



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

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Contact Person:

Identification Number:

Telephone Number:

UIL Index

501.03-00

4941.04-00

4943.04-03

Legend:

M =

X =

Dear _____ :

This responds to a letter from M's authorized representatives, who requested rulings under sections 501(c)(3), 4941, and 4943 of the Internal Revenue Code on M's behalf.

Facts:

M is a nonprofit corporation exempt from federal income taxation as an organization described in section 501(c)(3) of the Code. M is classified as a private foundation within the meaning of section 509(a) of the Code. N and O have not yet been identified, but will also be organizations described in section 501(c)(3) of the Code and private foundations within the meaning of section 509(a) of the Code. M, N, and O all hold investment assets and use the investment earnings to fund grants to other charitable organizations.

A substantial contributor to M ("Donor") is an individual with considerable wealth derived largely from the construction and development of commercial real estate and from investments in commercial real estate. Donor wishes to create a vehicle through which he may join with others who have experience with real estate investments to provide opportunities for their respective charitable foundations to participate in real estate investments at relatively low risk.

X is a general partnership. X is a disqualified person (within the meaning of section 4946 of the Code) with respect to M because substantial contributors (within the meaning of section 507(d) of the Code) with respect to M, including Donor, own more than 35 percent of the profits interest of X. Y and Z have not yet been identified, but will be entities or individuals that are disqualified persons with respect to N and O respectively. X will not be a disqualified person with respect to N or O, Y will not be a disqualified person with respect to M or O, and Z will not be a disqualified

person with respect to M and N.

M, N, and O will form a limited liability company (the "Land LLC") and will be the members of the Land LLC. Member interests will be measured in units. Each member will have 1,000 units and will be entitled to one vote for each unit. Profits and losses will be allocated in proportion to the number of units held by each member. The business and affairs of the Land LLC will be managed by a board of three directors. Each member will have the right to appoint one director and each director will have one vote. No person who is a disqualified person with respect to more than one private foundation that is a member of the Land LLC will be permitted to serve as a member, unit holder, or director of the Land LLC during the term of the lease described below.

The Land LLC will acquire one or more parcels of land (the "Land") from one or more persons who are not disqualified persons with respect to M, N, or O. The Land will not be subject to acquisition indebtedness within the meaning of section 514(c) of the Code. The sole activity of the Land LLC will be to own the land for the purpose of leasing it. The governing documents of the Land LLC will require that at least 95% of the gross income of the LLC be derived from passive sources within the meaning of section 4943(d)(3)(B) of the Code, and the Land LLC will comply with that requirement.

M, or one or more of its foundation managers acting only in such capacity, may not, by aggregating their votes or positions of authority, require the Land LLC to engage in any transaction. The same will be true of N and its foundation managers, and O and its foundation managers. X, together with one or more persons who are disqualified persons by reasons of such person or persons' relationship (within the meaning of section 4946(a)(1)(C) through (G)) to X, may not, only by aggregating their votes or positions of authority with that of M, require the Land LLC to engage in any transaction. The same will be true of Y and such disqualified persons with respect to N, and Z and such disqualified persons with respect to O. Neither M, nor M together with X or one or more persons who are disqualified persons by reason of such person's relationship (within the meaning of section 4946(a)(1)(C) through (G)) to X, will be able in fact to control the Land LLC, and no such person will have the right to exercise veto power over actions of the Land LLC.

X, Y, and Z will form a limited liability company (the "Building LLC") and will be the members of the Building LLC. Member interests will be measured in units. Each member will have 1,000 units and will be entitled to one vote for each unit. No person who is a disqualified person with respect to a private foundation that is a member of the Land LLC will be permitted to hold more than 35 percent of the units of the Building LLC during the term of the Lease. Profits and losses will be allocated in proportion to the number of units held by each member. The business and affairs of the Building LLC will be managed by a board of three directors. Each member will have the right to appoint one director. No person who is a disqualified person with respect to more than one private foundation that is a member of the Land LLC will be permitted to serve as a member, unit holder, or director of the Building LLC during the term of the Lease, defined below.

M, or any of its foundation managers acting only in such capacity, may not, by aggregating their votes or positions of authority, require the Building LLC to engage in any transaction. The same

will be true of N and its foundation managers, and O and its foundation managers. Similarly, the Land LLC will have no power, acting alone or with others, to require the Building LLC to engage in any transaction. Neither M, nor M together with X or one or more persons who are disqualified persons by reason of such person's relationship (within the meaning of section 4946(a)(1)(C) through (G)) to X, will be able in fact to control the Building LLC, and no such person will have the right to exercise veto power over actions of the Building LLC.

The Land LLC will lease the Land under a long-term lease (the "Lease") to the Building LLC, which will pay market-rate rent to the Land LLC for the term of the Lease. The rent amount will be based on a valuation conducted by an independent valuation expert. The Building LLC will construct one or more commercial buildings (the "Building") on the Land, and will lease the space within the Building at market rates. The construction of the Building will be debt-financed, with the debt secured by the Building and the leasehold interest. It is anticipated, although not a requirement of the Transaction, that X, Y, and Z will at some later date donate their membership interests in the Building LLC to one or more charitable organizations. The term "Transaction" refers to, collectively, the acquisition of the Land by the Land LLC, the leasing of the Land to the Building LLC, the construction of the Building by the Building LLC, and the leasing of the Building by the Building LLC to third parties.

Rulings Requested:

The following rulings are requested:

1. The Transaction will not adversely affect the status of M as an organization described in section 501(c)(3) of the Code.
2. The Transaction will not constitute one or more acts of self-dealing between M and a disqualified person with respect to M within the meaning section 4941 of the Code.
3. The Transaction will not result in M having excess business holdings in a business enterprise within the meaning of section 4943 of the Code.

Law:

Section 501(c)(3) of the Code describes corporations, trusts, and associations organized and operated exclusively for charitable and other exempt purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(a)-1(c) of the Income Tax Regulations provides that the words "private shareholder or individual" refer to persons having a personal and private interest in the activities of the organization.

Section 1.501(c)(3)-1(c)(2) of the regulations provides that an organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals.

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations provides that an organization is not organized or operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. Thus, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

Rev. Rul. 76-91, 1976-1 C.B. 149, holds that the purchase, in a transaction not at arm's length, of all of the assets of a profit-making hospital by a nonprofit hospital corporation at a price that includes the value of intangible assets, determined by the capitalization of excess earnings formula, does not result in the inurement of the hospital's net earnings to the benefit of any private shareholder or individual or serve a private interest precluding exemption under section 501(c)(3) of the Code. The ruling states that, generally, where an organization purchases assets from an independent third party, a presumption exists that the purchase price (arrived at through negotiations) represents fair market value. However, where the purchaser is controlled by the seller (or there is a close relationship between the two) at the time of the sale, this presumption cannot be made because the elements of an arm's length transaction are not present. In situations where there is common control of or a close relationship between the buyer and seller and both tangible and intangible assets are being purchased, the value of the tangible assets must first be established by independent appraisal. The purchaser must then establish the components of the intangible assets, indicate how these components will be used to further its exempt purposes, and establish the aggregate value of these intangibles.

Section 4946(a)(1) of the Code provides that the term "disqualified person" means, with respect to a private foundation, a person who is--

- (A) a substantial contributor to the foundation,
- (B) a foundation manager (within the meaning of subsection (b)(1)),
- (C) an owner of more than 20 percent of--
 - (i) the total combined voting power of a corporation,
 - (ii) the profits interest of a partnership, or
 - (iii) the beneficial interest of a trust or unincorporated enterprise,which is a substantial contributor to the foundation,
- (D) a member of the family (as defined in subsection (d)) of any individual described in subparagraph (A), (B), or (C),
- (E) a corporation of which persons described in subparagraph (A), (B), (C), or (D) own more than 35 percent of the total combined voting power,
- (F) a partnership in which persons described in subparagraph (A), (B), (C), or (D) own more than 35 percent of the profits interest,
- (G) a trust or estate in which persons described in subparagraph (A), (B), (C), or (D) hold more than 35 percent of the beneficial interest,
- (H) only for purposes of section 4943, a private foundation--
 - (i) which is effectively controlled (directly or indirectly) by the same person or persons who control the private foundation in question, or
 - (ii) substantially all of the contributions to which were made (directly or indirectly) by the same person or persons described in subparagraph (A), (B), or (C), or members of their families (within the meaning of subsection (d)), who made (directly or indirectly)

substantially all of the contributions to the private foundation in question, and
(l) only for purposes of section 4941, a government official (as defined in subsection (c)).

Section 4946(a)(2) of the Code provides that, for purposes of paragraph (1), the term "substantial contributor" means a person who is described in section 507(d)(2).

Section 4941(a)(1) of the Code imposes a tax on each act of self-dealing between a disqualified person and a private foundation.

Section 4941(d)(1) of the Code provides that the term "self-dealing" means any direct or indirect--

- (A) sale or exchange, or leasing, of property between a private foundation and a disqualified person;
- (B) lending of money or other extension of credit between a private foundation and a disqualified person;
- (C) furnishing of goods, services, or facilities between a private foundation and a disqualified person;
- (D) payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person;
- (E) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation; and
- (F) agreement by a private foundation to make any payment of money or other property to a government official (as defined in section 4946(c)), other than an agreement to employ such individual for any period after the termination of his government service if such individual is terminating his government service within a 90-day period.

Section 53.4941(d)-1(b)(1) of the Foundation and Similar Excise Taxes Regulations provides that the term "indirect self-dealing" shall not include any transaction described in section 53.4941(d)-2 (e.g., the leasing of property) between a disqualified person and an organization controlled by a private foundation under certain circumstances.

Section 53.4941(d)-1(b)(4) of the regulations provides that a transaction between a private foundation and an organization which is not controlled by the foundation (within the meaning of subparagraph (5) of this paragraph), and which is not described in section 4946(a)(1)(E), (F), or (G) of the Code because persons described in section 4946(a)(1)(A), (B), (C), or (D) own no more than 35 percent of the total combined voting power or profits or beneficial interest of such organization, shall not be treated as an indirect act of self-dealing between the foundation and such disqualified persons solely because of the ownership interest of such persons in such organization.

Section 53.4941(d)-1(b)(5) of the regulations provides that an organization is controlled by a private foundation if the foundation or one or more of its foundation managers (acting only in such capacity) may, only by aggregating their votes or positions of authority, require the organization to engage in a transaction which if engaged in with the private foundation would constitute self-dealing. Similarly, for purposes of this paragraph, an organization is controlled by a private foundation in the case of such a transaction between the organization and a

disqualified person, if such disqualified person, together with one or more persons who are disqualified persons by reason of such a person's relationship (within the meaning of section 4946(a)(1)(C) through (G) of the Code) to such disqualified person, may, only by aggregating their votes or positions of authority with that of the foundation, require the organization to engage in such a transaction. The "controlled" organization need not be a private foundation; for example, it may be any type of exempt or nonexempt organization including a school, hospital, operating foundation, or social welfare organization. For purposes of this paragraph, an organization will be considered to be controlled by a private foundation or by a private foundation and disqualified persons referred to in the second sentence of this subparagraph if such persons are able, in fact, to control the organization (even if their aggregate voting power is less than 50 percent of the total voting power of the organization's governing body) or if one or more of such persons has the right to exercise veto power over the actions of such organization relevant to any potential acts of self-dealing.

Section 4943(c)(1) of the Code provides that the term "excess business holdings" means, with respect to the holdings of any private foundation in any business enterprise, the amount of stock or other interest in the enterprise which the foundation would have to dispose of to a person other than a disqualified person in order for the remaining holdings of the foundation in such enterprise to be permitted holdings.

Section 53.4943-3(b)(1)(i) of the regulations provides that, except as otherwise provided in sections 4943(c)(2) and (4) of the Code, the permitted holdings of any private foundation in an incorporated business enterprise (including a real estate investment trust, as defined in section 856) are:

- (A) 20 percent of the voting stock in such enterprise reduced (but not below zero) by
- (B) The percentage of voting stock in such enterprise actually or constructively owned by all disqualified persons.

Section 53.4943-3(c)(2) of the regulations provides that, in the case of a partnership (including a limited partnership) or joint venture, the terms "profits interest" and "capital interest" shall be substituted for "voting stock" and "nonvoting stock," respectively, wherever those terms appear in paragraph (b) of this section.

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

- (A) a functionally related business (as defined in section 4942(j)(4)), or
- (B) a trade or business at least 95 percent of the gross income of which is derived from passive sources.

For purposes of subparagraph (B), gross income from passive sources includes the items excluded by section 512(b)(1), (2), (3), and (5), and income from the sale of goods (including charges or costs passed on at cost to purchasers of such goods or income received in settlement of a dispute concerning or in lieu of the exercise of the right to sell such goods) if the seller does not manufacture, produce, physically receive or deliver, negotiate sales of, or maintain inventories in such goods.

Section 512(b)(3) of the Code provides that, in the case of rents--

- (A) Except as provided in subparagraph (B), there shall be excluded--
- (i) all rents from real property (including property described in section 1245(a)(3)(C)), and
 - (ii) all rents from personal property (including for purposes of this paragraph as personal property any property described in section 1245(a)(3) (B)) leased with such real property, if the rents attributable to such personal property are an incidental amount of the total rents received or accrued under the lease, determined at the time the personal property is placed in service.
- (B) Subparagraph (A) shall not apply--
- (i) if more than 50 percent of the total rent received or accrued under the lease is attributable to personal property described in subparagraph (A)(ii), or
 - (ii) if the determination of the amount of such rent depends in whole or in part on the income or profits derived by any person from the property leased (other than an amount based on a fixed percentage or percentages of receipts or sales).
- (C) There shall be excluded all deductions directly connected with rents excluded under subparagraph (A).

Section 53.4943-10(c)(2) of the regulations provides, in part, that any income classified as passive does not lose its character merely because section 512(b)(4) or 514 of the Code (relating to debt-financed income) applies to such income.

Analysis:

Section 501(c)(3) status -- Inurement and Private Benefit

Rev. Rul. 76-91, *supra*, indicates that the purchase of assets, when the seller controls the purchaser (or has a close relationship with the purchaser), does not result in inurement of the purchaser's net earnings to the benefit of any private shareholder or individual if the value of the assets are established by independent appraisal.

X, Y, and Z each are "private shareholders or individuals" within the meaning of section 501(c)(3) of the Code and sections 1.501(c)(3)-1(c)(2) and 1.501(c)(3)-1(d)(1)(ii) of the regulations with respect to the private foundations with which they are associated, respectively. The Transaction will not, however, result in private inurement to X, Y, or Z, or result in M being operated for the benefit of private interests because the Land LLC will lease the Land to Building LLC for a market-rate rent which will be based on a valuation conducted by an independent valuation expert. Because the Land LLC will receive fair market rent, M, N, and O will not be using their income or assets to subsidize or otherwise benefit their respective private parties, X, Y, or Z. For the same reason, there is no impermissible private benefit to X, Y, or Z because the Lease between the Land LLC and the Building LLC will be for fair market value.

Direct Self-Dealing

Under section 4941(d)(1)(A) of the Code, the direct or indirect leasing of property between a private foundation and a disqualified person is, generally, an act of self-dealing. X is a disqualified person with respect to M because substantial contributors with respect to M own

more than 35 percent of the profits interest in X.

According to section 4946(a)(1)(F) of the Code, Land LLC would be a disqualified person with respect to M only if a substantial contributor to M, a foundation manager of M, a 20 percent owner of a substantial contributor, or family members of the foregoing owned more than 35 percent of the profits interest in Land LLC. Since only M, N, and O will be members of Land LLC, and each will hold less than a 35 percent profits interest, Land LLC is not a disqualified person with respect to M.

Similarly, the Building LLC is not a disqualified person with respect to M because substantial contributors, foundation managers, 20 percent owners of substantial contributors, and members of the families of the foregoing with respect to M do not own more than 35 percent of the profits interest of the Building LLC. The Transaction therefore will not involve any direct transaction between M and a disqualified person.

Indirect Self-Dealing through Building LLC

The interest of X (a disqualified person with respect to M) in the Building LLC will not cause the Transaction between X and Building LLC to be an indirect self-dealing transaction between X and M.

Under section 53.4941(d)-1(b)(4) of the regulations, transactions between a private foundation and an organization in which the foundation's disqualified persons own 35 percent or less of the voting power or profits interest shall not be treated as an act of indirect self-dealing between the private foundation and the disqualified persons solely because of the ownership interest of such persons in the organization, provided that the organization is not controlled by the private foundation.

X owns only 33¹/₃ percent of the voting and profits interest in the Building LLC. Because X does not hold more than 35 percent of the voting power or profits interest of the Building LLC, the first condition of section 53.4941(d)-1(b)(4) of the regulations is satisfied.

The second condition of section 53.4941(d)-1(b)(4) of the regulations is also satisfied because M does not control the Building LLC. Under section 53.4941(d)-1(b)(5), the Building LLC would be controlled by M if M or one or more of its foundation managers (acting only in such capacity) could, only by aggregating their votes or positions of authority, require the Building LLC to engage in a particular transaction. Alternatively, M would control the Building LLC if a disqualified person, together with one or more persons who are disqualified persons by reason of section 4946(a)(1)(C), (D), (E), (F), or (G) of the Code, could, only by aggregating their votes or positions of authority with that of M, require the Building LLC to engage in the transaction. Finally, M would control the Building LLC if M, or M together with its disqualified persons, were able "in fact" to control the Building LLC or if one or more of such persons were able to veto the actions of the Building LLC relevant to any potential acts of self-dealing. Neither M nor X nor any disqualified persons with respect to M, either alone or in combination, has any of the powers necessary in order to find control of the Building LLC under section 53.4941(d)-1(b)(5).

Indirect Self-Dealing through Land LLC

Section 53.4941(d)-1(b)(1) of the regulations implies that certain transactions between a disqualified person and an organization controlled by a private foundation will be regarded as indirect self-dealing. However, the interest of M in Land LLC will not cause the Transaction between Land LLC and X to be an indirect self-dealing transaction between M and X because the Land LLC will not be controlled by M within the meaning of section 53.4941(d)-1(b)(5). Neither M nor any disqualified persons with respect to M, either alone or in combination, has any of the powers necessary in order to find control of the Land LLC under section 53.4941(d)-1(b)(5).

Excess Business Holdings

Section 4943 of the Code imposes a tax on the excess business holdings of any private foundation in a business enterprise. Under section 4943(d)(3)(B) of the Code, a trade or business in which at least 95 percent of the gross income is derived from passive sources is not a "business enterprise" for purposes of section 4943. Income from passive sources includes rents from real property excluded by section 512(b)(3) of the Code. Income from passive sources does not lose its character merely because it is unrelated debt-financed income within the meaning of section 514.

M's interest in the Land LLC does not constitute an excess business holding in a business enterprise within the meaning of section 4943 of the Code because the Land LLC is not a "business enterprise." At least 95 percent of the income of the Land LLC will be passive income in the form of rents received from the Building LLC. Because the Land LLC will not be a business enterprise, M's interest in the Land LLC will not constitute excess business holdings in a business enterprise.

Conclusions:

Accordingly, based on the information submitted, we rule as follows:

1. The Transaction will not adversely affect the status of M as an organization described in section 501(c)(3) of the Code.
2. The Transaction will not constitute one or more acts of self-dealing between M and a disqualified person with respect to M within the meaning section 4941 of the Code.
3. The Transaction will not result in M having excess business holdings in a business enterprise within the meaning of section 4943 of the Code.

This ruling is made on the understanding that there will be no material changes in the facts upon which it is based.

Except as specifically ruled upon above, no opinion is expressed concerning the federal income tax consequences of the transactions described above under any other provision of the Code.

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

Pursuant to a Power of Attorney on file in this office, a copy of this letter is being sent to M's authorized representative. A copy of this letter should be kept in M's permanent records.

If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Jane Baniewicz
Manager, Exempt Organizations
Technical Group 2