Westlaw_August2014.pdf.

[63] *See* FED. STREET ADVISORS, *supra* note 57, at 3 ("It is therefore necessary to perform, or rely on a trust consultant to perform, a thorough due diligence process that examines the hedge fund's managers and investment process, as well as the legal structure, the organizational resources, and features of the investment."); Despite the need for additional oversight of alternative investments, the Commonfund Council on Foundation study showed private foundation investment committees are smaller than counterparts at community foundations. COMMONFUND STUDY, *supra* note 24, at 34.

[64] *See* Kronenberg, *supra* note 21, at 2; FED. STREET ADVISORS, *supra* note 57, at 1 (Hedge funds can "achieve risk reduction, to the extent a selected hedge fund is uncorrelated or has low correlation with other assets held in an investment portfolio.").

[65] *See* Kronenberg, *supra* note 21, at 3 ("The 5% payout requirement should affect a foundation manager's investment decisions. Foremost, the payout requirement will inform the decision on how

Presumably, the sophisticated private foundation will be able to evaluate whether alternative investing makes sense as a matter of risk/return and as a matter of administrative cost and attention.[66]

C. Foundation Investments Managed by Family Offices

A family foundation may utilize the services of a family office[67] to select and oversee the foundation's investments, including its alternative investments. In such circumstances, investment opportunities likely come from a common source: the family's outside investment professionals[68] or family office investment staff.[69] As a result, all of the family members and entities affiliated with the foundation may be looking at and participating in the same investment opportunities. According to some studies, single-family offices hold about $1.2 trillion in assets, while multi-family offices manage about $500 billion in assets.[70] "Some market experts say family offices are similar to what hedge funds were in the early 1990s—lightly regulated investment vehicles for the wealthy that can make big bets on markets, but remain out of the public spotlight."[71]

The family office is typically structured as a business entity (often a partnership or LLC taxed as a partnership) owned by various related family members. The family office then employs staff that can handle a variety of the family's needs—everything from basic bookkeeping, bill payment, and tax preparation to the identification and management of the family's overall

---

much should be allocated to equities, fixed income, and alternative assets.").

[66] *See generally* FED. STREET ADVISORS, *supra* note 57.

[67] A "family office" can refer to a family-controlled investment and administrative group. *See* Julie Steinberg & Kelly Greene, *Financial Advice, Served Rare*, WALL STREET JOURNAL (May 17, 2013), http://www.wsj.com/articles/SB10001424127887323551004578441002331568618 ("Family offices are private firms that manage just about everything for the wealthiest families: tax planning, investment management, estate planning, philanthropy, art and wine collections—even the family vacation compound.").

[68] Russ Alan Prince, *Family Offices Are Successful Middle-Market Investors*, FORBES (Dec. 1, 2014, 6:30 AM), http://www.forbes.com/sites/russalanprince/2014/12/01/family-offices-are-successful-middle-market-investors/ ("[T]he majority of direct investment opportunities are brought to family offices through the financial and legal professional in their networks."); Margaret Collins, *Family Offices Team Up Taking Page From Private Equity*, BLOOMBERG (May 28, 2014, 12:00 AM), http://www.bloomberg.com/news/articles/2014-05-28/family-offices-team-up-taking-page-from-private-equity ("About 22 percent of family offices had three or more people in their office tasked with the sourcing, screening, monitoring and exiting of direct investments in 2010, according to a survey by McNally's firm. That percentage has almost doubled as of this year to 37 percent, said McNally."). "Still, there are now more than 1,000 family offices in the United States, according to an estimate from the Wharton Family Office Alliance . . . ." Robert Frank, *Introducing the New Hedge Fund: The Family Office*, CNBC (June 5, 2013, 10:36 AM), http://www.cnbc.com/id/100791423.

[69] COMMONFUND STUDY, *supra* note 24, at 48–58.

[70] Collins, *supra* note 68 (citing Bob Casey, senior managing director for research at consulting firm Family Wealth Alliance).

[71] Frank, *supra* note 68.

investment portfolio. This allows the family to achieve economies of scale for certain services and projects.[72] In some cases, these costs are shared; in others, direct costs can be allocated to specific family members. Related family entities can contract for services from the family office in a manner designed to allocate costs and to track fees by entity cost centers.

Some family offices manage the family's investments through arrangements with third party advisors and managers. The more recent trend involves the family office actually creating the fund itself. [73] In this way, the family reduces costs, and the family can tailor fund holdings to the family's needs. Taken to the most sophisticated level, the family office can create multiple funds, each focused on a particular style of investing: growth versus value, small cap versus large cap, etc.[74] Each family member would then participate in selected funds to the extent necessary for the family member to reach a desired portfolio allocation.[75] Thus, a family's generation skipping trust designed to benefit multiple future generations would invest in the family investment funds that would create a long term growth portfolio allocation, while a trust for the benefit of an elderly family member might invest in only those family investment funds that would produce short term income.

D. Securities Law Issues and the Family Office

Use of the family office as an investment vehicle benefits the family and its foundation by providing economies of scale, lower fees, and familiarity with individual investment styles, especially in the alternative investment space. Investing in this manner raises obvious tax questions, but it also implicates federal and state securities regulation. While a full overview of the applicable securities laws is beyond the scope of this Article,[76] it is important to understand some of the

---

[72] Collins, *supra* note 68. Investing together or forming a partnership to take a stake in an investment results in lower fees and a better understanding of the businesses in which the family invests. Family offices can allocate due diligence duties and utilize expertise to maximize resources.

[73] There is a recent trend of family offices teaming up to coordinate direct investments (rather than through managed funds) as well, in order to share information and reduce fees. Antoine Drean, *Individual Investors and Family Offices Are the Rising Power in Private Equity*, FORBES (July 28, 2015, 11:39 AM), http://www.forbes.com/sites/antoinedrean/2015/07/28/individual-investors-and-family-offices-are-the-rising-power-in-private-equity/#64c286795663 (stating that family offices account for 8% of the world's $4.0 trillion in private equity assets under management, double the share of five years ago).

[74] *See generally* Michael J. Cooper, Huseyin Gulen & P. Raghavendra Rau, *Changing Names with Style: Mutual Fund Name Changes and Their Effects on Fund Flows*, 60 J. FIN. 2825 (2005).

[75] For a non-economic view of style selection see Henrik Cronqvist, Stephan Siegel, & Frank Yu, *Value Versus Growth Investing: Why Do Different Investors Have Different Styles?*, 117 J. FIN. ECON. 333 (2015) (discussing personal factors influencing an investor's style selection).

[76] This article by necessity will only briefly discuss some applicable federal securities laws and will not discuss the various state securities law regimes. Most states have a parallel system of securities regulation that requires independent analysis. *See Blue Sky Laws*, SEC. EXCH COMM'N (Oct. 14, 2014), https://www.sec.gov/answers/bluesky.htm. Each state's own set of securities laws, commonly

potential benefits accruing to the private foundation and its disqualified persons from securities law compliance perspective. Two key elements of the securities laws at issue are those that regulate the office itself and the advice that the office (or its employees) can give, and those that regulate the investments themselves.

The Investment Advisors Act of 1940[77] (the "IAA") generally provides that individuals who provide investment advice[78] to the public for compensation must register with the SEC[79] and meet certain minimum standards,[80] unless an exemption applies. While there is an exception for general advice on planning and administrative assistance, advice regarding individual securities will generally implicate the provisions of the IAA. Because many family offices provide individualized advice regarding specific securities to family members, related business entities, and (of course) the family's private foundation, each family office must consider whether it is an investment advisor under the IAA. Registration and continuous reporting[81] as an investment advisor under the IAA is expensive, time-consuming, and limiting; as a result, family offices and their investment professionals would rather avoid registering under the IAA, all other things being equal.[82]

Prior to 2011 (and, importantly, at the time that the IRS issued the PLRs), the SEC took the position that an individual giving investment advice to a limited number of clients was exempt from registration under the so-called "private adviser" exemption.[83] The SEC interpreted the private adviser exemption to

---

referred to as "Blue Sky Laws," are designed "to protect investors against fraudulent sales practices and activities." *Id.* Although these laws vary from state to state, most Blue Sky Laws require companies to make offerings of securities to register their offerings before they can be sold in a particular state (unless a specific state exemption is available). *Id.*

[77] Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1–21 (West 2015) [hereinafter IAA].

[78] *Id.* § 202(a)(11). IAA Section 202(a)(11) defines an investment advisor to include "any person who, for compensation, engages in the business of advising others . . . . as to the value of securities or as to the advisability of investing in, purchasing or selling securities . . ."

[79] *Id.* § 203(c)(1).

[80] *Id.* §§ 205, 206. For example, IAA Section 205 contains requirements for investment advisor contracts, while IAA Section 206 enumerates certain prohibited transactions.

[81] *Id.* § 204. See IAA Section 204 for investment adviser reporting requirements.

[82] Collins, *supra* note 68 (explaining "[f]"amilies should consider setting up a separate entity for these co-investments . . . to make sure their entire family offices aren't forced to register as investment advisers and therefore reveal financial details."; *see also* Ryan M. Harding & Elise J. McGee, *To Register or Not? SEC Investment Adviser Guidance for "Family Offices,"* PROB. & PROP., Sept.–Oct. 2012, at 22 (stating that registering a family office as an investment advisor would be an "unattractive outcome.").

[83] IAA § 203(b)(3) (prior to 2011 Dodd Frank amendments); *see also* Harding & McGee, *supra* note 82, at 22. Additionally, the SEC has the authority to exempt parties from the IAA if it was consistent with the purposes of the act. Under this authority, the SEC did issue exemptions to family offices that may have had more than fifteen clients due to the presence of a former employee, a charitable entity, or like clients. *See* Audrey C. Talley, Family Offices: Securities and Commodities Law Issues, 34 ACTEC J. 284, 286 (2009) (citing Donner Estates, Inc., Investment Advisers Act Release No. 21, 1941 WL 37202 (Nov. 3, 1941)); *see also* Family Offices, 76 Fed. Reg. 37,983 (June 29, 2011) (to be codified at 17 C.F.R. pt. 275), https://www.sec.gov/rules/final/2011/ia-3220fr.pdf [hereinafter Family Offices Final Rule] ("Historically, family offices that fell outside the private adviser

provide that an adviser did not have to register under the IAA if that adviser had less than fifteen clients.[84] The tricky part was how to count clients in a family office setting.[85] The SEC, in interpreting the private adviser provision, grouped certain related parties: spouses and minor children, for example, could be treated as one client.[86] Typically, individually organized entities were treated as different clients.[87] Importantly, it was not necessary to count any entity for whom investment services were provided without compensation; accordingly, if the family office provided advice free of charge, then the private foundation did not count as a client.[88] For those with an extensive family tree and a complicated trust and investment entity structure, the family office could reach fifteen separate (albeit related) clients relatively quickly. Reaching fifteen clients would be a virtual certainty for a multi-family office.

Under the pre-2011 rule, a family office had to be cautious about the number of entities to which it gave investment advice. On the one hand, this limit would advise against creating multiple legal entities (such as investment partnerships among family members) if those entities could not be aggregated with one another under the fifteen client rule. On the other hand, if various potential clients could be aggregated in a single entity structure, and the family office provided investment advice to that entity only, it could reduce the number of "clients" counted under the old rule. Including a private foundation and other entities in an investment partnership, and then counting the investment partnership itself as the client, the partnership might benefit the family office and the family if it ultimately allowed the family office to avoid registration.

In 2010, the Dodd-Frank Act amended the IAA to remove the private advisor exemption of Section 203(b).[89] In its place, however, the Dodd-Frank Act added Clause (G) to Section 202(a)(11) (the definition of an investment advisor), which now specifically provides that an investment advisor does not include "any family office, as defined by rule, regulation, or order of the [Securities and Exchange] Commission . . . ."[90] Under the SEC's new family office rules,[91] an advisor does not need to register under the IAA if all of the family office's clients

---

exemption have sought and obtained from us orders under the Advisers Act declaring those offices not to be investment advisors . . . .").

[84] IAA § 203(b)(3); Harding & McGee, *supra* note 82, at 22.

[85] *See* Talley, *supra* note 83.

[86] 17 C.F.R. § 275.203(b)(3)-1(a)(i) (2015) provides that for purposes of IAA Section 203(b)(3), a single client includes a natural person, their minor children, their spouse or other relatives who share the same principal residence, and accounts and trust of which those persons are the primary beneficiaries.

[87] *Id.* The SEC allowed the aggregation of separate legal organizations as a single client if they had identical owners. *Id.* § 275.203(b)(3)-1(a)(iii).

[88] *Id.* § 275.203(b)(3)-1(b)(4).

[89] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 11-203, 124 Stat. 1376, 1571 (2010) [hereinafter Dodd-Frank Act].

[90] IAA § 202(a)(11)(G); Dodd-Frank Act § 409.

[91] Family Offices Final Rule, *supra* note 83. Proposed rules were issued on October 12, 2010. *See* Family Offices, 75 Fed. Reg. 63,753 (proposed Oct. 12, 2010) (to be codified at 75 C.F.R. pt. 275).

are members of the same family, the family clients own and control the family office, and the family office does not hold itself out to the public as an investment advisor.[92] While the new rules specifically disallow the provision of investment advice to multi-family offices or to clients who are not family members,[93] a private foundation can be a family client if other family clients provide all of the foundation's funding.[94]

Under the new rule, a private foundation will not be related if accepted and holds non-family contributions.. Unless the private foundation purges itself of those non-family contributions,[95] it would be an unrelated party and therefore, would not be treated as an acceptable client for purposes of the IAA exception. In such a scenario, the family office must choose to either (1) no longer provide the private foundation with investment advice, or (2) register under the IAA. Either choice would have a significant impact on both the family and the private foundation. If the private foundation were to receive independent advice, it would, of course, need to pay for it. Moreover, to the extent that the family benefitted from the participation of the foundation in family investment opportunities, those benefits would be lost. The family and the foundation would lose the benefit of being able to pool resources to make larger investments or meet the minimum investment requirements of particular funds. If the family office chose to register due to the continuing participation of the private foundation, it would need to deal with the question of how to allocate the cost associated with that registration. Under the self-dealing rules, any agreement between the private foundation and its disqualified persons to share these costs would be itself an act of self-dealing. Thus, it would seem that the costs associated with IAA registration would need to be borne by the disqualified persons as a cost of keeping the private foundation within the investment fold.

The second set of securities laws apply to the investments themselves. The Securities Act of 1933[96] (the "1933 Act") generally requires the registration of all offers and sales of securities, absent an applicable exemption.[97] As with the registration provisions of the IAA, registering a security for offering can be a time-consuming and expensive proposition. As a result, there are a number of exceptions to the 1933 Act's registration requirements; investment opportunities are often structured to qualify for these exemptions.

The 1933 Act exempts from registration certain non-public offerings of securities, sometimes involving a limited dollar amount or a limited number or

---

[92] Family Offices Final Rule, *supra* note 83, at 37,984.
[93] *Id.* There is a limited exception for the provision of advice to non-family members who are key employees.
[94] *Id.* at 37,987; *see also* IAA § 202(a)(11)(G)-1(d)(4)(v).
[95] The Final Family Office Rule 202(a)(11)(G)-1(e)(1) contain specific transition rules in this regard. Family Offices Final Rule, *supra* note 83, at 37, 988.
[96] Securities Act of 1933, 15 U.S.C. §§ 77a–77aa (West 2015) [hereinafter 1933 Act].
[97] The terms "offer," "sale" and "securities" all have extraordinarily broad definitions. *See* THOMAS LEE HAZEN, PRINCIPLES OF SECURITIES REGULATION (CONCISE HORNBOOK SERIES) (3d ed. 2009).

type of purchaser.[98] Regulation D[99] describes the exemptions from the registration requirements of the 1933 Act for private placements. Section 506 of Regulation D contains the primary exemptions from registration. Section 506(b) provides that a sale of securities is exempt from registration if: there are no more than 35 purchasers[100] and each purchaser is an accredited investor,[101] or can demonstrate that they have the knowledge and experience to evaluate the investment properly.[102]

Alternatively, Section 506(c) of Regulation D exempts offerings with an unlimited number of investors, but all of the investors must be verified "accredited investors" within the meaning of the 1933 Act and Regulation D.[103]

Under Regulation D, an accredited investor includes a Section 501(c)(3) organization (such as a private foundation), or a corporation or partnership, that was not formed for the specific purpose of acquiring securities, and in each case, having assets in excess of $5.0 million.[104] For corporations and partnerships with over $5.0 million in assets, each individual owner of the entity does not need to be an accredited investor; the Regulation merely requires that the corporation or partnership not be formed for the purposes of acquiring the securities offered.[105] A corporation or partnership with under $5.0 million in assets will only be an accredited investor if all of its equity owners are accredited investors individually.[106] For purposes of counting investors, a corporation or partnership is counted as one purchaser unless it is formed for the purpose of acquiring the offered securities and it is not an accredited investor in and of itself. In that case, each beneficial owner is treated as a separate investor.[107]

For a family wishing to enter into any transaction that intends to qualify as a private placement, participation of a private foundation may be important. A larger private foundations will be an accredited investor by virtue of having over

---

[98] The statutory dollar limitation is currently $5.0 million, and has been at the time of the PLRs and since 1980, when it was increased from $2.0 million. 1933 Act § 3(b)(1). For example, Regulation D has special exemption provisions for sales under $1.0 million (530.504) and $5.0 million (230.505).

[99] *See generally* 17 C.F.R. § 230.501 (The SEC rules are safe harbors and are not the exclusive ways of conducting a private placement. These safe harbors are frequently relied upon by sellers and investors, however, because they are predictable and provide a level of certainty to the transaction.).

[100] 17 C.F.R. § 230.506(b)(2)(i) (2013); *see also* 17 C.F.R. § 230.501(e) (giving the rules regarding counting the number of purchasers).

[101] 17 C.F.R. § 230.506(b)(2)(ii).

[102] *Id.*

[103] *See* 17 C.F.R. § 230.506(c)(2).

[104] 17 C.F.R. § 230.501(a)(3). *See also* 17 C.F.R. § 230.501(a)(5), (6) (In addition, a natural person and his or her spouse with assets of over $1.0 million or who has income in excess of $200,000 ($300,000 with a spouse) is an accredited investor.).

[105] 17 C.F.R. § 230.501(e)(2) (Providing that if an "entity is organized for the specific purpose of acquiring the securities offered and is not an accredited investor" because all of its equity owners are accredited investors, then each equity is treated as" a separate purchaser for all provisions of Regulation D."

[106] 17 C.F.R. § 230.501(a)(8).

[107] 17 C.F.R. § 230.501(e).

$5.0 million in assets.[108] The private foundation may be able to contribute sufficient assets to an investment partnership to qualify the partnership itself as an accredited investor; other family members investing with the private foundation in the investment partnership need not be accredited investors if the partnership holds over $5.0 million and assets and was not formed solely to take part in the offering. Not only does this assist the family members that might not otherwise qualify as accredited investors, but it assists the issuer (who may also be a related party in some of these situations), who may only be able to allow a limited number of non-accredited investors (if any) into an investment.[109]

As these two examples demonstrate, a private foundation may find itself investing in an alternative investment not because it is in the best interests of the private foundation, but because it will benefit other family members from a cost, opportunity, and compliance standpoint.

III. PRIVATE FOUNDATIONS AND CHAPTER 42

A. Private Foundations, Generally

The Internal Revenue Code places a number of restrictions on the ability of charitable organizations to invest their assets in concert with affiliated parties; however, only private foundations are subject to the restrictions of Chapter 42 and specifically, Code Section 4941.

Code Section 501(c)(3) exempts from federal income taxation entities that are organized and operated exclusively for charitable and other tax-exempt purposes.[110] Organizations described in Code Section 501(c)(3) are further subdivided into two categories: private foundations and public charities.[111] A Code Section 501(c)(3) organization is deemed to be a private foundation unless it proves that it is entitled to public charity status.[112] There are, essentially, three categories of organizations that qualify for public charity status: certain organization deemed to be automatically public (such as churches, hospitals, and

---

[108] 17 C.F.R. § 230.501(a)(3) (treating Section 501(c)(3) organizations with over $5.0 million in assets as accredited investors). Although see the discussion *infra*, II.B., of the increase in the percentage allocation of investments to alternative for even small private foundations.

[109] *See generally* STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: CASES AND ANALYSIS (4th ed. 2015) ("In practice, most offerings [under Rules 505 and 506] are sold exclusively to accredited investors."); *see also* Rutheford B. Campbell Jr., *The Wreck of Regulation D: The Unintended (and Bad) Outcomes for the SC's Crown Jewel Exemptions*, 66 THE BUS. LAWYER 919 (2011); Stuart R. Cohn & Gregory C. Yadley, *Capital Offense: The SEC's Continuing Failure to Address Small Business Financing Concerns*, 4 NYU J.L. BUS. 1 (2007).

[110] *See generally* Elaine Waterhouse Wilson, *Better Late Than Never: Incorporating LLCS Into Section 4943*, 48 AKRON L. REV. 485 (2015). Technically, Section 501(a) confers the exemption on organizations described in Section 501(c), including Section 501(c)(3).

[111] I.R.C. § 509(a) (West 2015).

[112] *Id.*

schools);[113] organizations with a broad base of public support, as determined by one of two mathematical tests;[114] and supporting organizations, which are organizations that were created for the purpose of benefitting one or more other public charities. If an organization does not fall into one of these categories, it is treated as a private foundation. Typically, a private foundation holds a substantial endowment of investment assets that it obtained from a single person or family, the income from which is used to make grants for charitable purposes.[115]

There are significant consequences that arise from being characterized as being a private foundation rather than a public charity.[116] One of the most serious of these consequences is that private foundations are subject to the private foundation excise tax regime found in Chapter 42 of the Code.[117] These excise taxes, found in Code Sections 4940 to 4948, significantly impact all aspects of the administration of a private foundation, including the investment of its assets.

B. The Private Foundation Excise Taxes

In 1950,[118] Congress enacted a number of reforms in the exempt organization area, including Code Section 503 regarding related party transactions.[119] The original House legislation intended simply to prohibit private foundations from entering into certain related party transactions.[120] The Senate Finance committee substantially softened the House's absolute prohibition, allowing arm's-length dealings between private foundations and its related

---

[113] I.R.C. §§ 509(a)(1), (a)(4), 170(b)(A)(i)-(v) (West 2015). It also includes organizations that test for public safety.

[114] I.R.C. §§ 509(a)(1)–(2), 170(b)(1)(A)(vi) (West 2015). Donor advised funds are not in and of themselves Section 501(c)(3) organizations; however, they are typically accounts or funds sponsored by Section 501(c)(3) organizations that qualify as public charities because the charity meets one of the mathematical tests. For a more detailed discussion of donor advised funds *see supra* pp. 7–8.

[115] According to the Council on Foundations, in 2011 there were 73,764 private foundations with more than $604.0 billion in assets and more than $45.0 billion in annual giving. *Private Foundations*, COUNCIL ON FOUND. (Feb. 21, 2016), http://www.cof.org/foundation-type/private-foundations.

[116] *See generally* I.R.C. § 170(b)(1)(D), (e) (West 2015). Classification as a private foundation may also have a negative impact on a donor's charitable income tax deduction under Section 170. Very generally, a donor's income tax deduction is subject to a number of limitations, including an annual limitation in allowable deduction based on the donor's adjusted gross income and a decrease in the amount of the charitable deduction for appreciated property. For gifts to private foundation, a donor's deduction may be limited to 20% of the donor's adjusted gross income (as opposed to 50% or 30% for gifts to or the use of a public charity) and the donor's deduction may be limited to basis of certain types of appreciated property (as opposed to fair market value reduced by short term capital gain for gifts of appreciated property to a public charity); *see also* Wilson, *supra* note 110.

[117] I.R.C. §§ 4940–4948 (West 2015).

[118] The Revenue Act of 1950, Pub. L. No. 81-814, 64 Stat. 906. (1950).

[119] I.R.C. § 503 (West 1954).

[120] *See* H.R. Rep. No. 2319, at 42 (1950), reprinted in 1950-2 C.B. 380, 412; Thomas A. Troyer, *The 1969 Private Foundation Law: Historical Perspective on Its Origins and Underpinnings*, 27 TAX'N OF EXEMPTS 4 (2000).

parties.[121] As a result, then Code Section 503 loosely regulated transactions between private foundations and its affiliates.[122] Under these rules, a trust holding amounts for charitable purposes could not, among other things, lend without "adequate security" and a "reasonable rate of interest"; make "substantial purchases" of property for more than "adequate consideration;" or engage in any other transaction that would result in a "substantial diversion" of assets to the grantor, their family members, or certain controlled corporations.[123]

The language of Code Section 503 allowed for a significant amount of ambiguity and discretion. "Adequate" consideration and "substantial" diversions were not defined by the statute itself. One commentator noted that the "statutory standards are either very vague or . . . so specific as to be relatively useless . . . ."[124] Enforcement of such provision by the IRS was a case-by-case, fact specific, and time intensive endeavor[125] that, as a practical matter, would "depend, in the last analysis, upon the dictates of conscience of philanthropists."[126]

As it became clear that the reforms of 1950 were not sufficient to stop private foundations abuses,[127] congressional scrutiny of the private foundation sector intensified. In 1961, Representative Wright Patman initiated a survey of 534 private foundations, which formed the basis of the Patman Report, a multi-volume study cataloguing a myriad of private foundation of abuses.[128] Patman argued that

---

[121] *Id.* at 7.

[122] *Id.* The concept of the private foundation does not technically become a part of the Internal Revenue Code until 1969; however, Section 503 of the 1954 Code was limited in application to basically what would be private foundations currently, which would form the outlines of the private foundation/public charity distinction when it does officially become part of the Code. When the private foundation excise taxes were passed in 1969, Code Section 503 was amended to apply only to a select number of non-charitable exempt organizations. *See* I.R.C. § 503(a)(1)(2015) (applicable to organizations described in 501c17 and 501c18 (certain supplemental compensation and employee benefit trusts) and certain government and church retirement plans described in § 401(a) and either §§ 4975(g)(2) or (3)).

[123] Revenue Act of 1950, Pub. L. No. 81-814, § 321, 64 Stat. 906, 954-6; *compare* I.R.C. § 503 (West 1954), *with* I.R.C. § 503(b) (West 2015).

[124] Troyer, *supra* note 120, at 11 (citing Young, *Donor Foundation Dealings*, N.Y.U. 22D INST. ON FED. TAX 965, 1006 (1964)).

[125] S. COMM. ON FIN., 89TH CONG., REP. ON PRIVATE FOUNDATIONS 6 (Comm. Print 1965) [hereinafter 1965 REPORT] ("Fourteen years of experience have demonstrated that the imprecision of this statute makes the law difficult and expensive to administer, hard to enforce in litigation, and otherwise insufficient to prevent abuses."); *Id.* at 18 (Private foundation examinations under Code Section 503 were "require the skill of highly trained revenue agents and are both time consuming and expensive.").

[126] Troyer, *supra* note 120, at 11–12 (citing Young, *supra* note 124, at 1006).

[127] In its explanation of the 1969 Act, the Joint Committee on Internal Revenue Taxation states that one of the reasons for the prohibition on self-dealing was "to minimize the need to apply subjective arm's-length standards." Troyer, *supra* note 120, at 27 (quoting STAFF OF JOINT COMM. ON INTERNAL REVENUE TAXATION, 91ST CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1969 30-31 (Comm. Print 1970)).

[128] The results of the Patman hearings were published in three separate installments (the "Patman Reports"). CHAIRMAN'S REPORT TO H. SELECT COMM. ON SMALL BUSINESS, 87TH CONG., TAX-EXEMPT FOUNDATIONS AND CHARITABLE TRUSTS: THEIR IMPACT ON OUR ECONOMY, FIRST

the lost tax revenues attributable to the tax-exempt status of private foundations[129] were not justified by the charitable use of the assets held by those foundations, because the donor families and corporations could

> by a loan or exchange, secure a return of assets that have been donated should the occasion arise, that he can secure additional capital when needed, at "reasonable" rates; that foundation funds have been used to help a donor when he found himself in a proxy fight; and foundation funds have been used to confer benefits on employees of companies, a substantial competitive advantage.[130]

The Patman report clearly discusses abusive self-dealing transactions such as foundation lending to insiders at favorable rates, capital investments in family entities, use of foundation services on a preferable basis, and sales that were not at fair market value,[131] as well as more subtle types of self-dealing, such as proxy fight behavior[132] and investment selection.[133]

On the heels of the Patman report, the Senate Finance Committee in 1964 directed that the Treasury study private foundations, stating that it believed that foundation assets were being invested and "the advantages arising from control of these investments [were] likely to inure to the principal contributors to the foundations."[134] The resulting Treasury report, released in 1965, echoed many of the concerns identified by the Patman report.[135]

The 1965 Report identified subtle benefits inuring to the benefit of private parties engaged in investment transactions.[136] A foundation manager might change the investment of a foundation[137] or delay distributions if he knew that the liquidity might be used to make a loan to his personal business.[138] Evan if a loan to a

---

INSTALLMENT (Comm. Print 1962) [hereinafter PATMAN REPORT OR FIRST INSTALLMENT]; CHAIRMAN'S REPORT TO H. SELECT COMM. ON SMALL BUSINESS, 88TH CONG., TAX-EXEMPT FOUNDATIONS AND CHARITABLE TRUSTS: THEIR IMPACT ON OUR ECONOMY, SECOND INSTALLMENT (Comm. Print 1963) [hereinafter PATMAN REPORT 2 OR SECOND INSTALLMENT]; CHAIRMAN'S REPORT TO H. SELECT COMM. ON SMALL BUSINESS, 88TH CONG., TAX-EXEMPT FOUNDATIONS AND CHARITABLE TRUSTS: THEIR IMPACT ON OUR ECONOMY, THIRD INSTALLMENT (Comm. Print 1963) [hereinafter PATMAN REPORT 3 OR THIRD INSTALLMENT].

[129] PATMAN REPORT, *supra* note 128, at vi.

[130] *Id.*

[131] *Id.* at 16.

[132] *Id.*

[133] *Id.*

[134] Troyer, *supra* note 120, at 14–15 (quoting S. REP. NO. 88-830, at 60 (1964)).

[135] At least one commentator, however, referred to the "general tenor of the Treasury Report [as] one of moderation." Marcus Schoenfeld, *Initial Impressions of the Treasury Report on Foundations*, 14 CLEV.-MARSHALL L. REV. 286, 286 (1965).

[136] 1965 REPORT, *supra* note 125, at 15 (The Report notes that donors often continue to think of foundation assets as their money, and therefore should be handled in the manner the donor wishes, rather than in a manner that furthers charitable purposes.).

[137] *Id.* at 16.

[138] *Id.* at 15.

disqualified person carried an adequate interest rate and security, the private foundation would likely not require a detailed financial statement, ask "embarrassing questions," or delay the loan while an application was pending.[139] Such benefits, while "intangible," provided the donor with a "substantial and valuable benefit."

The 1965 Report further noted that "when a person is asked to represent two conflicting interests in the same transaction it is likely that he will, consciously or unconsciously, favor one side over the other." One of the examples of self-dealing noted in the 1965 Report involved a contribution of "blue chip" stock to the foundation, which was immediately sold and the proceeds used to buy stock in the donor's business from family members.[140] Thus, the 1965 Report clearly identified as an act of self-dealing any investment decision made on behalf of the Foundation that was not for the benefit of the foundation and its charitable endeavors, but to further the interests of the family.[141]

The Treasury noted that the rationale for keeping an arm's length transaction standard, in lieu of an absolute prohibition, was that "the charity benefits from allowing a donor to deal with 'his' foundation and that this benefit is so substantial and important that it warrants the high cost of administering existing law." The Treasury found, however, that the "inherent potential for private benefit . . . the cost of enforcing an arm's length standard, and . . . the damage to the confidence of all taxpayers in the fairness of the tax law" far outweighed any "isolated cases" of benefit to the charity.[142] Rather, the 1965 Report set out the following fundamental principal:

> [I]t is better to forbid self-dealing and to strike down all such transactions rather than to attempt to separate those transactions which are harmful from those which are not by permitting a fiduciary (as is the donor when he is dealing with charitable funds) to justify his representation of two interests.[143]

With the Patman Report and the 1965 Treasury Report as background, Congress took up the issues of legislative reform in the area of private foundations

---

[139] 1965 REPORT, *supra* note 125, at 15–16.

[140] *Id.* at 20 (Example 11); *see also id.* (example 12, where retention of a repurchase option in the donor's children forced a foundation to retain stock and not invest the assets that could have provided more income for distribution while reducing risk of loss).

[141] *See* Schoenfeld, *supra* note 135, at 288 ("For example, the investment and distribution policies of the foundation may be determined so as to best serve the needs of the donor rather than the needs of the charity.").

[142] 1965 REPORT, *supra* note 125, at 20–21, 23. The Report notes that "since a foundation may choose from a wide range of possible investments, it is not necessary for it to invest in the business of its donor, or to lend him any money. Similarly, a party who engages in transactions with the foundation on a truly arm's-length basis could, by definition, engage in the same transactions, on the same terms, with strangers."

[143] *Id*

in 1969.[144] Specifically with regard to the existing prohibited transaction rules of Code Section 503, the Joint Committee stated that

> the imprecise restrictions in present law against unwarranted private advantage, delay in benefits to charity and participation by private foundations in business have been difficult and expensive to administer, hard to enforce in litigation, and otherwise insufficient to prevent these abuses.[145]

Accordingly, in 1969 Congress enacted the private foundation excise taxes of Chapter 42 of the Code, specifically including Code Section 4941. Code Section 4941 now prohibits all self-dealing transactions (subject to limited statutory exceptions), *even if* those transactions are fair and reasonable to the foundation and at or below fair market value. Thus, the self-dealing statute passed in 1969 (for the most part)[146] avoided provisions based on "adequate," "reasonable," or "substantial" transactions; rather, a new strict liability approach would provide private foundations with definitive guidance and the IRS with ease of administration.

Code Section 4941 was not the only excise tax in 1969 that addressed private foundation investments. Simultaneously, Congress enacted Code Section 4944, which prohibits a private foundation from entering into jeopardizing investments[147] and Code Section 4943, which limits the amount of an equity interest that a private foundation may own in an operating business enterprise.[148] While Code Section 4943 has a number of independent justifications, one rationale for the limitation on the ability to own operating businesses in junction with its related parties was because "opportunities are created for self-dealing in forms too subtle for the specific prohibitions" set forth in Code Section 4941.[149]

---

[144] Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487.

[145] JOINT PUBL'N COMM. ON WAYS & MEANS, 91ST CONG., TAX REFORM STUDIES AND PROPOSALS 295 (Comm. Print 1969).

[146] Note that one important exception to the definition of an act of self-dealing is "reasonable" compensation, described more fully *infra* Section III.D.

[147] I.R.C. § 4944 (West 2015).

[148] *Id.* § 4943.

[149] *Id.* at 296; *see also* 1965 REPORT, *supra* note 125, at 34 ("Temptation for subtle and varied forms of self-dealing proliferate [with business ownership.] Remote relatives may be employed in the business; friends may be assisted; business acquaintances may be accommodated. However broadly drawn the restrictions upon self-dealing may be, many of the conflicts of interest arising in this area are likely to be sufficiently obscure or sufficiently beyond the realm of reasonable definition to escape the practical impact of the limitations.").

C. Code Section 4941's Excise Tax on Self-Dealing

Code Section 4941 imposes an excise tax on each "act of self-dealing between a private foundation and disqualified person."[150] In general, the excise tax is imposed on the self-dealer; however, if a foundation manager's participation in the transaction is willful and not due to reasonable cause, an excise tax can be imposed on the foundation manager as well.[151] In either case, acts of self-dealing that are not corrected in a timely manner are subject to an additional 200% excise tax.[152] This excise tax is not voluntary—it is not a transaction cost to be factored into the decision as to whether to undertake a transaction. Rather, it is intended to police private foundation actions and effectively to prohibit all covered self-dealing transactions.

In order to have an act of self-dealing under Code Section 4941, there must be (1) a self-dealing transaction described in the statute that is not subject to an exemption, and (2) that transaction must occur between a private foundation and a "disqualified person."

1. Disqualified Persons

In order to trigger the Code Section 4941 excise tax, an act of self-dealing[153] must occur between a private foundation and a disqualified person.[154] The term "disqualified person" is defined in Code Section 4946 to include the following:[155] Foundation managers;[156] substantial contributors to the private foundation;[157] if a substantial contributor to the private foundation is an entity, then

---

[150] I.R.C. § 4941(a)(1) (West 2015).

[151] *Id.* § 4941(a)(2). A foundation manager is defined as an officer, director or trustee of a private foundation (or person having similar powers and responsibilities, regardless of title), or any employee of a foundation that has the authority or responsibility to act (or not act) with regard to a specific transaction. *See also I.R.C.* § 4946(b) (West 2015).

[152] *Id.* § 4941(b). Of course, acts of self-dealing can also rise to the level of prohibited private inurement, which can cause loss of tax-exemption under Section 501(c)(3). *Id.* § 501(c)(3). It is possible, however, to have an act of self-dealing that is not an act of private inurement, since a fair market value transaction between a private foundation and a disqualified person may be an act of self-dealing under Section 4941 but would not cause private inurement under Section 501(c)(3). *See infra* Part III.C.2.

[153] For a more detailed discussion of the definition of an act of self-dealing and its statutory and regulatory exceptions, *see infra* Part III.C.2. and Part III.C.3.

[154] *See* I.R.C. § 4941(a)(1)-(2) (West 2015).

[155] *Id.* § 4946(a)(1). In addition to those listed above, the term "disqualified person" also includes certain related private foundations solely for the purpose of Code Section 4943, and certain government officials solely for the purpose of Code Section 4941. *Id.* § 4946(a)(1)(H), (I).

[156] *Id.* § 4946(a)(1)(B); *see id.* § 4946(b) (A foundation manager is "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 with respect to any act (or failure to act), the employees of the foundation having authority or responsibility with respect to such act (or failure to act)").

[157] *Id.* § 4946(a)(1)(A). A substantial contributor is defined as any person who contributes or bequeaths an aggregate amount in excess of $5,000 if that amount is more than 2% of the foundations

any owner of 20% of more of that substantial contributor (herein, a "20% Owner");[158] any member of the family of a foundation manager, a substantial contributor, or a 20% Owner;[159] entities 35% of which are owned by any combination of foundation managers, substantial contributors, 20% Owners, and members of the family of such individuals (herein, a "35% Controlled Entity").

For purposes of determining ownership[160] under both the 20% Owner rule and the 35% Controlled Entity rule, the owner of a corporation is determined with reference with voting power;[161] the owner of a partnership is determined with referenced to profits interest,[162] and the owner of a trust or other unincorporated enterprise[163] is determined by virtue of beneficial interest.[164]

As a result of the technical interlocking definitions of disqualified person, many individuals and family entities can unwittingly become disqualified persons with respect to a family foundation. For private foundations, one of the first tasks at hand is simply to identify the world of individuals and entities that constitute its disqualified persons.[165] For the family foundation, the definition draws in any number of family business and estate planning entities that the family might not otherwise consider to be related to the foundation in any way

---

total contributions received during the tax year. It also includes the creator of trust. *Id.* § 507(d)(2).

[158] *Id.* § 4946(a)(1)(C).

[159] *Id.* § 4946(a)(1)(D). A member of the family is defined by Code Section 4946(d) as an individual's spouse and ancestors, as well as the individual's children, grandchildren, great grandchildren, and their spouses. Note that the definition of members of the family does not include spouses of ancestors, descendants beyond great-grandchildren, or siblings and their descendants and spouses. *Compare id.* § 4958(f)(4) (including siblings).

[160] In addition, in determining ownership, Code Sections 4946(a)(3) and (4) required the application of some of the principles of Code Section 267, includes certain rules attributing stock ownership to family members, which often are referenced in parts of the Code where special rules for intra-family transactions are necessary. When applying the 20% Owner and 35% Controlled Entity rule to corporate interests, stock ownership includes indirect holdings in a corporation that would be taken into account under Code Section 267(c). *Id.* § 4946(a)(3). Similarly, the ownership of partnership profits or beneficial interests in trusts or other unincorporated entities is determined under the constructive stock ownership rules of Code Section 267(c). *Id.* § 4946(a)(4).

[161] I.R.C. § 4946(a)(1)(C)(i) (West 2015).

[162] *Id.* § 4946(a)(1)(C)(ii).

[163] Application of the Chapter 42 excise taxes to LLCs is somewhat unclear, given that LLCs did not exist at the time that the excise taxes were enacted. *See generally* Wilson, *supra* note 110, at 492.

[164] I.R.C. § 4946(a)(1)(C)(iii).

[165] *See* COUNCIL ON FOUNDS., STEWARDSHIP PRINCIPLES FOR FAMILY FOUNDATIONS 4, http://www.cof.org/sites/default/files/documents/files/Family_Stewardship%20Principles.pdf ("Document the affiliations or involvement of board members, grantmaking staff and their families with potential grantees . . . "); Benjamin T. White, *Avoiding Conflicts of Interest and Self-Dealing for Family Foundation Boards*, NAT'L CTR. FAM. PHILANTHROPY, https://www.ncfp.org/export/sites/ncfp/knowledge/passages/2013/downloads/Avoiding-Conflicts-and-Self-Dealing-for-Family-Foundation-Boards-NCFP-2013.pdf.

2. Acts of Self-Dealing

Even if a transaction between a private foundation and a disqualified person exists, that transaction must fall within the definition of an act of self-dealing (with no applicable exception) for the Code Section 4941 excise tax to apply. The definition of an act of self-dealing is quite broad and covers most transactions one could contemplate. The definition includes "any direct or indirect"[166] transaction involving any of the following: the sale, exchange, or leasing of property;[167] the lending of money or other extension of credit;[168] the furnishing of goods, services or facilities by a private foundation;[169] the payment of compensation or reimbursement of expenses;[170] and the transfer to or use by (or for the benefit of) the income or assets of the private foundation.[171]

Congress intended these broad categories of acts of self-dealing to be comprehensive and inclusive.[172] In addition, the statutory language specifically includes the notion that such transactions can be "direct" or "indirect," which would prohibit a private foundation from engaging in covered transactions through an intermediary.[173] Accordingly, the term "self-dealing" encompasses a broad range of transactions that one might not necessarily consider to be covered at first glance.[174] In the investment context, the regulations state that "the purchase or sale of stock or other securities by a private foundation" would be a prohibited use of the foundation's assets, and therefore "an act of self-dealing if such purchase or sale is made in "an attempt to manipulate the price of stock or other securities to the advantage of a disqualified person."[175]

The definitions of an act of self-dealing do not include the concept of fairness, benefit, or fair market value; as discussed earlier, it is intended as a blanket prohibition on the covered acts.[176] As a result, an act of self-dealing can

---

[166] I.R.C. § 4941(d)(1) (West 2015).
[167] *Id.* § 4941(d)(1)(A).
[168] *Id.* § 4941(d)(1)(B).
[169] *Id.* § 4941(d)(1)(C).
[170] *Id.* § 4941(d)(1)(D).
[171] *Id.* § 4941(d)(1)(E). In addition, Code Section 4941(d)(1)(F) includes special rules governing transactions between a private foundation and certain government officials.
[172] 1965 REPORT, *supra* note 125, at 15, 21 (finding that "transactions between a donor and his foundation often provide subtle private advantages to the donor . . . [and] recommending that private foundations be prohibited from engaging in any transaction with a donor, with a list of transactions that was illustrative only").
[173] 1965 REPORT, *supra* note 125, at 22 ("Indirect transactions . . . would also be prohibited.").
[174] For example, it often comes as a surprise to a donor that his private foundation cannot purchase tickets at a charity fundraising dinner which the donor will then use to attend. Because the donor will receive a private benefit in the form of the dinner, it is an act of self-dealing. The price of the ticket cannot be bifurcated, with the donor paying for the cost of the dinner, because the act of cost sharing would be self-dealing. *See* Jane C. Nober, *That's the Ticket*, COUNCIL ON FOUNDATIONS (2010), https://www.cof.org/sites/default/files/documents/files/Thats-the-Ticket.pdf.
[175] Treas. Reg. § 53.4941(d)-2(f)(1) (as amended in 1995).
[176] *See* discussion of the need for an absolute prohibition rather than an arm's length standard *infra* Part III.B.(b); *see also* Treas. Reg. § 53.4941(d)-1(a) (as amended in 1973) ("For purposes of [Code

occur even if the transaction is fair and reasonable and in the best interests of the foundation. A board of directors of a private foundation in corporate form may, for example, approve an interested director transaction in a manner that is fully consistent with applicable state law provisions governing interested director transactions, but it would still be an act of self-dealing for federal excise tax purposes.[177] In this manner, the self-dealing rules can be somewhat counter-intuitive for private foundations and their advisors.

3. Exceptions to Acts of Self-Dealing

To alleviate the harshness caused by such a blanket prohibition, Code Section 4941 includes a number of exceptions to the self-dealing rules.[178] For example, although the statute generally prohibits the "lending of money or other extension of credit" between a private foundation and a disqualified person, there is an exception for loans from a disqualified person to a private foundation if the loan carries no interest and the proceeds are used for charitable purposes.[179] Similarly, although compensation of a disqualified person is, at first glance, an act of self-dealing, Code Section 4941(d)(2)(E) provides that a private foundation may compensate a disqualified person for "personal services which are reasonable and necessary to the carrying out of the exempt purposes of the private foundation" as long as such compensation is not excessive.[180]

In an investment context, there are two special rules to the definition of self-dealing that are of particular note. First, a disqualified person may furnish goods, services or facilities to a private foundation without charge if the goods, services and facilities are used exclusively for charitable purposes.[181] Additionally, Code Section 4941 contains a special rule for transactions that involve certain corporate reorganizations.[182] If a corporation that is a disqualified person enters into a liquidation, merger, redemption, recapitalization or similar transaction, then

---

Section 4941] it is immaterial whether the transaction results in a benefit or a detriment to the *private* foundation.").

[177] See, for example, Section 8.31 of the Revised Model Nonprofit Corporation Act (1987), which generally provides that an interested director transaction is not voidable if the interested director's interest is disclosed and the disinterested directors believe in good faith that the transaction is fair to the corporation. REVISED MODEL NONPROFIT CORP. ACT § 8.31 (AM. BAR ASS'N 1987), http://www.muridae.com/nporegulation/documents/model_npo_corp_act.html#8.31http://; *see also* MODEL NONPROFIT CORP. ACT § 8.60 (AM. BAR ASS'N 2008), www.americanbar.org/content/dam/aba/events/real_property_trust_estate/joint_fall/2008/black_letter.authcheckdam.pdf.

[178] I126 U.SI.R.C.A. § 4941I § 4941(d)(2) (West 2015).

[179] *Id.* § 4941(d)(2)(B).

[180] *Id.* § 4941(d)(2)(E); the compensation exception is one of two areas where the self-dealing rules retain a subjective standard. The other can be found in the corporate reorganization exception of Section 4942(d)(2)(F), which requires such reorganization transactions to occur at fair market value. *See supra* text accompanying notes 171–74.

[181] *Id.* § 4941(d)(2)(C).

[182] *Id.* § 4941(d)(2)(F).

an act of self-dealing will not occur if any stock in the corporation owned by the disqualified person is subject to the same terms and conditions as all of the shareholders and the foundation receives at least fair market value in the transaction.[183] This exception appears to apply specifically to corporations only, as the statute does not mention partnerships or LLCs. Despite the statutory language discussing only corporate transactions, the Treasury has, on occasion, looked to Code Section 4941(d)(2)(F) for "guidance" for similar transactions for partnerships.[184]

4. Indirect Acts of Self-Dealing

As noted, the statutory definition of self-dealing specifically includes both direct and indirect transactions.[185] Neither the statutory language of Code Section 4941 nor the Treasury Regulations provides a specific definition of an "indirect" act of self-dealing. Rather, the regulations provide some working examples of transactions it considers to be (or not be) indirect self-dealing. For example, a loan from a corporation controlled by a private foundation to a corporation owned by two of the private foundation's foundation managers would be an indirect act of self-dealing.[186] The term 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.[187]

In addition, the Regulations provide various safe harbors for acts that might appear to be indirect self-dealing but are not treated as such for purposes of Code Section 4941.[188] These exceptions include (1) transactions with disqualified persons through entities that are not themselves disqualified persons;[189] and (2) transactions among disqualified persons that the private foundation could have entered into directly.[190]

---

[183] *Id.*

[184] I.R.S. Priv. Ltr. Rul. 9237032 (June 16, 1992) ("We believe that in some situations these stated provisions [Code Section 4941(d)(2)(F) and its regulations] provide guidance in the disposition of a private foundation's interests in a partnership which is a disqualified person."); *see also* I.R.S. Priv. Ltr. Rul. 200429013 (Apr. 23, 2004) (involving an LLC taxed as a partnership).

[185] I.R.C. § 494126 U.S.C. § 4941(d)(1) (2015); Treas.20165); Treas. Reg. § 53.4941(d)-1(a) (as amended in 1973).

[186] *Id.* at (d)-1(b)(8) (example 1).

[187] Treas. Reg. § 53.4941(d)-1(a) (the regulations cite as an example a bargain sale in which the seller becomes a substantial contributor and therefore, a disqualified person).

[188] In addition to the Regulatory exceptions to the definition of an act of indirect self-dealing discussed above, there are exceptions for (1) transactions arising out of pre-existing relationships (Treas. Reg. § 53.4941(d)-1(b)); (2) grants to intermediary organizations involving certain public officials (Treas. Reg. § 53.4941(d)(-)-)-1(B)(2)); (3) transactions during the administration of an estate or revocable trust (Treas. Reg. § 53.4941(d)(-)-)-1(B)(3)); and (4) retail transactions involving amounts under $5,000 (Treas. Reg. § 53.4941(d)-1(b)(6)).

[189] Treas. Reg. § 53.4941(d)-1(b)(4).

[190] *Id.* at § 53.4941(d)-1(b)(6).

Under the first exception, a private foundation will not be engaged in an act of self-dealing merely by having an ownership interest in an entity where other disqualified persons also have an ownership interest.[191] This exception is not unlimited, however, in that the entity cannot be controlled by the private foundation, nor can it be a 35% Controlled Entity.[192] For these purposes, a private foundation would control an entity if the foundation or one or more of its foundation managers (acting as such) could require the organization to engage in a transaction that would constitute self-dealing. Accordingly, this exception would allow a private foundation and its disqualified persons to be limited partners in many independent investment entities, such as a third party-managed hedge fund. This exception may be premised on the assumption that since neither the private foundation nor the disqualified persons control the entity, the entity will not operate for the benefit or detriment of either party.[193]

Under the second applicable exemption, a transaction between disqualified persons is not an act of self-dealing with respect to a private foundation if the private foundation could have engaged in the transaction directly. By way of example, the regulations indicate that an organization controlled by a private foundation could pay compensation to a disqualified person. Even though the private foundation is not a direct participant in the transaction, no act of indirect self-dealing would occur if the controlled organization qualified for the exception for reasonable compensation for personal services.[194]

Under these two exemptions, it is usually possible for a private foundation to enter into a commercial hedge fund or other investment created and controlled by a third party, even if other disqualified persons are participants in the fund.

D. Investing Along with Disqualified Persons Under Code Section 4941: The PLRs

With the increases in alternative investing and the growing sophistication of the family office, it is not surprising to see private foundations that wish to participate in investment vehicles in which their disqualified persons are participants—whether as co-investors, managers, or both. The investment vehicle itself often becomes a disqualified person due to the application of the 35% Controlled Entity rule. As a result of increased activity in this area, the IRS issued

---

[191] *Id.* at § 53-4941(d)-1(b)(4).

[192] *Id.*

[193] I.R.C. 4946(a)(1)(F) (West 2015). This assumption, however, is based on the power of the foundation and the disqualified persons to control the governance of the entity. This causes a disconnect when analyzing partnerships, however, as a disqualified person's status with respect to a partnership is judged not on voting control, but on the individual's profits interest in the partnership. Thus, a disqualified person may be the general partner of a limited partnership but only a 1% profits interest; the limited partnership would not be a disqualified person. Conversely, a disqualified person could hold 50% of the limited partnership interests and none of the general partnership interest (and therefore none of the control), and the partnership would still be a disqualified person.

[194] Treas. Reg. § 53.4941(d)-1(b)(7).

a series of private letter rulings in the early 2000s that provided a road map on how a private foundation could invest in a partnership alongside disqualified persons without triggering the Code Section 4941 excise tax.[195]

1. The 2001 PLR

In the first of the Private Letter Rulings in 2001, the IRS considered the transfer of limited partnership interests by an LLC to a private foundation.[196] A husband and wife (H and W), both of whom were trustees of the private foundation, funded, owned and controlled the LLC.[197] The LLC was, in essence, acting as a holding company for H and W.

The limited partnership invested in publicly traded companies and short positions to hedge its long positions in these companies.[198] The general partner of the limited partnership was an entity that was effectively controlled by H.[199] In addition, the limited partnership was managed by an entity that was also controlled by H.[200] Although the manager would otherwise have been entitled to compensation, the manager and the general partner waived its fee and profit allocation with respect to the private foundation.[201]

As both H and W were trustees of the private foundation, they were disqualified persons with respect to the private foundation because they were foundation managers.[202] H and W owned all of the outstanding interests in the LLC; therefore, the LLC itself is a disqualified person with respect to the private foundation because it was a 35% Controlled Entity.[203] The PLR states that the limited partnership itself was a disqualified person, as were the general partner entities and the manager entities.[204] As a result, the private foundation invested in, essentially, a hedge fund in limited partnership form that itself was a disqualified person, with disqualified persons as co-partners.

---

[195] *See generally* DAVID H. KIRK, SELF-DEALING AND THE LOBSTER POT OF JOINT VENTURES (2005).

[196] I.R.S. Priv. Ltr. Rul. 200148069 (Dec. 3, 2001) [hereinafter 2001 PLR]. It is unclear from the 2001 PLR whether the private foundation was admitted as a limited partner or merely continued on as an assignee of the transferred limited partnership interest.

[197] *Id.* at 1. The LLC was taxed as a partnership for federal income tax purposes.

[198] As such, it appears that the limited partnership itself was essentially a hedge fund run by H. *Id.* at 2; *see* the definition of a hedge fund *infra* note 204.

[199] Technically, the general partner of the limited partnership was another partnership; the general partner of the second partnership was an entity that was wholly owned by H. *Id.* at 2.

[200] Again, technically, the limited partnership was managed by another partnership, the general partner of which was an entity that was owned by H. *Id.* at 2.

[201] The limited partner normally would have received a management fee based on a percentage of assets of invested in the limited partner; the general partner received a profit allocation from the limited partner. *Id.* at 2.

[202] I.R.C. § 4946(a)(1)(B) (West 2015).

[203] I.R.C. § 4946(a)(1)(C)(ii); *see also* 2001 PLR, *supra* note 196.

[204] The PLR does not analyze these separate entities in specific detail, but simply states that they are disqualified persons due to ownership and/or control. I.R.S. Priv. Ltr. Rul. 200148069 (Dec. 3, 2001)

When the LLC transfers its interest in the limited partnership by gift to the private foundation, there could have been an act of self-dealing if the LLC had been relieved of debt as a consequence of the transfer. It appears that neither the LLC nor H or W were subject to any such liabilities; therefore, no act of self-dealing occurred on the gift.[205] Moreover, while reasonable compensation for personal services might have qualified as an exception to the definition of an act of self-dealing, compensation was specifically waived in this case. As providing services without charge is not an act of self-dealing, the investment was held to not violate the provisions of Code Section 4941.[206]

In the 2001 PLR, the private foundation did not invest directly in the hedge fund; rather, the LLC purchased the hedge fund interest and then gratuitously transferred the interest to the private foundation. Therefore, at no point did the private foundation exchange assets with the hedge fund in return for its interest. The 2001 PLR does not state whether the private foundation thereafter became a true limited partner in the hedge fund, or whether it was a mere assignee of the interest. If it actually became a substituted partner, query whether it was thereby relieving the limited partner of its legal obligations (which may be minimal under the partnership agreement if there was limited liability and no obligation to make additional capital transfers) as a consequence of the transfer. In addition, we do not know if there were any benefits to disqualified persons by virtue of having the private foundation's funds held in the hedge fund itself. Clearly, it seems that it would be beneficial to the fund's overall balance sheet to have more assets under management.[207] In any event, by allowing H to retain control over the investment of the funds through his various management entities, the IRS allows the exact conflict of interest predicted in the Patman report and the 1965 Report.[208]

2. The 2003 PLR

Following the 2001 PLR, the IRS again considered the issue of the investment by a private foundation in a limited partnership in 2003. It is this PLR that first introduced the language indicating that the private foundation and disqualified person were participating in a "co-investment."

In the 2003 PLR, a group of four investment advisors (known as A, B, C, and D) created an investment partnership in limited partnership form; the limited partners of this investment partnership were unrelated to the advisors or the private foundation at issue.[209] The general partner of the investment partnership was a

---

[205] The partnership interests were subject to short positions, but short positions do not count as indebtedness for these purposes. *Id.*

[206] Treas. Reg. § 53.4941(d)-2(d)(3) (as amended in 1995).

[207] *See generally* Houman B. Shdab, *The Law and Economics of Hedge Funds: Financial Innovation and Investor Protection*, 6 BERKELEY BUS. L.J. 240 (2009).

[208] *See* discussion *supra* Section II.B.

[209] I.R.S. Priv. Ltr. Rul. 200318069 (Feb. 3, 2003) [hereinafter 2003 PLR]. The investment partnership invested in publicly traded securities, including derivatives and short positions. *Id.* at 3.

second management limited partnership, of which the four investment advisors and various individuals and entities related to the investment advisors, directly and indirectly, were partners.[210] A created and was the sole trustee of a private foundation. B, C, and D were not disqualified persons with respect to A's private foundation.

Through a complex entity structure, the four investment advisors were indirectly compensated for managing the investments of the investment partnership. The managers were compensated in two ways: through a quarterly management fee[211] and through a special allocation of profits earned by the investment fund.[212] As the general partner was ultimately owned by the four investment advisors, part of the management fee after payment of the costs of the general partner would have been payable to A. Additionally, the investment managers indirectly received a special profits allocation from the hedge fund. [213]

The intention, however, was not for the private foundation to invest directly in the investment partnership, but in the general partner of the investment partnership. The PLR states that a direct investment in the hedge fund would not be permissible due to "security law concerns."[214] Interestingly, the PLR characterizes the private foundation was wanting to "avail itself of the services" of the investment managers, but as the investment managers only provided services to the hedge fund, the only way to obtain those services would be to participate in the hedge fund, directly or indirectly.[215]

Rather, the private foundation intended to invest in the general partner in the investment partnership. The general partner of the investment partnership would invest the private foundation's contributions in the hedge fund as its own capital contribution. Since the management fee is based upon the assets of the limited partners under management of the hedge fund, there would be no management fee payable to the general partner with respect to its own investment.

From the description, the investment partnership appears to have been a hedge fund, as with the investment partnership at issue in the 2001 PLR.

[210] The second limited partnership (the one acting as the general partner of the investment partnership was owned by (1) A; (2) a corporation owned by A and his immediate family; (3) B, C, and D and various entities related to them; and (4) W, an investment entity controlled by A, B, C, and D. *Id.* at 1–2. W was a wholly owned subsidiary of a business trust that had elected into S corporation status for federal income tax purposes, all of the beneficial interests of which were owned by A, B, C, and D. *Id.*

[211] The management fee was a set percentage of the all of the limited partner's assets under management valued quarterly, payable to the general partner. *Id.* at 3-4.

[212] *Id.* at 3. If the private foundation were to become a limited partner in the hedge fund, that part of the management fee attributable to its invested assets would indirectly constitute compensation to A for services rendered.

[213] *Id.*

[214] *Id.* at 36. The PLR does not indicate what securities law concerns were at issue; it is possible, for example, that the private foundation did not have $5.0 million in assets and therefore was not automatically an accredited investor. *See* discussion of accredited investors *supra* pp. 20–22.

[215] *Id.* Of course, an investment manager could provide personal service and received reasonable compensation and fall within an exception to the self-dealing rules. Treas. Reg. § 53.4941(d)-3(c)(2) (as amended in 19841984l(b)(iii)(b)(7).

Similarly, since the special profits allocation occurred on the hedge fund level, the private foundation's investment through the general partner would not be subject to the special allocation. The actual receipts passing to the private foundation would be governed by the partnership agreement of the entity acting as the general partner, not the investment partnership itself.

The partnership agreement of the general partner specifically prohibited the partnerships from engaging in any transaction that would be a direct or indirect act of self-dealing.[216] In addition, the taxpayer represented, and the IRS accepted, that the private foundation's investment "in [the hedge fund] will not create any economies of scale or any other benefit for the [general partner], [the hedge fund], or any other investor . . . In particular, [the private foundation's] proposed investment will not benefit the Investment Advisors personally in any way."[217]

The management limited partnership (the general partner of the investment partnership) is a disqualified person with respect to A's foundation because more than 35% of the partnership is owned by A and parties related to A.[218] Therefore, any transaction between the management limited partnership and the private foundation would be an act of self-dealing, unless an exception applied. In this case, if a transaction existed, there does not appear to be any applicable exception.

Therefore, it was necessary to look at the potential transactions that could have occurred between the general partner of the investment fund and the private foundation. The first, and most obvious, is the actual acquisition of the interest in general partner by the private foundation. Unlike the 2001 PLR, where the private foundation received its interest in the limited partnership by gift, the 2003 PLR involves a contribution of funds by the foundation to the partnership in return for a partnership interest. At first glance, the contribution of capital in return for an interest appears to be a sale or exchange of assets that would be an act of self-dealing. However, the 2003 PLR states as follows:

> [the private foundation's] proposed acquisition of a limited partnership interest in [the general partner] is in substance a "co-investment arrangement" by [the private foundation] in [the general partner] along with other partners of [the general partner], not a sale or exchange between [the private foundation] and [the general partner or any of the partners of the general partner]. This arrangement is more properly characterized as involving services in the nature of "brokerage and portfolio services" performed for [the private foundation] by [the general partner].[219]

The internal quotes surrounding "co-investment arrangement" are in the text of 2003 PLR, but there are no citations attributed to the quote, nor does the

---

[216] 2003 PLR, *supra* note 209, at 47.
[217] *Id.* at 4.
[218] *Id.* at 8.
[219] *Id.* at 15-16.

2003 PLR cite any authority for re-characterizing the transaction as in the nature of brokerage and portfolio services. In justifying this re-characterization, the IRS goes on to state as follows:

> The purpose of [the private foundation's] acquisition of a partnership interest in [the general partner] is to permit [the private foundation] to make an investment in [the investment partnership] 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 [the investment partnership] directly. This arrangement will also give [the private foundation] essentially the same rights as a direct investment in [the investment partnership]. No disqualified person will benefit from [the private foundation's] investment, by reducing their administrative expenses or in any other way.[220]

The IRS goes onto re-characterize the transaction not as an investment in the general partner, but in the underlying hedge fund itself.[221]

Thus, the IRS justified the re-characterization of the transaction as a co-investment on the basis that it was in the best interests of the foundation—which is, by Congressional design, not a justification for an act of self-dealing described in Code Section 4941.[222] It is worth questioning, of course, whether the private foundation should be investing in a fund that it would otherwise be prohibited in investing due to the securities law, and whether it should have substantially all of its assets invested with a single fund, even that fund is itself diversified.[223] Finally, the IRS seems to take at face value the representation that there is no benefit to the manager of the investment fund to have additional assets available for investment in the fund itself, whether from a securities law point of view or simply by virtue of having additional available liquidity or assets under management. In fact, one of the acts of self-dealing repeatedly cited in both the Patman report and the 1965 Report was having a ready source of liquid capital available in the form of foundation assets, were then invested in a manner that would benefit the disqualified persons.[224]

---

220 *Id.* at 16.

221 *Id.* at 16-17. (citing the diversification within the investment fund itself as sufficient diversification to avoid the jeopardizing investment excise tax of Code Section 4944).

222 See discussion *infra* Section II.BBI.

223 Investing with a single fund manager was one of the reasons why a number of private foundations lost everything in the Bernard Madoff scandal. *See* Sharon Schneider, *Private Foundations: Five Steps to Keep the Next Bernie Madoff Away from Your Assets*, RIABIZ (Oct. 23, 2009), http://www.riabiz.com/a/60019/private-foundations-five-steps-to-keep-the-next-bernie-madoff-away-from-your-assets. There was some discussion that the IRS would pursue these private foundations for making jeopardizing investments under Code Section 4944. Michele A. W. McKinnon, *Madoff's Unintended Legacy to Charities*, MCGUIREWOODS, https://www.mcguirewoods.com/newsresources/publications/taxation/madoffs%20unintended%20legacy.pdf (last visited Feb. 29, 2016).

224 Patman Report, *supra* note 128, at 16; 1965 REPORT, *supra* note 125, at 16 ("[T]he knowledge

3. The 2004 PLR

PLR 200420029[225] expanded the co-investment concept first introduced in the 2003 PLR, applying it to what appears to be a true family office scenario. The family[226] intended to set up a partnership for purposes of coordinating the family's investments.[227] The primary investors would be members of the family and related entities, although the 2004 PLR indicates that it would be possible that unrelated individuals would be invited to invest in a particular fund.[228] As a result, the 2004 PLR assumed that the investment partnership would at all times be a 35% Controlled Entity, and therefore a disqualified person with respect to the foundation. Accordingly, any transaction between the private foundation and the investment partnership would presumptively be an act of self-dealing, if not otherwise subject to an exception.

The family's private foundation intended to invest in one or more of these family investment partnerships in varying allocations. The PLR indicates that the rationale for the family to invest through these partnerships was "increased negotiating power and cost savings which the partners would not have if they invested separately, as well as access to certain brokerage, tax, and portfolio services."[229] Unlike the 2003 PLR, there is a clear benefit to the family from investing in these family partnerships. The private foundation specifically represented that in wanted to invest in the family partnerships because it would

> (1) [P]ermit [the foundation] to obtain certain brokerage, tax, and portfolio services provided by [the investment fund] or the Additional Partnerships; (2) assist [the private foundation] in diversifying its portfolio; (3) obtain access through [the investment fund] or the Additional Partnerships to investments with higher minimum investment requirements than [the foundation] would want to satisfy using its assets

---

that his foundation can be used as a source of capital – even at the prevailing interest rates – can influence the decision of the donor in his capacity as an official of the foundation as to the asset which the foundation should hold in its portfolio. A donor who thinks that he may want to call upon his foundation for funds at some future date may have the foundation keep its funds in a form readily convertible to cash . . .").

[225] I.R.S. Priv. Ltr. Rul. 200420029 (Feb. 19, 2004) [hereinafter 2004 PLR]; *see also* Priv. Ltr. Rul. 200042047 (Jun. 15, 2011) and Priv. Ltr. Rul. 200423029 (March 11, 2004) (accepting without question the representation that an investment by a charitable remainder trust in an LLC was not a sale or exchange for state (Ohio) law purposes.)

[226] The PLR indicates that participants in the investment partnership would include descendants and spouses of a particular company's founder, as well as trusts, LLCs and other partnerships in which the family would have more than a 50 percent voting or profits interest. *Id.* at 1.

[227] Ultimately, the family intended to set up multiple partnerships, each of which would have a different investment style. A particular family investor could then participate in the various partnerships in proportion to its desired portfolio investment allocation to the partnership's particular investment style. Thus, the investment partnerships at issue would essentially act as private funds for the family. *Id.* at 2.

[228] *Id.* at 223.

[229] *Id.*

> alone, and (4) permit [the foundation] to effect economies of scale and resulting cost savings as well as greater negotiating power.[230]

The PLR specifically states that the foundation did not know exactly how much of its assets would be invested in each investment partnership; however, it did state that the private foundation's investments "will constitute a substantial percentage, perhaps even exceeding fifty percent, of the total assets of each partnership in question."[231]

The provisions of the partnership agreement specifically prohibit the partnership from engaging in acts of self-dealing. To the extent that the private foundation's assets, when combined with all of the other assets of the partnership, would entitle the partnership as a whole to a discounted fee, those cost savings would accrue to the partnership.[232] Given that the private foundation's investments in each investment partnership would constitute such a significant portion of investment portfolio, the partnerships should have access to investments that would not otherwise be available. Thus, even if the other family members disclaimed the fee, there may be benefits to the family in terms of access to investments and, as with the fund in the 2003 PLR, access to ready liquidity to meet investment minimums.

In order to protect against potential acts of self-dealing, the investment partnership agreement gives the foundation certain protections, including a veto right over certain defined decisions. In addition, the foundation had a right to receive an in kind distribution of each of the partnership's assets if it chose to withdraw.[233]

As with the 2003 PLR, it appears that the private foundation was making the case that the investment was fair and reasonable to the foundation and in its best interests, which is not a rationale to excuse an act of self-dealing. These representations could have been made to negate an intent to provide a benefit to disqualified persons, although under a traditional Code Section 4941 analysis, intent is irrelevant. It is the existence of the transaction—a sale or exchange or the use of foundation assets—that triggers the excise tax. The partnership does not make the same representation made by the investors in the 2003 PLR that no

---

[230] *Id.* at 4-5.

[231] *Id.* at 3. If the foundation's investment in the partnership is significant enough in absolute dollars, the foundation's investment could be sufficient to make the partnership an accredited investor, to the extent such classification would be relevant for that fund's particular style. The 2004 PLR indicates that the private foundation was formed in 1943 and has investment assets in excess of "$650,000x." *Id.* at 1. See the discussion of accredited investor status *infra* Part II.D.

[232] By way of example, many financial institutions charge a percentage fee that is based on a sliding scale of assets under management, with the fee reduced as the amount of assets under management increase. The assets added to the partnership by the private foundation would likely qualify it for lower overall fees as a percentage. *See* Manisha Kathuria & Heather Meyers, *Investment Outsourcing Fee Basics*, RUSSELL INV. (Feb. 2014), http://non-profits.russell.com/documents/institutional-investors/research/investment-outsourcing-fee basics.pdf.

[233] 2004 PLR, *supra* note 225, at 3.

personal benefit would accrue to the family investors in the partnership; rather, it indicates that special provisions are included in the operating agreement to prevent any benefits from accruing to family members.[234]

Echoing the language of the 2003 PLR, the IRS states that the private foundation's proposed acquisition of an interest in the investment partnership would be

> in substance a "co-investment arrangement" by [the foundation] in [the investment fund] or an Additional Partnership along with the other investors in these entities; it is not a sale or exchange between [the foundation] and the other partners of [the investment fund] . . . In joint or co-investment situations, where a private foundation acquires an additional interest in the partnership entity after its formation and initial funding or withdraws its interest, there is neither an economic benefit to the other investors nor does the ownership or holdings of the other investors change in any economic or other material respect.[235]

As with the 2003 PLR, the 2004 PLR does not attribute the term "co-investment arrangement" to any particular source even though it is in quotes, nor does it cite to any support for its ability to re-characterize the transaction as "in substance" a co-investment arrangement.

As with the 2003 PLR, the 2004 PLR does not appear to take into account the benefit of having access to particular investments, of retaining control of family funds, or of the significant liquidity available to the family to make investments. Moreover, it does not take into account the potential benefits under the securities laws at the time to the family, which might influence the manner in which the private foundations invested. Finally, the mere fact that the private foundation needed to negotiate terms to attempt to prevent acts of self-dealing indicates that a transaction has, in fact, occurred and that the private foundation's assets are being used by the partnership and the other partners, presumably to their benefit. This does not necessarily mean that the assets are being used to the detriment of the private foundation, but that is not the touchstone of the self-dealing excise tax.

4. The 2005 PLR

The IRS issued the final letter ruling in the series in 2005.[236] As with the 2004 PLR, the founder of a private foundation and the founder's family and other related entities intended to create an investment fund in which the private foundation would invest—in this case, however, the fund appears to be an LLC for state law purposes.[237] As with the 2004 PLR, the investment fund benefitted the

---

[234] *Id.*
[235] *Id.* at 6.
[236] I.R.S. Priv. Ltr. Rul. 200551025 (Sept. 28, 2005) [hereinafter the 2005 PLR].
[237] *Id.* at 1.

entire family group by reducing administrative costs, providing access to investments that might otherwise be unavailable to individual members, facilitating diversification, and increasing negotiating power.[238] Unlike the 2004 PLR, the 2005 PLR involves a single fund invested in a number of different independently managed investment funds.[239]

Each investor in the investment fund could withdraw all or part of their investment quarterly upon appropriate notice to the partnership, assuming that the withdrawal exceeded $10,000. If the withdrawal request was in excess of $2.0 million, the LLC has the option to pay in cash, portfolio securities, or a combination thereof. If the withdrawal is of the member's entire investment, then the LLC retained some additional flexibility in the timing of the withdrawal payment.[240] Accordingly, the LLC has the power to delay a distribution or pay out a distribution in a manner that benefits the LLC in its discretion, despite the fact that it represented that the partnership would not "purchase or sell investments in an attempt to manipulate the price of investments to the advantage of a disqualified person."[241] Indeed, this is the first mention in any of the PLRs of the Treasury Regulation that indicates that manipulation of foundation investments for the benefit of a disqualified person is a prohibited use of foundation assets.[242]

As with the 2001 and 2003 PLRs, the manager of the LLC waived all fees with regard to the private foundation.[243] As with the 2004 PLR, the private foundation would be responsible for any third party costs and fees, but to the extent that the fee is based on a sliding scale, the foundation would pay the lowest percentage and the other member would pay the remaining fees.[244]

The family specifically represented that the investment fund would not engage in any self-dealing transactions (such as a lease to a disqualified person.) However, unlike the 2003 PLR, the family never makes the statement that the family would not receive any benefit from the foundation's participation in the fund. The family only represents that the LLC would not engage in specific types of self-dealing transactions with reference to the statutory provisions of Code Section 4941.[245]

In its analysis, the IRS uses the "in substance a 'co-investment arrangement'" language found in the 2003 and 2004 PLRs. As a result, the 2005 PLR states that there is no sale or exchange between the private foundation and the partnership or any of the other members. The IRS also employed the identical language from the 2004 PLR that states that there is no economic benefit to the

---

[238] *Id.* at 2.

[239] *Id.* at 1–2.

[240] If the withdrawal was the entire interest, 90% would be paid out at the regular quarterly date, with a delay of approximately one month in order to determine value.

[241] 2005 PLR, *supra* note 236, at 5.

[242] *Id.* See the discussion of Treasury regulation § 53.4941(d)-2(f)(1) *supra* Part III.

[243] *Id.* at 2.

[244] *Id.* at 3.

[245] *Id.*

other partners or the partnership upon formation, initial funding, or withdrawal.[246] As with the prior rulings, the 2005 PLR never discusses issues of access, liquidity, control, or volume, even though the private foundation states that it will invest approximately 56% of its assets in the investment fund.[247]

5. Investing After the 2005 PLR

As a result of these private letter rulings, any private foundation that wanted to participate in a collective investment fund or holding company that would be a disqualified person on its own accord had a clear road map. All of the PLRs spend an extraordinary amount of time analyzing compensation structures—usually involving a waiver. Such a concern seems misplaced, however, as reasonable compensation for personal services is one of the few transactions that are explicitly excepted from the definition of an act of self-dealing, although a waiver of compensation may have prevented the foundation from being a "client" for purposes of the Investment Advisors Act.[248] Alternatively, the investment funds may have waived such fees because they would not qualify as personal services or the private foundation did not want to go through (or could not support) a reasonable compensation analysis.[249]

Overall, the PLRs take an extraordinarily narrow view of the concept of benefit that can be taken from collective investment, a view that is inconsistent with the legislative history of Code Section 4941.[250] While the PLRs paid specific attention to the issue of the transfer of capital transfer, the IRS specifically avoided characterizing the investment by the foundation in the investment fund as a transaction. The IRS ignored the exchange of interests in the fund for capital even though it is clear from the PLRs that significant attention and negotiation went into the terms of the investment fund agreements and the use of the private foundation's capital.[251] In addition, as discussed in the next section, the IRS ignored the treatment of that exchange as a matter of both property law and federal tax law. Finally, the PLRs specifically ignored the benefits that could accrue to the family from controlling the private foundation's investments through the investment fund. These include cost savings from securities law compliance, access to investments with minimum investment requirements, cost sharing through the family office, having access to a pool of liquid funds available for investment, and otherwise not

---

[246] *Id.* at 5.
[247] *Id.* at 2.
[248] *See supra* Part II.D.
[249] The compensation exception is discussed *supra* Part III.C.2.
[250] 1965 REPORT, *supra* note 125, at 23 ("The imposition of a general prohibition of self-dealing properly limits the deduction for charitable donations to only those situations in which the donor has completely parted with the donated property and thus has committed it without reservation to charitable purposes.").
[251] For example, the private foundation apparently negotiated, as a condition of the contribution of capital, the very provisions of the investment fund agreements that, ironically, were specifically designed to avoid self-dealing. *See* 2004 PLR, *supra* note 225, at 3; 2005 PLR, *supra* note 236, at 3.

ceding control over a significant pool of assets under management to a third party. As a result of this retained control, the investment decisions of the private foundation could have been improperly informed by the needs of and benefits to disqualified persons.

IV. INVESTING IN PARTNERSHIPS: TAX AND PROPERTY LAW APPROACHES

Central to the treatment of partnerships as co-investments in the letter rulings is the concept that there is no transaction between the private foundation and a disqualified person. The IRS's position in the PLRs is that the private foundation, as a partner in the partnership, does not interact with the partnership itself, or with the other partners. Rather, the private foundation's interest in the partnership is a silo, with the other partners merely investing side-by-side, with each partner maintaining a separate interest in partnership property. The notion that there is no transaction with the partnership or among the partners is contrary to the modern view of the partnership as an entity in and of itself, as opposed to an aggregation of its partners. Similarly, the idea of co-investment contradicts the treatment of partnerships under other parts of the Internal Revenue Code itself.

A. State Law Treatment of Partnerships

The characterization of partnership property and the relationship among partners in the United States has a long history, going back as far as America's English common law roots.[252] Most modern statutory provisions governing U.S. partnerships, however, derive from the efforts of the Uniform Law Commission to promulgate uniform laws governing both general partnership and limited partnerships.

1. General Partnerships

In 1914, the Uniform Law Commission adopted the first uniform law on general partnerships, the Uniform Partnership Act (herein "UPA 1914").[253] Central to the discussions surrounding UPA 1914 was the conceptual framework of a partnership: is it an entity, or merely an aggregation of its partners?[254] At the time,

---

[252] For a summary of the history of partnership law in the context of the tax laws, see Bradley T. Borden, *Aggregate-Plus Theory of Partnership Taxation*, 43 GA. L. REV. 717 (2009) and DOUGLAS M. BRASON, JOAN M. HEMINWAY, MARK J. LOWENSTEIN, MARK I. STEINBERG, MANNING G. WARREN, BUSINESS ENTERPRISES: LEGAL STRUCTURES, GOVERNANCE, AND POLICY 1–3 (2d ed. 2012).

[253] UNIF. P'SHIP ACT (UNIF. LAW COMM'N 1914) [hereinafter UPA 1914].

[254] The Commissioners' Prefatory Note to UPA 1914 indicates that work on the uniform law started as early as 1902. In 1910, the commission was considering two competing drafts: "a draft of a partnership act on the so-called entity idea . . . [and] . . . a draft of a proposed uniform act, embodying the theory that a partnership is an aggregate of individuals associated in business, which is that at

the common law favored the aggregate theory. After much debate, however, the resulting UPA 1914 embodied an amalgam of both approaches.[255] The definition of[256] a partnership under UPA 1914 was "a partnership is an association of two or more persons to carry on as co-owners a business for profit."[257] This recognizes the existence of individual partners, but clearly identifies the partnership as an association separate from its co-owners.

Under Section 24 of UPA 1914, a partner had three property rights: "his rights in specific partnership property," "his interest in the partnership," and "his right to participate in management."[258] With a nod to the aggregate theory of partnerships, UPA 1914 did maintain a concept of a "tenancy by partnership." Under this approach, each partner was treated as co-owner of each partnership asset as "a tenant in partnership."[259] Tenancy in partnership gave each partner an equal right to possess specific partnership property for partnership purposes, subject to the provisions of the statute and any agreement among the partners.[260] UPA 1914 placed a significant limitation on a partner's right to use the property, in that it could only be used for partnership purposes. Thus, unlike a true tenancy-in-common, a partner's interest in partnership property was significantly more limited in scope. At the same time, UPIA 1914 defined the partner's interest in the partnership as merely the partner's "share of the profits and surplus."[261]

In commenting on the new UPA 1914, Prof. Williston indicated that the primary benefits of the use of the entity theory were obtained despite the fact that the original UPA mostly followed the common law, aggregate theory roots of partnership. The joint ownership of partnership property under common law provided administratively difficult and the settlement of claims of creditor became problematic when the identity of the partners changed.[262] The creation of the tenancy by partnership was designed to avoid the administrative difficulties caused by true co-ownership by partners, while still recognizing the existing common law.

---

present accepted in nearly all the states of the Union." *Id.* at prefatory note; *see also* Samuel Williston, *Uniform Partnership Act with Some Remarks on Other Uniform Commercial Laws*, 63 U. PA. L. REV. 196, 207 (1914) ("Very many of the troublesome questions involved in that branch of the law depend for their answer on whether what is called the entity theory of partnership, or the so-called aggregate theory be adopted.").

[255] The most serious objection to adopting full entity theory, and one of the last vestiges of aggregate theory remaining today, is the joint and several liability of partners in an individual capacity. At the time of the original UPA, there was a concern that use of full entity theory would force creditors to proceed only against the partnership. Williston, *supra* note 254, at 211.

[256] *Id.* at 209.

[257] UPA 1914, *supra* note 253, § 6. This definition carried forward into RUPA at Section 101(b), discussed *infra* note 265. REVISED UNIF. P'SHIP ACT § 101(b) (UNIF. LAW COMM'N 1994) [hereinafter RUPA].

[258] *Id.* § 24.

[259] *Id.* § 25(1).

[260] *Id.* § 25(2)(a).

[261] *Id.* § 26.

[262] Williston, *supra* note 254, at 211.

If UPA 1914 had espoused a pure aggregate theory of partnership, one could argue that the IRS' view of partners as co-investors is at least initially plausible. The aggregate theory of partnership could support the view the private foundation was simply an investor in the hedge fund, along with its fellow partners in the family entity—that is, they were co-investing. This theory is flawed, however, because UPA 1914 did not adopt a pure aggregate theory; it was an amalgam of both theories. UPA 1914 clearly recognizes the partnership as an entity. Although a private foundation might have a tenancy in partnership in each asset held by the partnership, the private foundation was not free to deal with its interest in those assets as it pleased. Its use of its interests in the partnership's assets was limited by its obligation to use the for partnership purposes. In fact, UPA 1914 specifically states that joint tenancy, tenancy-in-common and tenancy-by-the-entireties do not establish a partnership.[263] Even under UPA 1914, the partnership could not be seen as merely a conduit through which the private foundation held a proportionate share of the underlying partnership assets with co-investors.

The story of UPA, however, does not begin and end in 1914. In 1986, the American Bar Association recommended a number of revisions to the UPA 1914, specifically stating that "entity theory 'should be incorporated into any revision of the UPA wherever possible.'"[264] After a string of revisions throughout the 1990s,[265] the Revised Uniform Partnership Act (herein "RUPA") was the end result, even though the Act is not officially titled as such.

RUPA explicitly codifies the entity theory of partnerships: "A partnership is an entity distinct from its partners."[266] The Comment to this section unambiguously states, "RUPA embraces the entity theory of the partnership. In light of the UPA 1914's ambivalence on the nature of partnerships, the explicit statement provided by subsection (a) is deemed appropriate as an expression of the increased emphasis on the entity theory as the dominant model."[267] RUPA Section

---

[263] UPA 1914, *supra* note 253, § 7(2).

[264] UNIF. P'SHIP ACT prefatory note (UNIF. LAW COMM'N 1997) [hereinafter UPA 1997 or RUPA] (citing UPA Revision Subcommittee of the Committee on Partnership and Unincorporated Business Organizations, *Should the Uniform Partnership Act Be Revised?*, 43 Bus. Law. 121 (1987).

[265] In the early 1990s, there were a series of revisions to the UPA 1914, with a significant recodification occurring in 1992 and subsequent amendments in 1993, 1994, 1996, and 1997. UNIF. P'SHIP ACT (UNIF. LAW COMM'N 1992); UNIF. P'SHIP ACT (UNIF. LAW COMM'N 1993); UNIF. P'SHIP ACT (UNIF. LAW COMM'N 1994); UNIF. P'SHIP ACT (UNIF. LAW COMM'N 1996). The 1996 amendments introduced the concept of the limited liability partnership. *See* UPA 1997, *supra* note 264, prefatory note addendum. The 1997 amendments revised Section 801, which changed the rule under UPA that a partnership technically dissolves and reforms with the withdrawal of a partner. This led to questions as to whether it was necessary to transfer property from the "old" partnership to the "new" partnership. Revised Section 801 does not necessarily do away with the deemed dissolution and reformation but limits the events that cause it to occur. Thus, a limited partner's withdrawal does not cause a dissolution, for example. This change reinforces the ascendance of the entity theory of the partnership form. *See generally* Donald J. Weidner & John W. Larson, *The Revised Uniform Partnership Act: The Reporters' Overview*, 49 BUS. LAW. 1 (1993).

[266] RUPA, *supra* note 264, § 201(a).

[267] *Id.* § 201 cmt.

501 further states "a partner is not a co-owner of partnership property and has no interest in partnership property which can be transferred, either voluntarily or involuntarily."[268] As a result, UPA 1914's concept of tenancy in partnership is officially discarded.[269] Thus, effective with RUPA, a partner no longer has any interest in specific partnership property.

Accordingly, when a partner contributes assets to a partnership under RUPA, the partner ceases to have a property interest in the contributed assets. RUPA envisions an exchange of property rights—a giving up of specific property rights in contributed property, which are thereby extinguished, in return for a proportionate interest in the partnership itself. Consistent with entity theory, there is in fact a transaction with the partnership when the partner makes a capital contribution to the partnership.[270]

2. State Laws Governing Limited Partnerships

UPA 1914 did not specifically cover the issues unique to limited partnerships, which instead were subject the Uniform Limited Partnership Act, adopted by the Uniform Law Commission in 1916 (herein, "ULPA 1916"). While some states had limited partnership statutes prior to ULPA 1916,[271] the Uniform Law Commission attempted not only to regularize the treatment of limited partnership investments, but also to integrate that treatment of limited partnerships with the UPA 1914 provisions adopted two years earlier.

In drafting ULPA 1916, the Commission intended to create a non-corporate mechanism in which an individual could contribute capital to a venture without having to assume liability in excess of the amount contributed.[272] To this end, ULPA 1916's commentary explained, "the person who contributes capital, though in accordance with custom called a limited partner, is not in any sense a partner. He is, however, a member of the association."[273] Although this confusing commentary seems to treat the limited partners as something other than a partner, UPLA 1916 Section 1 defines a limited partnership as follows:

> A limited partnership is partnership formed by two or more persons under the provisions of Section 2, having as members one or more

---

[268] *Id.* § 501.
[269] *Id.* § 501 cmt.
[270] Most recently, amendments were made to the 1997 version of the Act in 2011 and 2013. As part of these revisions, the term transfer includes an assignment, a conveyance, a sale, and a transfer by operation of law. UNIF. BUS. ORGS. CODE § 1-102(47) (UNIF. LAW COMM'N, amended 2013).
[271] According to the Official Comment to ULPA 1916, the first limited partnership act was adopted by the state of New York in 1822 with many of the "commercial states" following suit over the next thirty years. UNIF. LTD. P'SHIP ACT cmt. (UNIF. LAW COMM'N 1916) [hereinafter ULPA 1916].
[272] *Id.*
[273] *Id.*

> general partners and one or more limited partners. The limited partners as such shall not be bound by the obligations of the partnership.[274]

Unlike UPA 1914, the ULPA 1916 does not set forth the limited partner's rights in partnership property.[275]

As with UPA 1914, a significant period of time passed before the Uniform Law Commission revisited the ULPA 1916. A Revised Uniform Limited Partnership Act was adopted in 1976,[276] which was later updated in 1985 (herein "RULPA 1985").[277]

To the extent the Commentary to Section 1 to ULPA 1916 caused any confusion regarding the status of a limited partner as a partner, RULPA 1985 resolves the issue. RULPA 1985 states that that a limited partnership is "a partnership formed by two or more persons under the laws of this State and having one or more general partners and one or more limited partners,"[278] with the term "partner" meaning either a "limited or general partner."[279] As a true partner, the limited partner's interest in the partnership is his or her share of the profits and losses and the right to receive distributions of partnership assets; it does not include an interest in partnership property.[280]

With the passage of ULPA 1916, and then RULPA 1985, limited partnerships were still governed by the general partnership code as then in effect except to the extent the provisions of ULPA/RULPA affected the rights of the limited partners.[281] This changed in 2001, when the Uniform Law Commission

---

[274] *Id.* § 1.

[275] Section 18 of the ULPA does state that a limited partner's interest in the partnership itself is personal property, and Section 19 provides that the limited partner's interest is assignable. *Id.* § 18, 19. As a result, it appears that the UPA 1914's tenancy-by-partnership rules would have applied, although it is unclear whether anything in ULPA 1916 could be read to be inconsistent with that rule. *See* ULPA 1916, *supra* note 271, § 6(2) ("This Act shall apply to limited partnerships except in so far as the statutes relating to such partnerships are inconsistent herewith").

[276] REVISED UNIF. LTD. P'SHIP ACT (UNIF. LAW COMM'N 1976).

[277] *Id.* § 101(6). REVISED UNIF. LTD. P'SHIP ACT (UNIF. LAW COMM'N 1985) [hereinafter RULPA 1985] RULPA 1985 made some significant changes to the law of limited partnerships. It introduced the concept of the partnership agreement into the statute; previously, the legislation only discussed the limited partnership certificate filed with the appropriate state authorities. *See id.* prefatory note (recognizing that "the limited partnership agreement, not the certificate of limited partnerships, is the primary constitutive, organization, and governing document of a limited partnership.") As a substantive matter, RULPA expanded the role that limited partners could play in the business of the partnership without losing the limited partner's liability shield. *Id.* (revisions regarding the permissible activities of limited partners "are among the principal innovations in the 1985 Act.").

[278] *Id.* § 101(7). A limited partner is a person who has been admitted to a limited partnership as a limited partner in accordance with the partnership agreement.

[279] *Id.* § Section 101(8).

[280] *Id.* § 101(10). This definition was "intended to define what it is that is transferred when a partnership interest is assigned." *Id.* § 101 cmt. RULPA 1985 Section 301 makes the crucial distinction between a limited partner and the assignee of a limited partnership interest, who does not become a partner until admitted into the partnership. *Id.* § 301.

[281] *See* ULPA 1916, *supra* note 271, § 6(2) ("This Act shall apply to limited partnerships except in so far as the statutes relating to such partnerships are inconsistent herewith"); RULPA 1985, *supra*

again updated the limited partnership provisions. The Uniform Limited Partnership Act (2001),[282] "de-linked" the limited partnership law from the general partnership law, now providing that the limited partnership act was a "'stand alone' act."[283]

Thus, prior to ULPA 2001, the nature of a general partner's interest in a partnership was governed not by ULPA or RULPA but by the applicable version of the UPA. Similarly, the nature of the limited partner's interest was governed primarily by the UPA, except to the extent that is changed by ULPA or RULPA—neither of which has much to say on the subject. As of ULPA 2001, the nature of the limited partner's interest is solely governed by the new act. As first of the PLRs was issued in 2001, the underlying fact patterns would have occurred at the time of transition between RULPA 1985 and ULPA 2001.[284]

ULPA 2001 Section 104(a) states that "a limited partnership is an entity distinct from its partners." Thus, as with the trend in the general partnership statute, ULPA 2001 fully and explicitly adopts an entity theory of partnerships.[285] ULPA 2001 clearly takes the position that an exchange occurs on at least a contribution of capital to a limited partnership. Section 102 defines a contribution as "any benefit provided by a person to a limited partnership *in order to become* a partner or in the person's capacity as a partner."[286] Thus, in the case of a private foundation that makes a contribution to a partnership in order to become a partner, as was the

---

note 277, § 1105 ("In any case not provide for in this act the provisions of the Uniform Partnership Act govern.").

[282] UNIF. LTD. P'SHIP ACT (UNIF. LAW COMM'N 2001) [hereinafter ULPA 2001].

[283] *Id.* The Commissioners noted that LLCs and LLPs now were utilized in many instances where LPs were formerly employed; thus, ULPA 2001 focused on "sophisticated, manger-entrenched commercials deals whose participants commit for the long term," as well as "estate planning arrangements (family limited partnerships)." *Id.*

[284] ULPA 2001 would have been the Uniform Law Commission's latest pronouncement at the time of the 2001 PLR, although was not widely enacted. The current Uniform Law Commission website indicates that only 20 states have enacted ULPA 2001 as amended in 2013. *See Legislative Fact Sheet – Limited Partnership Act (2001) (Last Amended 2013)*, UNIFORM L. COMM'N, http://www.uniformlaws.org/LegislativeFactSheet.aspx?title=Limited%20Partnership%20Act%20(2001)%20(Last%20Amended%202013) (last visited Feb. 28, 2016). Thus, ULPA 2001 would have been the most modern statement of limited partnership law, although many states may still have been working under RULPA 1985.

[285] ULPA 2001, *supra* note 282, § 104(a). Also following the trend established in UPA and RULPA 1985, ULPA 2001 emphasizes the partnership agreement as the governing document setting for the relationship of the partners to one another and to the partnership. *Id.* § 110(a). The comment to Section 110(b)(13) specifically acknowledges that "the partnership is a contract . . . ." *Id.* § 110 cmt. Further, a limited partner does not owe fiduciary duties to any other partner, but shall act consistently with the contract obligation of good faith and fair dealing. *Id.* § 305(a)–(b). Further, ULPA 2001 restricts the nature of the partner's interest in the partnership, stating that the only interest of the partners that is transferable is the right to receive distributions. Section 701 says that "the only interest of a partner which is transferable is the partner's transferable interest." *Id.* § 701. The comment to section 701 states "like all other partnership statutes, this Act dichotomizes each partner's rights into economic rights and other rights." *Id.* § 701 cmt.

[286] *Id.* § 102(2) (emphasis added); *but see* DEL. CODE ANN. tit. 6, § 15-205 (2015) (Delaware RUPA section providing that a person can be admitted as a partner and may receive a partnership interest without making a contribution or being obligated to make a contribution).

case in the 2003 and 2004 PLRs, a *quid pro quo* exchange occurs under ULPA 2001.[287]

B. Subchapter K of the Internal Revenue Code

Modern partnership statutes are not the only bodies of law that view the investment in a partnership as a transaction—the Internal Revenue Code does so as well. Subchapter K of the Code[288]comprehensively addresses the taxation of partnerships—or, more appropriately, the taxation of partners in partnerships.[289] Subchapter K takes both an entity and an aggregate approach to partnerships, depending upon the circumstances.[290] At least one commentator has noted that the blending of the aggregate and entity approaches to partnership "is a primary source of uncertainty and confusion" in the Internal Revenue Code.[291]

The definition of a partnership under Code Section 761 appears to embrace an entity theory of partnership taxation. Code Section 761 defines a partnership for purposes of the income tax as "a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate."[292] The IRS can, however, exclude an organization from the application of Subchapter K, at the election of all of the members of the organization, if the organization is "for investment purposes only and not for the active conduct of a business" or "for the joint . . . use of property, but not for the purposes of selling service or the property."[293] By regulation, the IRS can exclude an unincorporated association from the provisions of Subchapter K as an investment partnership under Code Section 761(a)(1) if the participants: (1) own the property as co-owners; (2) reserve the right to dispose of shares of any property acquired or retained; and (3) do not actively conduct business or irrevocably authorize some person or persons acting in a representative capacity to purchase, sell, or exchange such investment property, although each separate participant may delegate authority to purchase, sell, or exchange his share of any

---

[287] The 2005 PLR involved an LLC, as opposed to a state law partnership, although the LLC was treated as if were a partnership for federal tax purposes. The majority view is that an LLC operating agreement is a contract, and as such, participation in an LLC out to be treated as if there is consideration and mutual assent. As a result, the better (but not universal view) is that a private foundation transferring assets to a non-single member LLC and signing an operating agreement is entering into a contractually enforceable transaction. *See, e.g.*, Joan MacLeod Heminway, *The Ties That Bind: LLC Operating Agreements as Binding Commitments*, 68 SMU L. REV. 811 (2015).

[288] I.R.C. §§ 701–777 (West 2015).

[289] *Id.* § 701.

[290] *Compare* Borden, *supra* note 252, at 720, with Alfred D. Youngwood & Deborah B. Weiss, *Partners and Partnerships – Aggregate v. Entity Outside of Subchapter K*, 48 TAX LAW. 39 (1994) (favoring a presumption of aggregate theory in approaching partnership tax issues outside of the provisions of Subchapter K).

[291] Youngwood & Weiss, *supra* note 290, at 39.

[292] I.R.C. § 761(a).

[293] *Id.* § 761(a)(1)–(2).

such investment property for the time being for his account, but not for a period of more than a year.[294] The IRS has taken the position that limited partners own an interest in the partnership and therefore, are not co-owners of the property owned by the partnership.[295] Such a position is entirely consistent with a modern entity view of partnerships, since individual partners do not co-own the underlying partnership assets.[296]

While Subchapter K's definition of a partnership recognizes the partnership as an entity, its approach to the taxation of the individual partners starts with an aggregate theory of partnerships. Code Section 701 provides that "a partnership as such shall not be subject the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities."[297] Upon further inspection, however, even Subchapter K's approach to taxation does not ignore the existence of the partnership as an entity. Rather, the partnership exists as an accounting entity[298] and the partner's interest in the partnership is a separate property interest,[299] even if the imposition of the income tax focuses on the separate economic interests of the individual partners.

It is difficult to conceptualize the tax treatment of transfers to a partnership by a partner unless the partnership itself is treated as an entity and not merely as a collection of individuals investing side-by-side. Under Code Section 1001, gain or loss is recognized on "sale or other disposition"[300] of property, unless there is another provision of the Code that authorizes non-recognition.[301] An exchange is an "other disposition" of property for purposes of Code Section 1001.[302]

Code Section 721 specifically provides that "no gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership." Code

---

294 Treas. Reg. § 1.761-2(a)(2) (as amended in 1995).

295 I.R.S. Priv. Ltr. Rul. 200305025 (Oct. 29, 2002).

296 ULPA 2001, *supra* note 282, § 104(a); RUPA, *supra* note 264, § 501 ("a partner is not a co-owner of partnership property and has no interest in partnership property which can be transferred, either voluntarily or involuntarily.").

297 I.R.C. § 701.

298 The obligation to make a return of income under Section 6031 falls on the partnership itself as an entity. Treas. Reg. § 1.701-1; I.R.C. § 6031.

299 The anti-abuse regulation of Treas. Reg. 1.701-2(a)(3) (discussed in more detail, *infra*, pp. 68–69) specifically states that that ". . . the tax consequences under subchapter K to each partner of the partnership operations *and of transactions between the partners and the partnership* must accurately reflect the partners' economic agreement . . . ." Treas. Reg. § 1.701-2(a)(3) (as amended in 1995) (emphasis added). Thus, the regulations recognize that the partnership is an entity and that property transactions can occur between the partners and the partnership.

300 I.R.C. § 1001(b).

301 *Id.* § 1001(c).

302 *See* Cottage Sav. Ass'n v. C.I.R., 499 U.S. 554 (1991) ("Regulation that gain or loss arises from exchange of property for other property differing materially either in kind or in extent is a reasonable interpretation of statute defining gain or loss from sale or other disposition of property."); Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184 (1954) (calculating the basis of the property received in a taxable exchange).

Section 721, by its terms, specifically acknowledges the possibility of exchange of property for an interest in the partnership.[303] Because the default rule of Code Section 1001(c) is that gain is recognized without a specific exception elsewhere in the tax code, it is clear that Subchapter K would treat the contribution of property to a partnership in exchange for a partnership interest as a "sale or other disposition" for purposes of Section 1001. Thus, the default rules of Code Sections 1001 and 721(a) seem specifically to contradict the assertion in the 2003, 2004 and 2005 PLRs that no sale or exchange occurred when the private foundation transferred assets to an investment partnership that was a disqualified person.

There is, however, a specific exception to this default non-recognition rule for investment partnerships. Code Section 721(b) states that the non-recognition rule for exchanges for capital contributions "shall not apply to gain realized on a transfer of property to a partnership which would be treated as an investment company (within the meaning of Code Section 351) if the partnership were incorporated."[304] The exception of Code Section 721(b) does not negate the fact that a sale or other disposition occurred on the contribution of capital to an investment partnership—quite to the contrary. It reinforces the fact that a sale or other disposition (here an exchange) occurred by specifically providing that it is a taxable event that should be recognized for tax purposes.

In case that wasn't clear enough, Code Section 761, which includes definitions generally applicable to Subchapter K, states as follows:

> Except as otherwise provided in regulations, for purposes of (1) section 708 (relating to continuation of partnerships, (2) section 743 (relating to optional adjustments to basis of partnership property, and (3) any other provision of this subchapter specified in regulations prescribed by the secretary, any distribution of an interest in a partnership *(not otherwise treated as an exchange)* shall be treated as an exchange.[305]

---

[303] One might employ a theoretical construct that the exchange of property between a partner and a partnership is really an exchange of interests among partners, where by the existing partners relinquish an allocable portion of their interest in the partnership to the new partner. Subchapter K, however, already has specific provisions that govern the sale of partnership interests, including the sale of interest between partners. I.R.C. § 741; Treas. Reg. § 1.741-1(b) (as amended in 2000) ("Section 741 shall apply whether the partnership interest is sold to one or more members of the partnership or to one or more persons who are not members of the partnership."). If the contribution of capital to a partnership were re-characterized as the deemed sale of a partnership interest among the partners, then Code Section 721 would be irrelevant and Code Section 741 would apply. By way of example, if contributed property is subject to a liability that is assumed by the partnership, not as an assumption by the other partners directly; rather the assumption is by the partnership but results in a distribution of money to the contributing partner. Conversely, the assumption of a liability by the other partners is treated as a contribution by them to the partnership. Treas. Reg. § 1.722-1 (as amended in 2004).

[304] I.R.C. § 721(b).

[305] *See id. Id.* § 761(e) (emphasis added). Treas. Reg. § 1.761-1(e) provides that certain deemed distributions of interests in a new partnership of a partnership are not sales or exchanges of the new interest. Treas. Reg. § 1.761-1(e) (as amended in 1997).

Thus, the Code itself acknowledges that in most instances,[306] that the contribution of capital in return for a partnership interest is an exchange, and that treatment is clarified or negated in the case of specific provisions.

Once assets are contributed to a partnership, the baseline assumption is that a partner does not have a specific interest in or pro rata ownership share of any particular partnership asset, which is consistent with the approach taken by state law. Going forward, the partner's interest in the partnership assets is represented by his or her partnership ownership interest, and for tax purposes, his or her economic interest in the partnership as represented by the partner's capital account. It is at this point in Subchapter K that the analysis that the tax treatment of the partnership income is based upon an aggregate approach to the partnership. Some commentators suggest that the aggregate approach should apply with respect to partnership income and distributions, while entity theory should apply to transactions involving partnership interest themselves.[307] In either event, the baseline structure of Subchapter K, however, does not appear to support the notion that partners are investing "side by side" such that there was no transaction on the entry of the partner into the partnership.

V. SHOULD THEORETICAL CONSISTENCY BE A GOAL OF THE TAX LAW?

Even if we accept that the IRS' "co-investment" characterization is inconsistent with state law and Subchapter K, should it matter? After all, different legal codes have different purposes; therefore, differences in definitions and approaches are wholly appropriate if those differences further the needs of the codes they serve.[308] As noted by one commentator, "[b]ecause partnership law serves policy goals that differ from tax policy goals, partnership law does not guide partnership taxation."[309] Theoretical consistency, however, within a code and between different codes with regard to similar subject matter, does have value, even if there are times when deviation is warranted.[310]

---

[306] The concept that a partner's ownership in assets contributed to the partnership ceases and is replaced by an ownership interest in the partnership itself is reinforced by the basic rules applicable to partnerships. The partner's outside basis in its new partnership interest is generally equal to its basis in the assets it contributed. I.R.C. § 722. Going forward, the partnership (not the partner) has inside basis in all of the assets contributed by all of its various partners.

[307] Borden, *supra* note 252, at 721-22 (citing 1 WILLIAM S. MCKEE, WILLIAM F. NELSON & ROBERT L. WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 1.02[3] (3d ed. 1997)).

[308] *See id.* at 723 ("The central problem of partnership law has been the development of a framework for determining the substantive rights and obligations arising out of the partnership relationship.") (quoting Gary S. Rosin, *The Entity-Aggregate Dispute: Conceptualism and Functionalism in Partnership Law*, 42 ARK. L. REV. 395, 396 (1989)).

[309] *Id.* at 721.

[310] This desire for theoretical consistency is different than the administrative law concept of treating similarly situated taxpayers consistently. *See* Christopher M. Pietruszkiewicz, *Does the Internal Revenue Service Have a Duty to Treat Similarly Situated Taxpayers Similarly?*, 74 U. CIN. L. REV. 531 (2005).

A. Consistency Within a Code

When the UPA 1914 was first enacted, the Uniform Law Commissioners found themselves defending the law—not only the substantive law of UPA, but the concept of codification itself. On December 19, 1914, Professor Samuel Williston[311] delivered an address to the Law Association of Philadelphia, which was later reprinted by the University of Pennsylvania Law Review in 1915. Professor Williston spent the first part of his address defending the effort to codify partnership law, much of which had previously been in the form of common law precedent,[312] stating as follows:

> Codification has an ugly sound to most American lawyers. We have been trained to believe that no code can be expressed with sufficient exactness, or can be sufficiently elastic to fulfill adequately the functions of our common law. The iridescent legal utopia proposed by Bentham and his followers in which everyone should readily know the law or be able quickly to find it by turning to a code, in which the professional lawyers would be abolished has been proved a dream.[313]

While acknowledging the limits of a codification in a common law country, Williston went on to make the case for codification of the partnership law. In Williston's mind, codification would be beneficial because: (1) it produces uniformity; (2) provides for ease of reference; (3) settles uncertain questions of law; and (4) harmonizes "into a more consistent whole a body of doctrines, many of which have grown up, if not at haphazard, at least without particular references to one another."[314]

Williston's defense of the codification of the partnership law applies equally to adopting a unified approach to partnerships within the entirety of the Internal Revenue Code. Use of a uniform approach to partnerships will make to a subject that is understandable and approachable. "The absence of a unifying entity or aggregate theme in [partnership tax law] means that these situations must be resolved on an ad hoc basis by reference to the way in which the statute applies the entity and aggregate concepts to related or analogous situations—a process that is difficult, tedious, and uncertain."[315] For example, it is these types of theoretical gaps within the tax code and ad hoc determinations that allow for the rise of tax shelters, where a taxpayer complies with the letter of the law but violates the law's

---

[311] Samuel Williston, of "Willison on Contracts" fame, was a law professor at Harvard from 1895 to 1938, and served as Dean. He was on the drafting commission for the UPA, as well as many of the Uniform Law Commission's laws that would form the basis for the Uniform Commercial Code.
[312] Williston, *supra* note 254.
[313] *Id.* at 196–97.
[314] *Id.* at 199.
[315] Borden, *supra* note 252, at 721 (citing 1 WILLIAM S. MCKEE, WILLIAM F. NELSON & ROBERT L. WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 1.02[3] (3d ed. 1997)).

underlying purpose.[316] Accordingly, consistency of terms and theoretical approach ought to be a goal of any legal code, unless it simply cannot be achieved without sacrificing a major purpose of the code itself.

This desire toward consistency is enshrined in a number of rules of construction used by courts in reviewing statutory language. The "whole act rule" provides that statutory terms are presumed to have consistent meaning throughout an act or related legislation.[317] Similarly, the statutory construction canon *in pari materia* generally requires similar statutory provisions to be interpreted similarly.[318] Professors Gluck and Bressman found that "this presumption of consistent usage . . . is widely accepted in the federal courts. Indeed, leading commentators have called it one of the most important and consistently applied textual default rules."[319]

Of course, there is some question as to whether judicial canons of interpretation reflect legislative reality. The survey of legislative drafting counsel by Professors Gluck and Bressman found that 93% of respondents wanted to use the "whole act" canon—that terms should be used consistently within an act or related statutes.[320] The survey by Professor Walker of regulatory drafters at various executive branch agencies found that 89% used the whole act rule in concept when drafting, although only 25% used *in pari materia*.[321] Indeed, Professor Walker found that the concept that "statutory terms are presumed to have a consistent meaning through a statute - always or often applies."[322] To the extent that the whole act canon was not used by legislative or regulatory drafters, however, it was due to "the significant organizational barriers that the committee system, bundled legislative deals, and lengthy multidrafter statutes post to the realistic operation of those rules."[323]

---

[316] *See generally* Shannon Weeks McCormack, *Tax Shelters and Statutory Interpretation: A Much Needed Purposive Approach*, 2009 U. ILL. L. REV. 697.

[317] Abbe R. Gluck & Lisa Schultz Bressman, *Statutory Interpretation From the Inside—An Empirical Study of Congressional Drafting, Delegation, and the Canons: Part I*, 65 STAN. L. REV. 901, 905, 930 (2013); Christopher J. Walker, *Inside Agency Statutory Interpretation*, 67 STAN. L. REV. 999, 1023 (2015).

[318] Gluck & Bressman, *supra* note 317, at 930; Walker, *supra* note 317, at 1023. Gluck and Bressman surveyed 137 Congressional counsel about approaches to legislative drafting while Walker did a similar survey of individuals involved in drafting agency regulations.

[319] Gluck & Bressman, *supra* note 317, at 937.

[320] Gluck and Bressman found that 93% of their respondents found that statutory consistency of terms was a goal, but emphasized that organizational barriers prevented them from reaching that goal. *Id.* at 936.

[321] Walker, *supra* note 317, at 1020. In Prof Walker's study of 123 individuals involved in drafting regulations, 89% of drafters responded that they employed the whole act concept when drafting, while only 25% utilized *in pari materia* and only 1% employed the whole code rule—in the specific context of the survey, however, the code at issue was the entirely of the federal code, not just the Internal Revenue Code.

[322] *Id.* at 1026.

[323] Gluck & Bressman, *supra* note 317, at 905; *see also* Walker, *supra* note 317, at 1029–30. Walker's survey found that drafters were "more confident in the presumption of consistent usage in the same statute or section of a statute than they are across statutes, much less the entire [U.S.] Code." This

According to Gluck and Bressman, use of the whole act canon cannot be justified on the basis that it reflects Congressional will.[324] That being said, the canons of construction can be viewed as "external to the legislative process," which means that they can be used to coordinate "systemic behavior" or "impose coherence" on the Code.[325] Gluck and Bressman refer to this notion as "rule of law norms": "the idea that interpretive rules should coordinate systemic behavior or impose coherence on the corpus juris."[326]

Gluck and Bressman studied the legislative process, while Walker studied the regulatory drafting process. In the case of the PLRs, however, the question of theoretical consistency applies in the context of enforcement and application. The IRS can recognize that the federal courts will use these canons as a basis for interpretation, and that legislative counsel would like to use these canons more but are restrained by the realities of the legislative process. To the extent that the legislative process makes consistency difficult to achieve, the IRS has both the power (through regulation and administrative guidance) as well as the expertise to provide this consistency of viewpoint. Professor Walker's study shows that consistency becomes more of a reality, a least on a "whole act basis" at the regulatory level; the next step would be to reinforce that consistency at the enforcement/application level. Reinforcing the use of these canons in interpreting statutory language can reinforce Professor Williston's desire to "harmonize into a more consistent whole a body of doctrines, many of which have grown up, if not at haphazard, at least without particular references to one another."[327]

B. Consistency Between State Property Law and Federal Tax Law

The IRS has long struggled with the issue of the interplay of state property law and federal tax law. Paul Caron coined the term "tax myopia" for the mistaken view that the tax law stands on its own as a "self-contained body of law."[328] While

---

uncertainty among drafters was caused in part by a lack of confidence that consistency in language was even considered at the legislative level. *Id.* at 1029–30.

[324] Gluck & Bressman, *supra* note 317, at 954–55 ("Under most versions of the faithful-agent theory, these canons should be rejected" but "if the courts applied these textual rules more consistently, their application in the drafting process might persuade drafters to at least attempt to surmount some of the institutional hurdles.").

[325] *Id.* at 905.

[326] *Id.* at 961 ("the body of the law should make sense, and . . . it is the responsibility of the courts, within the permissible meanings of the text, to make it so.") (quoting Antonin Scalia & Bryan A. Garner, READING LAW: THE INTERPRETATION OF LEGAL TEXTS 252 (2012)); *see also* Abbe R. Gluck & Lisa Schulz Bressman, Statutory Interpretation From the Inside – An Empirical study of Congressional Drafting, Delegation and the Canons: Part II, 66 Stan. L. Rev. 725, 788 (2014).

[327] Williston, *supra* note 254, at 7; *see also* Gluck & Bressman, *supra* note 317, at 913 ("[J]udges are legislative partners who should interpret statuses 'in a manner that . . . will produce a workable set of laws.") (citing Stephen Breyer, *On the Uses of Legislative History in Interpreting Statutes*, 65 S. CAL. L. REV. 845, 867 (1992)).

[328] Paul L. Caron, *Tax Myopia, or Mamas Don't Let Your Babies Grow Up to Be Tax Lawyers*, 14 VA. TAX REV. 517, 518 (1994).

is axiomatic that federal tax law does not create or change state property rights;[329] it is equally understood that state court interpretations of property do not dictate a transaction's federal tax consequences.[330] In *Estate of Bosch*, the Supreme Court held that lower court decisions regarding the property rights of taxpayers were not binding on the IRS for tax purposes, but should be given "proper regard." Of course, this raises the question of what constitutes proper regard.[331] The inherent tension between state property law and federal tax law creates significant ambiguity regarding the implications of the characterization of transaction for state law purposes.[332]

In this case, the interplay between state law and federal law appears at a much different point in the enforcement process. None of the PLRs address the question of whether a contribution to capital to a partnership in return for a partnership interest is a "transaction" or an "exchange." What would have been the impact if the private foundation had obtained a state court ruling that its investment in the partnership was (or was not) a transaction? In a state using an entity-based theory of partnerships, the state court would have found that a transaction occurred. Under *Estate of Bosch*, the IRS would need to give such a finding due regard, even if it was not bound by such a finding—presumably, the IRS would give such a finding "proper regard."[333] Presumably, the IRS would disregard such a finding only if it found that the proceeding was non-adversarial[334] or that it was not a correct statement of the law as would have been decided by the state's highest court.[335] Posing this hypothetical question is not to say that state law should have the final say or that consistency is always necessary—rather, giving some consideration to application of state law abides by the spirit of *Estate of Bosch's* "proper regard" standard. To the extent that the treatment of a transaction under the tax law can be harmonized with state property law without sacrificing the purposes of the tax law it minimizes the need to resolve the thorny question of how courts should deal with the conflict.[336]

---

[329] In the partnership context, for example, if the IRS determines that a tax allocation among partners does not have substantial economic effect, it can re-order the allocation to prevent abuse under Subchapter K. *See* I.R.C. § 704(b)(2) (West 2015). Such a re-alignment, however, does not change the underlying economic agreement (and associated state law contract and property rights) among the parties.

[330] *See* Commissioner v. Estate of Bosch, 387 U.S. 456 (1967) (state court decisions arising out of a *bona fide* adversary proceeding must be given "proper regard" but are not binding in determining the federal tax consequences of a transaction).

[331] *Id.*

[332] *See* Caron, *supra* note 328, at 587.

[333] *Estate of Bosch*, 387 U.S. at 464.

[334] *Id.*

[335] *See* Caron, *supra* note 328, at 587.

[336] *Id.*

C. Toward Achieving Consistency

Courts and regulators should attempt to interpret codified statutory provisions in a manner that is both internally consistent and shows "proper regard" of applicable state law provisions. This would further the goals of codification, the underlying canons of statutory interpretations, and the dictates of *Estate of Bosch*. In this case, the IRS should treat transactions in which a private foundation exchanges capital in return for its partnership interest as a transaction in accordance with and bringing consistency to the provisions of Code Sections 4941 and 721. Such an interpretation pays proper regard to the approach of most state laws that a partnership is an entity, at least in this context. This consistency can be achieved in a manner that serves the underlying purpose of Code Section 4941—preventing acts of self-dealing between a private foundation and its disqualified persons even if it disallows transactions that might be beneficial to the foundation.[337]

That being said, the IRS unquestionably has the authority to re-characterize transactions if the form of the transaction does not follow its economic substance, or otherwise may be necessary to prevent avoidance of the tax laws.[338] For the IRS, this authority derives mostly from the common law, although the IRS has specific statutory and regulatory authority to re-characterize transactions as necessary to serve the purposes of the tax code. This specific authority is especially evident in Subchapter K.[339] For example, Treasury Regulation Section 1.701-2 sets forth a direct statement of regulatory authority to re-characterize transactions to further the purposes of the Internal Revenue Code.[340] The regulation starts with a statement of the purpose of Subchapter K: "Subchapter K is intended to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity level tax."[341]

One of the assumptions "implicit in the intent of subchapter K" is that "the form of each partnership transaction must be respected under substance over form principles."[342] This anti-abuse rule goes on to state if a partnership transaction is for the principal purpose of reducing the partners' aggregate federal tax liability in a manner that is inconsistent with the stated intent of Subchapter K, then the "Commissioner can recast [a] transaction for federal tax purposes, as appropriate

---

[337] *See* supra Part III.C.

[338] *See, e.g.*, Old Colony Trust Co. v. Commissioner, 279 U.S. 716, 731 (1929); *see also* Commissioner v. Nat'l Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974) (stating that the taxpayer may not use the substance over form doctrine to re-characterize a transaction, as the taxpayer had choose the original form of the transaction).

[339] In addition to general partnership anti-abuse rule of Treasury Regulation 1.701-2, the substantial economic effect rules of Code Section 704 and Treasury Regulation 1.737-4 have anti-abuse rules specifically applicable to the pre-contribution gain rules. I.R.C. § 704 (West 2015); Treas. Reg. § 1.737-4.

[340] Treas. Reg. § 1.701-2 (as amended in 1995).

[341] *Id.* § 1.701-2(a).

[342] *Id.* § 1.701-2(a)(2).

to achieve tax results that are consistent with the intent of subchapter K," including disregarding the partnership in whole or in part, and treating the partnership's assets and activities as to be owned and conducted, respectively by one or more of its purported partners.[343]

Although Subchapter K appears to give the IRS plenary authority to re-characterize transactions for partnership income tax purposes, that authority is not unlimited. The anti-abuse regulations state that "[t]he Commissioner can treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purpose of *any provision* of the Internal Revenue Code or the regulations promulgated thereunder."[344] However, this authority is specifically limited if the Code prescribes the treatment of a partnership as an entity, and that treatment and the ultimate tax results, taking into account all of the relevant facts and circumstances, are clearly contemplated by that provision.[345]

Re-characterization of the form of a transaction by the IRS is done in the name of preventing abuse of the tax laws. The anti-abuse rules are invoked by the IRS in order to re-order a transaction in a situation where slavish devotion to the form of the transaction would work to the detriment of the Code. That is not the case here—in fact, it is quite the opposite. The re-characterization of the family investment fund transaction as a co-investment is actually an attempt by the IRS to liberalize the application of Code Section 4941—in effect, creating a safe harbor where one does not otherwise exist. The PLRs ignore the state law form of the transaction (by disregarding it as a transaction at all) not in the name of preventing abuse of the tax code, but to allow it. Moreover, the IRS has chosen (to date) to do so in the context of a series of private letter rulings, rather than more binding (and more scrutinized) guidance in the form of regulations or a revenue ruling or revenue procedure.

In all of these PLRs, the private foundation is not merely investing in a commercial hedge fund run by a third party of which disqualified persons happen to be the other parties. As discussed earlier, the regulatory exceptions to indirect self-dealing state that merely participating in an investment entity with other disqualified persons is not an act of self-dealing if the entity is not controlled by the private foundation and is not a 35% Controlled Entity.[346] The self-dealing concern arises, therefore, only in a situation where the private foundation controls a significant stake in the partnership such that it has control of the investment entity or other disqualified persons combined own over 35% of the interests in the entity—voting interest in the case of a corporation, and profits interests in the case of a partnership.[347] Thus, disqualified persons have retained investment control

---

[343] *Id.* § 1.701-2(b)(1).
[344] *Id.* § 1.701-2(e)(1) (emphasis added).
[345] *Id.* § 1.701-2(e)(2)(i)–(ii). By way of example, the Regulations cite to the entity treatment of a partnership under the controlled foreign corporation rules of Code Section 904. *Id.* § 1.701-2(f) ex. 3.
[346] *See supra* Part III.C.
[347] I.R.C. § 4946(a)(1)(E)–(F) (West 2015).

over the private foundation's assets, indirectly—the exact situation not allowed by the regulatory exception for non-controlled entities. Direct control over the investments of the private foundation by disqualified persons as the foundation's trustees or directors subjects those individuals to an unqualified duty of loyalty to the foundation when making investment decisions.[348] Indirect control through a controlled entity such as a family investment partnership now subjects those same investment decisions to a second set of fiduciary duties and interests—those of the disqualified persons who are co-partners. It is exactly this type of conflict of interest that Congress intended to address, even if it meant that certain beneficial transactions could not occur.[349]

D. Living with the Dissonance: A Possible Safe Harbor

Given the history of Code Section 4941, it seems strange that Treasury would go through the mental gymnastics of inventing the concept of co-investment to justify these types of transactions. Conceptually, the weight of authority both as a matter of legislative history, state law, and Subchapter K compels a contrary conclusion at least with regard to the capital contribution exchange for a partnership interest—there is, in fact, an exchange that should be a transaction for tax purposes. Thus the concept of co-investment in the PLRs creates significant dissonance with the treatment of partnership investments in almost every other context.

Is the cost of this dissonance worth the price? Is the need to allow private foundation investment in these types of family vehicles sufficiently important to justify a tortured interpretation of Chapter 42 in a manner that is inconsistent with other areas of law? The only compelling interest in allowing such transactions appears to be that they are in the best interest of the private foundations engaging in the transactions, which is decidedly not what Congress intended to be a factor in the determination. Rather, the IRS should recognize that control over the private foundation investments in this matter allows exactly the type of self-dealing that Code Section 4941 was designed to prevent.

That being said, should the IRS determine that it is advisable to allow such transactions to further the orderly investment of private foundation assets, it should provide a limited regulatory safe harbor allowing such transactions, rather than leaving an ad hoc road map to be reconstructed from the pieces of various PLRs. In crafting such a safe harbor, the IRS should ask whether there is a way for the

---

[348] For the duties of a directors of a nonprofit corporation, see MODEL NONPROFIT CORP. ACT §§ 8.30, 8.31 (AM. BAR ASS'N, 3d ed. 2008); for the duties of a trustee of a charitable trust, see UNIF. TRUST CODE art. 8 (UNIF. LAW COMM'N 2010).

[349] See *supra* Part III.C. (discussing the 1965 Report, which notes that that "when a person is asked to represent two conflicting interests in the same transaction it is likely that he will, consciously or unconsciously, favor one side over the other" and indicating that "it is better to forbid self-dealing and to strike down all such transactions rather than to attempt to separate those transactions which are harmful from those which are not by permitting a fiduciary (as is the donor when he is dealing with charitable funds) to justify his representation of two interests.").

state property law of partnerships, the provisions of Subchapter K, and Code Section 4941 to co-exist peacefully. The answer may be found in Code Section 761's definition of a partnership.

Code Section 761 allows the IRS to power to exclude from the definition of a partnership, and therefore, from the income tax regime of Subchapter K, certain unincorporated associations formed for investment purposes.[350] Assuming all of the members of the organization agree, the IRS can exclude an unincorporated association from the provisions of subchapter K as an investment partnership under Code Section 761(a)(1) if the participants: (1) own the property as co-owners; (2) reserve the right to dispose of share of any property acquired or retains; and (3) do not actively conduct business or irrevocable authorize some person or persons acting in a representative capacity to purchase, sell, or exchange such investment property, although each separate participant may delegate authority to purchase, sell, or exchange his share of any such investment property for the time being for his account, but not for a period of more than a year.[351]

If an investment partnership elects out of the Subchapter K regime, it is then treated as co-owned property. This co-ownership concept parallels the co-investment concept that appears in the PLRs. As the tax code already has a mechanism by which an investment partnership can be treated as co-ownership of property, why not use it? Code Section 761 explicitly references co-ownership and requires the foundation to have a right to dispose of its share of the property. Moreover, it limits the ability of third parties to control investments in the long term. Therefore, to the extent the concern arising out of family investment partnerships is the conflict of interest in investment decisions, this conflict is at least limited in time to a period of a year and gives the foundation the ability to remove itself from the investment partnership if it is not furthering its own investment authority. Finally, such a provision harkens back to the days of the UPA 1914 and the aggregate theory of partnership, one could view this arrangement as establishing a version of a tenancy-by-partnership. Under modern partnership laws, co-tenancies are explicitly excepted from the definition of a partnership, thereby eliminating the consistency by making state partnership law inapplicable.

The IRS previously has approved the direct co-ownership of investment property under the self-dealing rules.[352] The use of property during co-ownership is not unlimited, however. While clearly a sale or exchange of property is an act of self-dealing,[353] the use of private foundation assets by or for the benefit a disqualified person is also an act of self-dealing.[354] Thus, even if the co-ownership of an asset may be acceptable under Code Section 4941,[355] the subsequent use of

---

[350] *See supra* note 294 (discussion of Code Section 761(a)(1) and (2)).

[351] Treas. Reg. § 1.761-2(a)(2) (as amended in 1995).

[352] I.R.S. Priv. Ltr. Rul. 96-51-037 (Sept. 20, 1996).

[353] I.R.S. Gen. Couns. Mem. 39,770 (Dec. 15, 1988) (addressing PLR 8842045).

[354] I.R.C. § 4941(d)(1)(E).

[355] I.R.S. Gen. Couns. Mem. 39,770 specifically states, "We wish to note that we do not conclude

the asset in a manner that is not consistent with proportionate co-ownership may be an act of self-dealing separate and apart from the ownership. For example, Treasury considered a tenant-in-common fractional interest ownership of an art collection[356] by a private foundation and a disqualified person. Because the art was owned as tenants-in-common, both the private foundation and the disqualified person by law had a right to possession for at least part of the time. This legal right to possession notwithstanding, the IRS found hanging the art in the personal residence of the disqualified person, even if for a proportionate amount of time, would be a direct use of a foundation asset and therefore an act of self-dealing.[357] Under this authority, the IRS would not abdicate its ability to oversee foundation assets; rather, self-dealing transactions within the administration of the co-tenancy would be subject to sanction.

This regime could be applied not only to the treatment of an investment partnership for Subchapter K purposes, but also for purposes of the application of Code Section 4941. Clearly, if the investment partnership could elect out of Subchapter K, then it would be ignored for subchapter K purposes and, instead, would be treated as if it were co-owned by the partners (here, presumably, the private foundation and its disqualified persons) directly. The concern arises, however as to whether the property is truly owned by the parties as "co-owners," as the property is, for state law purposes, treated as owned by the partnership. The IRS has taken the position that a limited partnership by definition cannot elect out of Subchapter K because it is not co-owned (a position completely contrary to the PLRs). Accordingly, the Code Section 761 election may not necessarily need to be made for purposes of Code Section 4941; rather, Code Section 761's standard might be deemed fulfilled by a general partnership if the foundation retains an interest in the underlying partnership property along the lines of a tenancy-in-partnership.

VI. CONCLUSION

The series of PLRs issued by the IRS endorsing the participation of private foundations in investment entities controlled by a foundation's disqualified persons could have been motivated by a desire to allow foundations to invest in manner that lowers fees and expands investment opportunities. In that regard, the

---

that the ownership of property as tenants in common by private foundations and disqualified persons is per se self-dealing." I.R.S. Gen. Couns. Mem. 39,770 n.1 (Dec. 15, 1988); *see also* Priv. Ltr. Rul. 96-51-037 (Sept. 20, 1996).

[356] Fractional ownership of art with a charity is a common technique used to avoid the limitation on the charitable contribution income tax deductions for partial interests in property. *See* I.R.C. § 170(f)(3)(B)(ii). *See generally,* Ramsay H. Slugg, HANDBOOK OF PRACTICAL PLANNING FOR ART COLLECTORS AND THEIR ADVISORS, ch. 11 (2015).

[357] I.R.S. Gen. Couns. Mem. 39,770 n.1 (Dec. 15, 1988) (citing Rev. Rul. 74-600, 1974-2 C.B. 385) (incidental or tenuous standard does not apply to the direct use of foundation assets by a disqualified person, as opposed to a benefit to a disqualified person flowing from the private foundation's use of its own assets).

IRS efforts may have been well intentioned, but the only way to achieve the desired result—by ignoring the existence of a transaction between the partnership and the foundation and re-characterizing the transaction as co-investment—is significantly flawed. The IRS exercised its anti-abuse discretion to allow a transaction that fundamentally violated the underlying tenants of Code Section 4941 and in so doing, caused significant theoretical inconsistency between various sections of the Internal Revenue Code as well as a disconnect between state and federal law. While consistency within the Code and among codes is not a necessary outcome if it otherwise does not accomplish the underlying goals of the legislation, to the extent that theoretical consistency can be achieved, it provides a beneficial level of guidance and uniformity that might otherwise be unachievable through other processes. Accordingly, the IRS should discard the co-investment concept of the PLRs and apply Code Section 4941 as if a transaction between the foundation and the investment partnership has occurred. To the extent that the IRS finds a need for a limited safe harbor, it should craft regulations that use existing law to create a theoretically consistent approach to co-ownership of investment assets that works with Subchapter K, Code Section 4941, and applicable state law.