PRIVATE FOUNDATIONS AND CO-INVESTMENTS—ANOTHER REASON THERE IS NO SELF-DEALING

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The more compelling reason for the conclusion is that the investment is not a sale or exchange.

In a recent *Taxation of Exempts* article,[1] Douglas Mancino and Ofer Lion conclude that a private foundation's investment in, or disposition of, a pooled investment vehicle (taxed as a partnership) is a "sale or exchange" for purposes of Section 4941 that, absent an exception, would be an act of self-dealing.[2] The authors further conclude that such an investment by a private foundation does not result in a self-dealing transaction between the pooled investment vehicle and the private foundation under Section 4941, based on the personal services exception to self-dealing contained in Section 4941(d)(2)(E) and the substance over form doctrine.[3]

The author of this article agrees with Mancino and Lion's ultimate conclusion that investments in pooled investment vehicles should not trigger the application of Section 4941. However, this article concludes that a more compelling reason for finding that such an investment or disposition is not an act of self-dealing is that the transaction is not a sale or exchange for purposes of Section 4941(d)(1)(A). This conclusion is based on an analysis of the meaning of the term "sale or exchange" as it is used in Section 4941, the propriety of treating the pooled investment vehicle as an aggregate of its owners for purposes of Section 4941, and the relationship between Section 4941 and Section 4943 and the regulations under each.[4]

The analysis in the following discussion is limited to investments by a private foundation in a pooled investment vehicle taxed as a partnership (a "co-investment partnership") with the following characteristics. The co-investment partnership is formed and operated to facilitate co-investment by its partners in corporate stocks, debt instruments, and other securities that generate passive income. At least 95% of such partnership's gross income is derived from passive sources; thus, under Section 4943(d)(3)(B) such partnerships are not "business enterprises" for purposes of Section 4943. The partnership's books and records maintain separate capital accounts for each of its partners; these accounts have the effect of strictly segregating each partner's interest in the partnership's assets from the interests of the other partners. Under Reg. 1.704-1(b)(2)(iv)(f), the capital accounts are adjusted to equal the fair market value of the partnership's assets immediately before any investment of funds is made in the partnership, or any withdrawal of funds is made from the partnership, so increases and

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decreases in the value of each partner's share of the partnership's assets are allocated and belong solely to that partner. Finally, the co-investment partnership is a disqualified person under Section 4946(a)(1)(F) with respect to any private foundation that becomes a partner because more than 35% of the interests in the partnership are held by disqualified persons with respect to the private foundation under Section 4946.

Mancino and Lion's article takes the position that an investment in a co-investment partnership, or a redemption of an interest in such a partnership, in form constitutes a sale or exchange of property under Section 4941. They maintain, however, that the IRS has implicitly adopted a substance-over-form approach in prior letter rulings and conclude that Section 4941 does not apply.[5] The article cites several examples in support of their conclusion that a contribution is in form a sale or exchange for purposes of Section 4941.[6] Two examples are in Reg. 53.4941(d)-2(a)(1). They involve a sale of incidental supplies and a bargain sale of stock or other securities by a disqualified person to a private foundation. Clearly, these examples involve transactions that should be treated as sales or exchanges for purposes of Section 4941(d)(1)(A) because the transactions are, at least in part, outright sales, both in form and substance. The economic relationship between the parties to the transaction in each example is changed by the transaction. By contrast, for the reasons discussed in detail below, a contribution made to a co-investment partnership does not change the economic relationship between the parties involved in the transaction. Thus, the examples in the regulations are not determinative with respect to whether a contribution to a co-investment partnership constitutes a sale or exchange for purposes of Section 4941(d)(1)(A).

Mancino and Lion also point out, in support of their conclusion that a contribution is in form a sale or exchange for purposes of Section 4941, that the acquisition of an interest in a co-investment partnership is comparable to acquiring an intangible personal property interest in stock or other securities, and that state law and the entity classification regulations under Section 7701 provide that a partnership is a distinct entity (and not a disregarded entity) for state law and federal tax purposes, respectively.[7] This author agrees that an interest in a co-investment partnership is intangible personal property. However, the status of an entity under state law should not affect the determination of whether there is a sale or exchange for federal income tax purposes in general and under Section 4941(d)(1)(A) specifically.[8] Further, an analogy to acquiring corporate stock or other corporate securities is misplaced because it does not address the tax law's requirement that a partnership be treated as an aggregate of its partners, rather than as an entity, when such treatment is appropriate.

This author submits that the analysis of the existence of a sale or exchange provided by Mancino and Lion is not comprehensive. The following discussion is intended to offer an alternative analysis of the meaning of the term "sale or exchange" for purposes of Section 4941(d)(1)(A) and to support the conclusion that a contribution by a private foundation to a co-investment partnership is not a sale or exchange, irrespective of form over substance considerations.

Meaning of 'sale or exchange' under Section 4941(d)(1)(A)—General propositions

Section 4941(d)(1) sets out several enumerated acts of self-dealing. Section 4941(d)(1)(A) specifies that any "sale or exchange, or leasing, of property between a private foundation and a disqualified person" is an act of self-dealing. The following, by way of background, are general propositions relevant to the meaning of the term "sale or exchange" as it appears in Section 4941(d)(1)(A).

The term "sale or exchange," as it appears in Section 4941(d)(1)(A), is not defined in the Code or regulations.[9] Section 4941(e) and Reg.

1 Mancino and Lion, "Co-Investing by Private Foundations and Disqualified Persons," 23 Exempts 3 (Nov/Dec 2011), page 3.

2 *Id.* at 8.

3 *Id.*

4 The remainder of this article makes reference only to contributions by a private foundation to such investment vehicles. The analysis would apply equally to a redemption of such an interest. Mancino and Lion's article also discusses the application of the personal services exception to self-dealing with respect to the management and investment advisory services provided by the co-investment partnership to its partners. This author agrees with the application of the personal services exception with respect to such services.

5 Mancino and Lion, *supra* note 1 at 5, 8-9.

6 *Id.* at 5.

7 *Id.*

8 See Morgan, 309 U.S. 78, 80-81, 23 AFTR 1046 (1940); Pierre, 133 TC 24, 29 (2009).

9 See Section 4941(d)(1)(A) and Reg. 53.4941(d)-2(a)(1).

53.4941(e)-1 define various terms used in Section 4941, but not "sale or exchange." Furthermore, it appears that "sale or exchange," as it appears in Section 4941(d)(1)(A), has no legislative history. Specifically, the legislative history of the Tax Reform Act of 1969 (which enacted Section 4941(d)(1)(A)) does not provide any guidance regarding the meaning that should be accorded to the term as used in that section.[10]

Because the term "sale or exchange" as used in Section 4941(d)(1)(A) is defined in neither the Code nor the regulations, it must be accorded a meaning that is consistent with the purposes that Section 4941(d)(1)(A) is designed to achieve.[11] Importantly, the meaning that should be given to the term as used in Section 4941(d)(1)(A) is not necessarily the same as the meaning given to this term when it is used elsewhere in the Code. This point deserves emphasis.

It is well-established that the same word or phrase may have one meaning for purposes of a particular section of the Code and a different meaning for purposes of another. For example, *Venture Funding Ltd.*[12] involved the meaning of the word "included" as it is used in almost adjacent Sections 83(a) and 83(h). A concurring opinion in that case stated:

> The dissent overlooks the different purpose and context of sections 83(a) and (h). The same word or phrase appearing in different places in the internal revenue laws may have different meanings depending on the context and legislative purpose involved. The context of section 83(a), an income inclusion provision, is different than section 83(h), a deduction provision.[13]

The leading cases in this area, cited in *Venture Funding*, are U.S. Supreme Court decisions. In one of these cases, *Helvering v. Stockholms Enskilda Bank*, 293 U.S. 84, 14 AFTR 675 (1934), the court reasoned with respect to the meaning of the term "obligations" as used in the Code that:

> [S]ince most words admit of different shades of meaning, susceptible of being expanded or abridged to conform to the sense in which they are used, the presumption [that a term has only one meaning] readily yields to the controlling force of the circumstance that the words, though in the same act, are found in such dissimilar connections as to warrant the conclusion that they were employed in the different parts of the act with different intent.[14]

Indeed, the Supreme Court has expressly said that it is appropriate to look to and follow the purpose of a statute when a literal reading of the statute would yield an unreasonable result.[15] This rule of statutory construction applies in construing the Code.[16]

The point here is that "sale or exchange," as used in Section 4941(d)(1)(A), does not necessarily have the same meaning as it has when it is used in (or in connection with) other sections of the Code. Assuming that a capital contribution is a sale or exchange for purposes of Section 721 (an income tax rule governing the recognition of gain by the contributor), it does not follow that the contribution must likewise be a sale or exchange for purposes of Section 4941(d)(1)(A). The two sections appear in different chapters of the Code and serve entirely different purposes. Capital contributions are not sales or exchanges even for all purposes of Subchapter K (i.e., the partnership provisions) of the Code. For example, Reg. 1.708-1(b)(2)

[10] See H. Rep't No. No. 91-413, 91st Cong., 1st Sess. (1969); S. Rep't No. 91-552 91st Cong., 1st Sess. (1969); H. Rep't No. 91-782, 91st Cong., 1st Sess. (Conference Report, 1969).

[11] Venture Funding Ltd., 110 TC 236, 238-42 (1998), *aff'd*, 198 F.3d 248, 84 AFTR2d 99-6929 (CA-6, 1999).

[12] *Id.*

[13] Note 11, *supra*. at Venture Funding Ltd., 110 TC at 251, Colvin, J., concurring.

[14] Helvering v. Stockholms Enskilda Bank, 293 U.S. 84 at 87, 14 AFTR 675. See also Helvering v. Morgan's Inc., 293 U.S. 121, 14 AFTR 681 (1934) (reasoning, with respect to the meaning of "taxable year" as used in the tax law, that "[t]he same meaning need not always be attributed to a phrase which, by hypothesis, has more than one meaning for purposes of statutory construction."). Additional authorities to the same effect include Rohmer, 153 F.2d 61, 65, 34 AFTR 826 (CA-2, 1946) (noting disagreement among the courts about the meaning of the term "sale" in the context of the tax treatment of intellectual property licenses, and observing that "[i]t is well to remember that the concepts employed in construing one section of a statute are not necessarily pertinent when construing another with a distinguishable background.") and B.C. Cook & Sons, Inc., 65 TC 422, 437-38 (1975) (Wilbur, J., dissenting) (noting that "[t]he words 'trade or business,' like the word 'deduction' a bread-and-butter term in the tax lexicon, have been given different meanings depending on context and legislative purpose." (citation omitted)).

[15] American Trucking Associations, 310 U.S. 534, 543 (1940).

[16] See B. C. Cook & Sons, Inc., *supra* note 14 at 434-35.

[17] McKee, Nelson and Whitmire, *Federal Taxation of Partnerships and Partners* (Warren, Gorham & Lamont, 2007), ¶ 9.01[8] at 9-45.

[18] See Youngwood and Weiss, "Partners and Partnerships—Aggregate vs. Entity Outside of Subchapter K," 48 Tax Law. 39 (Fall, 1994).

[19] Cf. Rev. Rul. 98-15, 1998-1 CB 718 (to analyze the consequences under Section 501(c)(3) of a tax-exempt charitable organization's participation in certain partnerships, it was first necessary to determine whether the partnerships should be viewed as aggregates of the partners or as entities).

[20] See, e.g., *id.*; Rev. Rul. 95-69, 1995-2 CB 38; Reg. 1.368-1(d)(4), Reg. 1.368-1(d)(5), Example (8), and Reg. 1.368-1(e)(5).

[21] Willis and Postlewaite, *Partnership Taxation* (Warren, Gorham & Lamont, 2011) ¶ 1.04[2][b] at 1-68.

[22] H. Rep't No. 83-2543, 83d Cong., 2d Sess. (1954) (Conference Report) (emphasis added).

expressly provides that a "contribution of property to a partnership does not constitute such a sale or exchange" (i.e., it does not constitute a sale or exchange for purposes of Section 708). Similarly, Reg. 1.707-3(a)(2) provides that the term "sale," when used in Reg. 1.707-3 through Reg. 1.707-5 to refer to a transaction between a partner and a partnership, means a transaction in which the partner acts in a capacity other than as a member of the partnership, and does not mean a capital contribution to a partnership or a distribution from a partnership to a partner governed by Sections 721 and 731, respectively. The term "sale or exchange" as it is used in Section 4941(d)(1)(A) should be given a meaning that is consistent with the purposes that Section 4941 is intended to achieve.

Capital contribution not a transaction between the foundation and the partnership

Many and perhaps all tax issues involving partnerships may be resolved only after making a threshold determination of whether a partnership should, for purposes of the particular problem, be treated as an entity or as an aggregation of its partners. According to the authors of one treatise: "Aggregate and entity concepts are intertwined throughout Subchapter K and can impact nearly every analysis made thereunder."[17] Two other authors essentially make the point that resolving this "entity versus aggregate" issue is integral to determining the tax consequences of virtually all scenarios in which partnerships are involved, and not merely those that arise under Subchapter K.[18]

Under Section 4946(a)(1)(F), a co-investment partnership is, by definition, a disqualified person with respect to a private foundation that may become a partner of that partnership. The reason is that more than 35% of the ownership interests in the partnership are owned by persons that are disqualified persons with respect to the private foundation under Section 4946. However, classification of that partnership as a disqualified person does not, in and of itself, have any bearing on whether that partnership should be treated as an entity or as an aggregate of its partners for any particular purpose. Nowhere in Section 4946, Section 4941, or the corresponding regulations is there guidance about whether a partnership that is a disqualified person may or must be treated as an entity, as opposed to an aggregate of its partners, for purposes of analyzing the consequencesof a capital contribution (or a redemption of a co-investment partnership interest) under Section 4941(d)(1)(A).

If the co-investment partnership is properly treated for these purposes as an aggregate of its partners, a capital contribution made by a private foundation to the partnership would not be a transaction between the private foundation and the partnership for tax purposes. The existence of the partnership would, in effect, be disregarded. Accordingly, it is appropriate to address this entity versus aggregate issue in connection with determining whether there is a sale or exchange between the co-investment partnership and a private foundation.[19]

How the entity versus aggregate issue is resolved depends on the circumstances at issue in any given situation. In some instances, the Code expressly adopts the entity approach. Section 706 (the entity's separate tax year), Section 708 (entity termination), and Section 703(b) (elections being generally made by partnerships, not partners) are examples. In other instances, the Code takes an aggregate approach and disregards the existence of the partnership. This happens in Section 701 (subjecting the partners, but not the partnerships, to tax) and Section 702 (under which income, deductions, and credits are taken into account by partners, not the partnership). In most situations, though, the Code does not resolve the issue. When this occurs, the Service has sometimes provided guidance in the form of published rulings and regulations.[20] In still other cases, the entity versus aggregate question has been resolved by litigation.

A prominent partnership tax treatise states that in *Basye,* 410 U.S. 441, 31 AFTR2d 73-802 (1973), the Supreme Court "left the entity-aggregate dichotomy intact to be dealt with almost on an ad hoc basis."[21] Such case-by-case resolution of the propriety of entity or aggregate partnership treatment actually seems consistent with Congressional intent. The Conference Committee Report regarding the enactment of the Internal Revenue Code of 1954 states:

> Both the House provisions and the Senate amendment provide for the use of the "entity" approach in the treatment of the transactions between a partner and a partnership which are described above. No inference is intended, however, that a partnership is to be considered as a separate entity for the purpose of applying other provisions of the internal revenue laws if the concept of the partnership as a collection of individuals is more appropriate for such provisions.[22]

Reg. 1.701-2(e) allows the Service to 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" (emphasis added).

As exemplified by the comprehensive "any provision of the Internal Revenue Code" language in Reg. 1.701-2(e), Section 4946(a)(1)(F), and Section 4941(d)(1)(A) are not exempted from the normal rules regarding the necessity of examining and taking into account the entity-aggregate dichotomy. The Service should treat a co-investment partnership as an aggregate of its partners if doing so is appropriate for carrying out the purposes of Section 4941(d)(1)(A). This author submits that it is appropriate, and that the co-investment partnership should be treated as an aggregate of its partners, rather than as an entity, for purposes of determining the consequences of a contribution made by a private foundation under Section 4941(d)(1)(A). This result is the most consistent with the economic realities of the co-investment partnership. It also appears that the Service has determined that aggregate treatment is appropriate in circumstances that are analogous to those involved in such a capital contribution.

When a private foundation and disqualified persons invest together in a co-investment partnership, the partnership, for purposes of analyzing the consequences of capital contributions, exists only to facilitate the co-investment arrangement of the partners. The partnership itself does not provide any products or services to anyone other than the partners, nor does it have any other separate or independent (i.e., entity-level) objectives or rationale for existing. When capital contributions are made by a private foundation, the only economic consequences, if any, are those that fall on the private foundation and possibly the other partners, not the partnership, which as an entity is indifferent to its economic circumstances. Thus, treating a co-investment partnership as an aggregate of its partners for purposes of determining whether a capital contribution is a sale or exchange under Section 4941(d)(1)(A) is consistent with the economic realities of the co-investment arrangement.

In addition, and as mentioned above, it appears that the Service has determined that aggregate treatment of partnerships is appropriate in circumstances that are similar to those involved in a capital contribution. For example, in Rev. Rul. 98-15, 1998-1 CB 718, the Service specifically blessed the aggregate treatment of partnerships in the exempt organizations context, stating:

> For federal income tax purposes, the activities of a partnership are often considered to be the activities of the partners [citing Butler, 36 TC 1097 (1961), *acq.*, 1962-2 CB 4]. Aggregate treatment is also consistent with the treatment of partnerships for purpose of the unrelated business income tax under section 512(c). See ... section 1.512(c)-1 [references to legislative history omitted]. In light of the aggregate principle discussed in Butler and reflected in section 512(c), the aggregate approach also applies for purposes of the operational test set forth in section 1.501(c)(3)-1(c). Thus, the activities of an LLC treated as a partnership for federal income tax purposes are considered to be the activities of a nonprofit organization that is an owner of the LLC....

This analysis, if applied to a capital contribution, would dictate that a private foundation partner in a co-investment partnership be treated as investing in the underlying assets of the partnership, and not as engaging in any transaction whatsoever with the partnership itself.

Similarly, Rev. Rul. 95-69, 1995-2 CB 38, involves a distribution of assets by a partnership. In this ruling the Service considered the consequences of a distribution by a partnership to its partners of stock received in a corporate merger. The ruling expressly reasons that the partners (not the partnership) indirectly owned the partnership's business, so the distribution to the partners of the stock received by the partnership in the merger did "not result in a change in [the partners'] underlying ownership of the ... business enterprise." Based on this aggregate partnership analysis, the ruling holds that satisfaction of the continuity of interest requirement applicable to corporate reorganizations was not affected by the partnership's distribution of the stock.

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[23] By applying the aggregate theory to a co-investment partnership to determine that there is not a sale or exchange for purposes of Section 4941(d)(1)(A), it is not necessary to rely on the substance-over-form analysis that appears to be implicitly acknowledged by the IRS in Ltr. Rul. 200318069. See Mancino and Lion, *supra* note 1, at 9.

[24] See Youngwood and Weiss, *supra* note 18, at 39 ("The basic thesis of this article is that there should be a strong presumption that the aggregate view prevails in applying the substantive domestic provisions of the Code outside of Subchapter K. There is no appropriate reason for such Code provisions to be applied one way when the business is jointly conducted by two or more persons through a partnership, and another way when the business is separately conducted by a single person. The presumption of aggregate treatment should apply both with respect to life as a partner and to the acquisition or disposition of a partnership interest.").

[25] Section 4943(c)(3).

[26] Section 4943(d)(3).

In both Rev. Rul. 98-15 and Rev. Rul. 95-69, the Service found that the purposes underlying the statutory provisions at issue were best achieved by disregarding—as entities—the existence of the partnerships involved in the rulings. Consider the effect on these rulings if the partnerships involved were disqualified persons with respect to private foundation partners. Surely the holdings of the rulings would not be affected. Again, mere classification of a partnership as a disqualified person under Section 4946(a)(1)(F) does not dictate entity level treatment of the partnership for all purposes.

Based on the apparent purposes of the Code, the only economic relationship of significance in a capital contribution is the relationship among the partners of the partnership. Under that premise and the revenue rulings discussed above, it is appropriate to treat a co-investment partnership receiving a capital contribution as an aggregate of the partners, not as a separate entity, for purposes of analyzing the consequences of the capital contribution under Section 4941(d)(1)(A).[23] Therefore, a capital contribution made by a private foundation to such a partnership is not a transaction between the private foundation and the partnership at all. The existence of the partnership is disregarded.[24]

Capital contribution not a sale or exchange under Section 4941(d)(1)(A)

As discussed above, the term "sale or exchange" as it is used in Section 4941(d)(1)(A) should be given a meaning that is consistent with the purposes of that section. More broadly, it should be given a meaning that gives effect to all of the private foundation provisions of Chapter 42 of the Code. The purposes of Section 4941(d)(1)(A) can be carried out, and all of the provisions of Chapter 42 can be given effect, only if capital contributions are not treated as sales or exchanges under that section.

As a starting point, Sections 4941(d)(1)(A) and 4943(c)(3) can both be given effect only if a capital contribution is not treated as a sale or exchange under Section 4941(d)(1)(A). The apparent express purpose of Section 4943 is to limit the extent to which private foundations and disqualified persons may co-invest in business enterprises. Section 4943 expressly permits private foundations to invest in partnerships together with disqualified persons, subject to certain aggregate ownership limitations.[25] The amount of such collective investment that is permitted by Section 4943 is unlimited in the case of a co-investment partnership (which derives at least 95% of its gross income from passive sources).[26] In other words, under Section 4943, a private foundation and disqualified persons with respect to the private foundation may own any amount of a co-investment partnership, up to and including a 100% interest.

If a capital contribution were treated as a sale or exchange under Section 4941(d)(1)(A), private foundation investments in a co-investment partnership that has disqualified person partners, although expressly permitted without limitation as to amount by Section 4943, would in every case constitute self-dealing and so would be prohibited under Section 4941. (This would be so if, as laid out in the introduction of this article, disqualified persons with respect to the private foundation own more than 35% of the interests in the partnership). This cannot be what Congress intended. It does not make sense to interpret Section 4941 as prohibiting something that is expressly permitted by Section 4943. These sections were enacted at the same time and must be read in harmony with each other.

Sections 4941 and 4943, when read together, provide that a capital contribution made by a private foundation to a co-investment partnership (if it is not a "business enterprise" as defined in Section 4943(d)(3)) cannot be treated as a sale or exchange under Section 4941(d)(1)(A). In enacting Section 4943(d)(3), Congress expressly singled out this type of partnership for special treatment that is not accorded to other partnerships. Recognizing that these types of capital contributions are not sales or exchanges under Section 4941(d)(1)(A) does not necessarily affect all capital contributions made by private foundations to partnerships, but rather affects only capital contributions made to partnerships like a co-investment partnership. This special treatment is, again, dictated by Section 4943(d)(3). Unless it is recognized that this special treatment effectively precludes capital contributions made by private foundations to a co-investment partnership from being treated as sales or exchanges under Section 4941(d)(1)(A), effect cannot be given to both Section 4941 and Section 4943.

Beyond the relationship between Sections 4941(d)(1)(A) and 4943, further guidance into the proper treatment of capital contributions made to a co-investment partnership is found in the self-dealing rules themselves—specifi-

cally, Section 4941(e)(3) and Reg. 53.4941(e)-1(c), which deal with correcting acts of self-dealing. The corrective actions required in the case of self-dealing described in Section 4941(d)(1)(A) (involving sale or exchanges) are not the same as are required in the case of self-dealing described in Section 4941(d)(1)(E) (involving transfers to or use by a disqualified person). Looking at the correction provisions as a whole, it is clear that Section 4941(d)(1)(A) is intended and designed to prevent any change in the economic relationship between a private foundation and a disqualified person, whereas Section 4941(d)(1)(E) is generally intended to prevent a disqualified person from receiving any benefit from the use of a private foundation's assets.

Specifically, in the case of sales or exchanges between a private foundation and a disqualified person, correction generally involves rescission of the entire transaction, not just the payment of an amount equal to the benefit realized by the disqualified person.[27] In the case of a disqualified person using private foundation property, correction generally involves terminating such use and paying the foundation an amount equal only to the economic benefit received by the disqualified person; rescission of the entire transaction is not required.[28] The difference between complete rescission and giving back only the benefit received shows that the prohibition on sales or exchanges is intended to prevent any change in the economic relationship of the parties. Otherwise, correction of a sale or exchange would involve only the repayment of any benefit received.

Given that the intent of Section 4941(d)(1)(A) is to prevent change in the economic relationship between a private foundation and disqualified persons, it logically follows that a capital contribution to a co-investment partnership is not a sale or exchange under that section. The reason is that a capital contribution does not result in any change in the economic relationship between a partner that is a private foundation and partners that are disqualified persons.

When property is transferred by a private foundation to a co-investment partnership in exchange for a partnership interest there is no change in the economic position of the partners among themselves. The private foundation holds an indirect interest in the assets of the partnership and is in the same economic position vis-à-vis the other partners as it would be in if it had purchased the assets directly. The values of the other partners' investments are unchanged by the transfer. They continue to hold their investments in the same pool of assets, with the same investment objectives, as before the transfer. There is no economic change in the relationship between the private foundation that transferred the assets and disqualified persons who were partners in the co-investment partnership before the transfer.

This result—no change in the economic relationship of the partners—is accomplished through the mechanism of a typical partnership agreement used for a co-investment partnership. Such a partnership generally must maintain a capital account for each partner that reflects that partner's share of the partnership's assets.[29] The capital accounts are adjusted to equal the fair market value of the partnership's assets immediately before any investment of funds is made in, or any withdrawal of funds is made from, the partnership. Thus, increases and decreases in the value of each partner's share of the partnership's assets are allocated and belong solely to that partner.[30] Even if a person may invest in the partnership at any time and the partners may withdraw part or all of their investment at any time, no such investment or withdrawal affects the value of the partnership interest of any other partner. The effect of the provisions of the partnership agreement is to preclude a private foundation's investment in a co-investment partnership in exchange for a partnership interest from having any economic impact on the partners, as among themselves.

The absence of—and the impossibility of there being—any change in the economic relationship between the contributing private foundation and the other partners demonstrates that a capital contribution to a co-investment partnership is not a sale or exchange under Section 4941(d)(1)(A). As discussed

[27] Regs. 53.4941(e)-1(c)(2), (3).

[28] Reg. 53.4941(e)-1(c)(4).

[29] Regs. 1.704-1(b)(2)(ii)(b)(1), (iv).

[30] Reg. 1.704-1(b)(2)(iv)(f).

[31] Reg. 53.4943-10(c)(1).

[32] Ltr. Rul. 9546028; Ltr. Rul. 9014063; Ltr. Rul. 8909027; Ltr. Rul. 8628076; Ltr. Rul. 8531072; Ltr. Rul. 7903001 and Ltr. Rul. 7830092 (both dated 4/28/78 and apparently the same ruling); Ltr. Rul. 8710095; Ltr. Rul. 9009067; Ltr. Rul. 9421039. *Cf.* Ltr. Rul. 8718049.

[33] Mancino and Lion, *supra* note 1, at 6-7.

above, Section 4941(d)(1)(A) is intended to prevent any change in the economic relationship between a private foundation and a disqualified person, without regard to whether the disqualified person receives any benefit from the transaction. Also as discussed above, under a typical partnership agreement of a co-investment partnership it is impossible for there to be any such change. If the capital contribution does not and cannot result in such a change, then the transaction is not a sale or exchange under Section 4941(d)(1)(A).

Additional considerations

The following considerations support the conclusion that capital contributions to a co-investment partnership should not be treated as a sale or exchange under Section 4941(d)(1)(A).

First, the conclusion that there is no sale or exchange is conservative. Section 4941(d)(1)(A)'s prohibition of a sale or exchange deals with the existence of economic change, regardless of benefit. Viewing a co-investment partnership as an aggregate of its partners, it is clear that no such change occurs when a capital contribution is made. Importantly, however, in recognizing that such a transfer is not a sale or exchange, there is no risk that a partnership arrangement might somehow nevertheless be used to benefit a disqualified person. Section 4941(d)(1)(E), which applies whether or not there is a sale or exchange, absolutely prohibits the existence of any such benefit (except benefit that is incidental or tenuous under Reg. 53.4941(d)-2(f)). Therefore, concluding that a transfer of assets to a co-investment partnership in exchange for a partnership interest is not a sale or exchange under Section 4941(d)(1)(A) does not constitute a loophole for abuse.

Second, the conclusion that there is no sale or exchange reflects the most authentic reading of the applicable provisions of the Code, regulations, and other authorities. Even if the co-investment partnership was treated as an entity, however, Section 4943 makes it clear that there would be no sale or exchange. The co-investment partnership is a passive investment partnership and is not a "business enterprise" under Section 4943(d)(3). The amount of ownership that a private foundation may have in the partnership is unlimited.[31] Therefore, a capital contribution to the co-investment partnership cannot be a sale or exchange, even if the partnership is treated as an entity for Section 4941(d)(1)(A) purposes. Any other conclusion would read Section 4943 out of the Code.

In addition, Section 4941(d)(2)(F) by its terms applies only to certain corporate readjustments. Corporations are separate entities, and so Section 4941(d)(2)(F) is needed to prevent transactions that merely rearrange the ownership of assets (but do not change economic relationships) from being treated as sales or exchanges and therefore as acts of self-dealing. A similar provision is not needed in the case of partnerships because the economic relationship of importance in a partnership is the relationship of the partners among themselves. Thus, Section 4941(d)(2)(F) supports the treatment of partnerships as aggregates, rather than as entities, for purposes of Section 4941(d)(1)(A). Moreover, the apparent underlying rationale of Section 4941(d)(2)(F) would seem to apply to a capital contribution made in exchange for a partnership interest. In this regard, Section 4941(d)(2)(F) is analogous to Reg. 53.4941(d)-1(b)(2), which by its terms deals only with payments that are made to government officials by an intermediary organization that has received a grant from a private foundation. However, the rationale of Reg. 53.4941(d)-1(b)(2) would appear to apply equally to any other grant that is made by a private foundation to a public charity and used by the public charity for the benefit of a disqualified person; the Service has, in fact, uniformly applied the regulation in that way.[32] In a similar fashion, the rationale of Section 4941(d)(2)(F) should be considered to support the conclusion regarding the consequences of a transfer of assets by a private foundation to a co-investment partnership in exchange for a partnership interest.

The transaction is not a sale or exchange for purposes of Section 4941(d)(1)(A)

Finally, but very importantly, co-investment partnerships provide significant benefits to private foundations, including obtaining cost savings and greater negotiating power through achieving economies of scale and access to investments that would not otherwise be available due to minimum investment requirements, providing opportunities for better investment diversification, and obtaining various packaged investment services. As noted by Mancino and Lion, the Service has recognized in numerous private letter rulings that such partnerships are fundamentally good.[33]

Conclusion

For the above-stated reasons, a capital contribution to a co-investment partnership should not be treated as a sale or exchange under Section 4941(d)(1)(A), regardless of form-over-substance considerations.

The statutory scheme respecting the treatment of such capital contributions has three main elements. One element is the treatment of partnerships as aggregates of their partners. The second and third elements are the relationship between Sections 4941(d)(1)(A) and 4943, on the one hand, and the relationship between the self-dealing correction provisions set forth in Section 4941(e)(3) and Reg. 53.4941(e)-1(c), on the other. The purposes of Section 4941(d)(1)(A) can be carried out, and the relevant provisions of Chapter 42 of the Code can be given effect, only if all three of these elements are considered together. When they are, it is clear that capital contributions are not sales or exchanges under Section 4941(d)(1)(A).

Finally, the Service's ruling policy allowing a private foundation to invest in a co-investment partnership should not be reversed. This author agrees with Mancino and Lion that it would be helpful if the Service issued guidance to assure private foundations that investments in co-investment partnerships will not result in self-dealing taxes under Section 4941. ■