



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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Release Number: **201407021**
Release Date: 2/14/2014
Date: November 18, 2013
UIL: 4941.00-00,
4943.00-00

Contact Person:
Identification Number:
Telephone Number:
Employer Identification Number:

Legend:

Founder =
LLC =

Dear :

This is in response to your letter dated April 3, 2013 in which you requested certain rulings with respect to §§ 4941 and 4943 of the Internal Revenue Code ("Code").

Background:

You are a private foundation founded by Founder. After the death of the later to survive of Founder or Founder's wife, his estate plan stipulates that an ownership interest in LLC will go to you, as discussed below.

Founder made capital contributions to and currently owns all of the membership units, voting and nonvoting, of LLC, a Limited Liability Company, which is a disregarded entity for federal income tax purposes. LLC is managed by the members owning voting units (Managing Members). A Managing Member's signature is sufficient to bind LLC. Managing Members are authorized to invest or reinvest available funds in investments consistent with the purposes of LLC, to vote any stock or other voting security, to exercise the rights of a general partner, to expend LLC funds to borrow as they deem appropriate, to collect obligations payable to LLC, and to generally perform the duties of running LLC. Managing Members will also make distributions from time to time in such amounts as they decide after considering the needs of LLC and their fiduciary obligations to all members. All distributions will be made to all unit holders, voting and nonvoting, ratably in proportion to ownership of units. These rights and responsibilities are designated solely to the Managing Members. LLC may only be dissolved with the written approval of members holding at least fifty percent of the units in each member class, voting and nonvoting.

The sole asset of LLC is a note from Founder's daughter. The only income derived by LLC will be income from the note. Taxpayer represents that LLC is engaged solely in passive investment activities and does not engage in, and will not be engaged in, the operation of any business enterprise. The promissory note from Founder's daughter bears interest at the long-term federal rate determined under § 1274(d) in effect at the time Founder and Founder's daughter entered into the agreement. The principal of the note is due at the end of the note's term. This note will continue to be an asset of LLC, and the interest therefrom will be LLC's sole income. Founder proposes to transfer at death a non-voting interest of LLC to you, but not a voting interest, through

either Founder's or Founder's wife's estate. LLC will have multiple owners and will not be a disregarded entity.

Rulings Requested:

1. The distribution from the asset holders and retention by you of non-voting units in LLC following the death of the survivor of Founder and his wife will not constitute indirect acts of self-dealing pursuant to § 53.4941(d)-1(b)(5)-(b)(6), and accordingly, will not violate § 4941 even though LLC's sole assets will be the notes and income generated by the notes.
2. Your ownership of non-voting units in LLC will not constitute a violation of the prohibition against ownership of "excess business holdings" under § 4943, because LLC is not a "business enterprise" for such purposes.

Law:

I.R.C. § 4941(d)(1) defines self-dealing as the sale or exchange, or leasing, of property between a private foundation and a disqualified person as well as the lending of money or other extension of credit between a private foundation and a disqualified person.

I.R.C. § 4943(a)(1) imposes a tax on the excess business holding of any private foundation in a business enterprise during any taxable year which ends during the taxable period a tax equal to a ten percent of the value of such holdings.

I.R.C. § 4943(c)(1) defines "excess business holdings" as 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 holding of the foundation in such enterprise to be permitted holdings.

I.R.C. § 4943(c)(2) defines "permitted holdings" as 20 percent of the voting stock, reduced by the percentage of the voting stock owned by all disqualified persons. Additionally, a private foundation shall not be treated as having excess business holdings in any corporation in which it owns not more than two percent of the voting stock and not more than two percent in value of all outstanding shares of all classes of stock.

I.R.C. § 4946(a)(1) provides that a "disqualified person," with respect to a private foundation, includes a substantial contributor, as defined under section 507(d)(2), a foundation director or officer, and any spouse, ancestor, child, grandchild, great grandchild, and any spouse of a child, grandchild, or great grandchild of that contributor, director, or officer.

Treas. Reg. § 53.4941(d)-1(b)(5) 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 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.

Treas. Reg. § 53.4941(d)-2(c) provides that, "the lending of money or other extension of credit between a private foundation and a disqualified person shall constitute an act of self-dealing. Thus, for example, an act of self-dealing occurs where a third party purchases property and assumes a mortgage, the mortgagee of which is a private foundation, and subsequently the third party transfers the property to a disqualified person who either assumes liability under the mortgage or takes the property subject to the mortgage. Similarly, except in the case of the receipt and holding of a note pursuant to a transaction described in § 53.4941(d)-1(b)(3), an act of self-dealing occurs where a note, the obligor of which is a disqualified person, is transferred by a third party to a private foundation which becomes the creditor under the note."

Treas. Reg. § 53.4943-10(c)(1) 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. Thus, stock in a passive holding company is not to be considered a holding in a business enterprise even if the company is controlled by the foundation. Instead, the foundation is treated as owning its proportionate share of any interests in a business enterprise held by such company under § 4943(d)(1).

Revenue Ruling 76-158, 1976-1 C.B. 354, A private foundation, owning thirty-five percent of the voting stock of a corporation and having a foundation manager personally owning the remaining sixty-five percent but not holding a position of authority in the corporation by virtue of being foundation manager, does not control the corporation for purposes of the self-dealing provisions of § 4941.

Analysis:

RULING 1:

Section 53.4941(d)-1(a) of the regulations states that "the term 'self dealing' means any direct or indirect transaction described in § 53.4941(d)-2. Section 53.4941(d)-2 describes five specific acts of self-dealing: (1) sale or exchange of property; (2) leases; (3) loans; (4) furnishing goods, services, or facilities; and (5) transfer or use of the income or assets of a private foundation. Section 53.4941(d)-2(c) provides that an act of self-dealing occurs when a note, the obligor of which is a disqualified person, is transferred by a third party to a private foundation which becomes the creditor under the note.

If the option holders fail to exercise their option after your death, LLC will retain ownership of the note payable by Founder's daughter, and you will own nonvoting units in LLC. Both LLC and Founder's daughter are disqualified persons as to you. Section 4946(a)(1). Your retention of a nonvoting interest in the LLC and your receipt of passive income from LLC, however, will not constitute any of the acts of self-dealing described in § 4941(d)(1) or § 53.4941(d)-2. The arrangement between the LLC and you will neither be a loan nor an extension of credit. Section 53.4941(d)-2(c). You would acquire nonvoting units in LLC by gift, rather than through a self-dealing transaction. As a holder of nonvoting units, you will have a right to receive distributions only if LLC dissolves or it chooses to make current distributions, but the timing and amount of such distributions would be uncertain, and could not be compelled by you. The Managing Members, holders of voting units, are given sole power to manage the affairs of LLC and determine the timing

and amount of distributions. Additionally, you cannot compel dissolution of LLC since it requires the vote of a holder of fifty percent of the voting units in addition to your own.

You will not have "control" over LLC (as defined in section 53.4941(d)-1(b)(5) of the regulations) due to the lack of voting power to manage or operate LLC. We do not consider the power associated with the non voting interest in LLC as a necessary party to vote on the liquidation of the LLC to be the equivalent of a "veto power" within the meaning of section 53.4941(d)-1(b)(5) in that the other attributes of that interest lack any other powers with respect to operation and management. Furthermore, the liquidation of LLC in this context could result in a self-dealing problem for Foundation. Therefore, the retention by LLC of Founder's daughter's note following Founder's death would not be an act of direct or indirect self-dealing between you and one or more disqualified persons under § 53.4941(d)-(1) or § 4941. Therefore, the retention by LLC of the note following Founder's death would not be an act of indirect self-dealing between you and one or more disqualified persons under § 53.4941(d)-(1) or § 4941.

RULING 2:

Despite the size of your holdings in LLC your investments therein do not constitute excess business holdings under § 4943. Section 4943 imposes an excise tax on the excess business holding of private foundations. In order for your holdings in LLC to constitute excess business holdings, LLC must qualify as a "business enterprise." Section 4943(a). If a trade or business derives ninety-five percent of its income from passive sources, as demonstrated by sources described in §§ 512(b)(1), (2), (3), and (5), then it is not considered a business enterprise. Section 53.4943-10(c)(1). LLC's only holding is the note, which generates interest – a passive source under § 512(b)(1). As such, LLC meets the ninety-five percent rule of the regulation, and therefore it is not considered a "business enterprise." Since LLC is not a business enterprise, and it holds no interest in any business enterprise, your holding of "profit interest" in LLC is not an excess business holding under § 4943.

Rulings:

1. The distribution from Founder's estate, Founder's revocable trust, or Founder's wife's estate, whichever holds the assets prior to distribution, and retention by Foundation of non-voting units in LLC following the death of the survivor of you and your wife will not constitute indirect acts of self-dealing pursuant to § 53.4941(d)-1(b)(5)-(b)(6), and accordingly, will not violate § 4941 even though LLC's sole assets will be the notes and income generated by the notes.
2. Foundation's ownership of non-voting units in LLC will not constitute a violation of the prohibition against ownership of "excess business holdings" under § 4943, because LLC is not a "business enterprise" for such purposes.

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