

§ 7973—Prohibited Transactions

34 Am Jur 2d

ceives the benefit of, the transaction is one of the following:

... The creator of the organization (if a trust).

... A substantial contributor to the organization.

... A member of the family (brother, sister, spouse, ancestors, or lineal descendant) of the creator or of a substantial contributor.

... A corporation controlled by the creator or a substantial contributor through direct or indirect ownership of 50% or more of the total combined voting power or of the total value of all the stock.²

1. Code Sec. 503(c).
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§ 7973. Potential prohibited transactions don't bar exemption. The prohibited transaction bar is against *actually engaging* in prohibited transactions. The mere fact that an organization has authority under its governing instrument to enter into what would be prohibited transactions won't deprive it of its exemption as long as it doesn't actually engage in any prohibited transactions.¹

1. *Waller*, 39 T.C. 665(A).

§ 7974. Decisions, rulings, etc., on prohibited transactions. The following have been held not to constitute prohibited transactions:

... Indirect benefit derived, from distributions by an exempt trust, by relatives of employees of the creator corporation.¹

... A loan by an exempt trust to a corporation which controls the creator corporation.²

... A loan to the creator who gave his note which required him to deliver as security, on request, mortgages on specific real estate worth several times the amount of the loan. The loan wasn't without adequate security.³

But the following have been held to be prohibited transactions:

... An unsecured loan to the creator of an exempt trust notwithstanding that the creator was solvent and in sound financial condition. *Adequate security* refers to collateral not to the creator's financial condition.⁴

... Loan to partnership by an exempt organization to which the general partner was a substantial contributor, notwithstanding that the loan was the joint and several liability of all the partners and each partner had sufficient assets to satisfy the entire loan, where it wasn't otherwise secured.⁵

✓ *observation*: The Sixth Circuit suggests that where an exempt trust purchases equipment by borrowing under a chattel mortgage arrangement and then leases the mortgaged

equipment to the creator of the trust, the transaction may constitute a prohibited loan.⁶

✓ *observation*: Some decisions have allowed employer's deductions for their unsecured notes given to an employee trust in payment of their contributions. Where the deduction is allowed in one year and the note isn't paid until the following year, the effect is the same as if the employer had borrowed from the trust for the period from the end of the year in which deduction is allowed until the note is paid.

1. Rev. Rul. 96, CB 1963-1, 264.
2. Rev. Rul. 58-526, CB 1958-2, 269.
3. *William Clay, Jr., Foundation v. U.S.*, 233 F. Supp. 628.
4. *Van Products, Inc.*, 40 T.C. 1018.
5. Rev. Rul. 65-202, CB 1965-2, 172.
6. *Cooper Tire & Rubber Co. Employee's Retirement Fund v. Com.*, 306 F. (2d) 20.

§ 7975. Security for loans by employee trusts. A special rule exempts certain loans by employee trusts from the *adequate security* requirement. This exemption applies only to:

... Employees' supplemental unemployment benefit trusts, described in Code Sec. 501(c)(17).

... Qualified employee pension, profit sharing or stock bonus trusts, described in Code Sec. 401(a).

A bond, debenture, note, or certificate or other evidence of indebtedness acquired by such an employee trust won't be treated as a loan made without adequate security if:

... The obligation is, in general, acquired by the trust *either* in the market at the market price *or* from an underwriter in an SEC registered offering at the public offering price at which a substantial portion of the same issue is acquired by persons independent of the issuer *or* from the issuer at a price that isn't higher than that paid currently for a substantial portion of the same issue by persons independent of the issuer. These rules are spelled out in detail in the Code and regs.¹

... Immediately following the trust's acquisition of the obligation, it holds not more than 25%, and persons independent of the issuer hold at least 50%, of the aggregate amount of obligations issued, in such issue, and outstanding at the time of acquisition.²

... Immediately following the trust's acquisition of the obligation not more than 25% of the trust's assets is invested in obligations of the creator of the trust or any other person or corporation with whom a prohibited transaction is barred.³

A change in the terms of an obligation is considered as the acquisition of a new obligation to which the foregoing requirements apply.⁴