



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:
Employer Identification Number:

Legend:

Enterprises =
Estate =
x1 =

Dear

This is in response to your ruling request dated August 15, 2006 and as amended on April 8, 2011, requesting a ruling on the proper treatment, under section 4943 of the Internal Revenue Code ("Code"), of your continued retention of the shares of Enterprises stock.

FACTS

You are a non-profit corporation recognized as an organization exempt from federal income tax under section 501(c)(3) of the Code and are classified as a private foundation within the meaning of section 509(a). The purposes for which you are organized and operated are to provide charitable and educational services to underprivileged children, who come from troubled or broken homes, who are in need of special services or treatment, or who are otherwise at risk, underprivileged or institutionalized.

You were created to receive the assets of the Estate. The assets you received included cash and _____ shares of the issued and outstanding common stock of Enterprises. The shares represent a 100 percent interest in Enterprises.

You state that you hold the stock for the following purposes:

- Enterprises will continue to lease a portion of its real property to a local rancher, and you desire to maintain Enterprises as a separate entity in order to obtain the benefit of the liability shield,
- Enterprises will conduct sporadic logging and thinning activities by contracting with independent third parties,

- During the course of the probate proceedings for the Estate, a dispute arose concerning the ownership of Enterprises stock by other family members who are not disqualified persons. In order to settle the dispute, Enterprises was required to borrow money from the Estate in order to redeem the Enterprises stock held by those other family members. Enterprises gave the Estate a promissory note. This transaction was approved by the probate court during the settlement and distribution proceeding of the Estate. You are now the holder of the note through your ownership of 100 percent of the stock of Enterprises and,
- Enterprises will facilitate the payment of the debt obligation to you resulting from the settlement of the Estate and provide a liability shield with respect to the hazardous logging and milling activities.

You represent that all of Enterprises income will be from passive sources, including the rental income from the leasing of the grazing land to a rancher. In addition, Enterprises will pay the excess income to you in the form of dividends. On occasion, an independent third party company will enter upon the property for timber harvesting activities; the timber harvesting is a sporadically conducted thinning activity. You state that Enterprises will enter into contracts with third parties who will cut and remove the timber. Under the contracts you will retain an economic interest in the timber pursuant to section 631(b) of the Code. In addition, you represent that all of Enterprises' revenue will be passive source income and that no election under section 631(a) will be made in conjunction with the timber harvesting activity. This ruling request is limited to those timber cutting transactions that you represent qualify under sections 631(a) and (b).

RULINGS REQUESTED

You requested a ruling that your ownership of 100 percent of the Enterprises stock will not be classified as "excess business holdings" under section 4943(c) of the Code because at least 95 percent of Enterprises gross income will be derived from passive sources.

LAW

Section 512(b)(3) of the Code excludes from unrelated business taxable income (i) all rents from real property, 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.

Section 512(b)(5) of the Code excludes from the computation of unrelated business taxable income all gains or losses from the sale, exchange, or other disposition of property. However, this section does not apply with respect to the cutting of timber which is considered, on the application of section 631, as a sale or exchange of such timber.

Section 513(a)(1) of the Code provides that the term unrelated trade or business means any

trade or business the conduct of which is not substantially related, aside from the need of such organization for the income or funds or the use it makes of the profits derived, to the exercise or performance by such organization of its charitable, educational or other purpose constituting the basis of its exemption under section 501.

Section 631(a) of the Code provides that a taxpayer may make an election to treat the cutting of timber as a sale or exchange of such timber cut during the year provided that the timber was owned or held under a contract right to cut for a period of more than one year.

Section 631(b) of the Code provides that, in the disposal of timber held by the owner for more than one year under a contract by which the owner retains an economic interest in such timber, the difference between the amount realized from the disposal and the adjusted depletion basis shall be considered as though it were a gain or loss on the sale of such timber.

Section 4943(a)(1) of the Code imposes excise taxes on the excess business holdings of any private foundation in a business enterprise.

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 4943(c)(2)(A)(i) of the Code provides in part that the permitted holdings of any private foundation in an incorporated business enterprise are 20 percent of the voting stock, reduced by the percentage of the voting stock owned by all disqualified persons.

Section 4943(d)(3) of the Code provides that the term "business enterprise" does not include a trade or business at least 95 percent of the gross income of which is derived from passive sources. Gross income from passive sources includes the items excluded by section 512(b)(1), (2), (3), and (5).

Section 1.512(b)-1(d)(1) of the Income Tax Regulations ("regulations") states in part, that the exclusion from unrelated business taxable income contained in section 512(b)(5) of the Code does not apply with respect to the cutting of timber which is considered, upon the application of section 631(a), as a sale of such timber.

Section 1.631-2(a)(2) of the regulations provides that in the case of a disposal of timber under section 631(b) of the Code, the provisions of section 1231 apply and such timber shall be considered to be property used in the trade or business for the taxable year in which it is considered to have been sold, along with other property of the taxpayer used in the trade or business as defined in section 1231(b), regardless of whether such timber is property held by the taxpayer primarily for the sale to customers in the ordinary course of his trade or business.

Section 53.4943-10 of the Foundation and Similar Excise Taxes Regulations ("foundation regulations") provides that the term "business enterprise," except as provided in paragraph (b)

or (c) of this section includes the active conduct of a trade or business, including any activity which is regularly carried on for the production of income from the sale of goods or the performance of services and which constitutes an unrelated trade or business under section 513.

Section 53.4943-10(c)(1) of the foundation regulations provides that the term business enterprise does not include a trade or business at least 95 percent of the gross income of which is derived from passive sources.

Section 53.4943-10(c)(2) of the foundation regulations provides states that gross income from passive sources, for purposes of this paragraph, includes the items excluded by section 512(b)(1) (relating to dividends, interest, and annuities), 512(b)(2) (relating to royalties), 512(b)(3) (relating to rent) and 512(b)(5) (relating to gains or losses from the disposition of certain property).

ANALYSIS

Generally, section 4943(a)(1) of the Code imposes a tax on the excess business holdings in a business enterprise of a private foundation. Section 4943(c)(2) provides in part that the permitted holdings of any private foundation in an incorporated business enterprise are 20 percent of the voting stock, reduced by the percentage of the voting stock owned by all disqualified persons. In your case you currently own 100 percent of the issued and outstanding voting stock of Enterprises, which would constitute an excess business holding absent an exception.

The term "business enterprise" as defined in section 53.4943-10(a)(i) of the foundation regulations includes the active conduct of a trade or business, including any activity which is regularly carried on for the production of income from the sale of goods or the performance of services and which constitutes an unrelated trade or business under section 513(a)(1) of the Code. Section 513(a)(1) provides that the term unrelated trade or business means any trade or business the conduct of which is not substantially related, aside from the need of such organization for the income or funds or the use it makes of the profits derived, to the exercise or performance by such organization of its charitable, educational or other purpose constituting the basis of its exemption under section 501. However, the tax on excess business holdings does not apply to, among other things, a trade or business that derives at least 95 percent of its gross income from passive sources, which includes dividends, interest, annuities, rents described in section 512(b)(3), and capital gains described in section 512(b)(5).

For purposes of section 4943(d)(3) of the Code, a business enterprise does not include a trade or business at least 95 percent of the gross income of which is derived from passive sources such as rents from real or personal property. You state that Enterprises will receive rental income from the leasing of the grazing land to a rancher, and income from contracts that Enterprises will enter into with independent third parties who will cut and remove timber in which you will retain an economic interest in that timber pursuant to those contracts in accordance with section 631(b) of the Code. Therefore, income received from the timber harvesting activities and related timber sales in which there is no election made under section 631(a), would be

characterized as gains or losses from the sale, exchange, or other disposition of property that is excluded from unrelated business taxable income under section 512(b)(5). As such, the income received by Enterprises from the timber harvesting activities will be from passive sources within the meaning of section 4943(d)(3). Therefore, your ownership interest of 100 percent of the stock of Enterprises will not be considered a business enterprise and excess business holdings under section 4943(a)(1) since Enterprises derives at least 95 percent of the gross income from passive sources as defined in section 4943(d)(3)(B) and section 53.4943-10(c)(2) of the foundation regulations.

RULING

Your ownership interest of 100 percent of the Enterprises stock will not be considered a business enterprise and excess business holdings under section 4943(c) of the Code because at least 95 percent of Enterprises gross income will be derived from passive sources.

You have represented that you will not make an election under section 631(a) of the Code and pursuant to section 631(b) you will retain an economic interest in the timber. Therefore, we are making no determination involving sections 631(a) or (b) and assume that the above timber cutting transactions will meet the requirements of section 631.

This ruling will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, *Notice of Intention to Disclose*. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

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

This ruling is based on the facts as they were presented and on the understanding that there will be no material changes in these facts. This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described. Because it could help resolve questions concerning your federal income tax status, this ruling should be kept in your 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.

In accordance with the Power of Attorney currently on file with the Internal Revenue Service, we are sending a copy of this letter to your authorized representative.

Sincerely,

Ronald Shoemaker
Manager, Exempt Organizations
Technical Group 2

Enclosure
Notice 437