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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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507.04-00
512.10-00
4940.02-01
4941.00-00
4943.03-04

Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

Legend:

Company =
Trust =

Dear :

This is in response to your letter dated March 28, 2014 in which you requested certain rulings with respect to I.R.C. §§ 501(c)(3), 512(b), 507(b)(1)(B), 4940, 4941, and 4943.

Background:

You are a trust that has been recognized as exempt as being described in § 501(c)(3) and as a non-operating private foundation under § 509. Your purposes are to make grants to established public charities within the meaning of §§ 501(c)(3) and 509(a). Your founder and sole trustee is also the founder and CEO of Company. Company is an S corporation, nearly ninety percent of which is owned by Trust. Trust is a revocable trust that is currently administering the estate of your trustee's late wife. Your founder and trustee is the sole beneficiary of Trust during his lifetime. Prior to the proposed transaction your funds have primarily been cash contributions from your founder.

Your trustee plans to terminate Trust, distributing the shares of Company to you, your founder, and other trusts, the beneficiaries of which include your founder and his family members. The shares that will be distributed to you will be considered a gift and no consideration will be given by you for such shares. After the distribution you will own over two percent of the stocks in Company. Additionally, you have stated that over thirty-five percent of the stocks in Company will be held by persons who are disqualified persons as to you, including your founder and trustee. As a shareholder in Company you will receive a Schedule K-1 passing income directly through the S corporation to you. That income will likely exceed fifty percent of your overall income. Furthermore, Company proposes to create an Employee Stock Ownership Plan (ESOP) that will purchase shares from you. Company has six hundred employees that are eligible to participate in the ESOP. The employees participating in the ESOP will be able to direct the vote of their shares of Company through the trustee of the ESOP. Additionally, you have stated that no individual that is a disqualified person as to you will participate in the ESOP.

by Company. Company exists as a separate entity for the valid business purpose of conducting activities as a broker-dealer and registered investment advisor. Company's activities are separate, distinct, and independent from yours. You will not participate in the day-to-day operations of Company. Furthermore, you will never own more than twenty percent of the stock of Company.

Following the termination of Trust you have stated that you may seek to terminate your private foundation status and seek to be a supporting organization. You have not yet named an organization that you would support.

Rulings Requested:

1. You will have five years from the date your holdings in Company exceed two percent to reduce your entire holdings in Company to two percent or less to avoid the tax on excess business holdings under § 4943. Furthermore, if circumstances arise in which you are unable to reduce your holdings in Company to two percent or less during the initial five year period, you are eligible to request an additional five year disposition period to avoid the tax on excess business holdings via written request to the Secretary pursuant to § 4943(c)(7).

2. You were organized and operated exclusively for exempt purposes pursuant to § 501(c)(3) and continue to qualify for exemption under § 501(c)(3) because the for-profit unrelated business operations of Company, regardless of the amount of unrelated business taxable income generated therefrom, will not be attributed to you.

3. Your income from Company's S corporation Schedule K-1 will not be taxed as net investment income under § 4940(c)(2), since it is treated as unrelated trade or business taxable income.

4. The proposed purchase of your shares in Company by Company's ESOP will not be an act of self-dealing under § 4941.

Law:

I.R.C. § 501(c)(3) provides that organizations may be exempted from tax if they are organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes and "no part of the net earnings of which inures to the benefit of any private shareholder or individual."

I.R.C. § 512(e) provides that if an organization described in §§ 1361(c)(2)(A)(vi) or 1361(c)(6) holds stock in an S corporation such interest shall be treated as an interest in an unrelated trade or business, and notwithstanding any other provision of this part all items of income, loss, or deduction taken into account under § 1366(a), and any gain or loss on the disposition of the stock in the S corporation, shall be taken into account in computing the unrelated business taxable income of such organization.

I.R.C. § 4940(a) imposes a tax on each private foundation which is exempt from taxation under § 501(a) for the taxable year, with respect to the carrying on of its activities, a tax equal to 2 percent of the net investment income of such foundation for the taxable year.

I.R.C. § 4940(c)(1) defines net investment income as the amount by which (A) the sum of the gross

investment income and the capital gain net income exceeds (B) the deductions allowed by paragraph (3).

I.R.C. § 4940(c)(2) defines gross investment income as the gross amount of income from interest, dividends, rents, payments with respect to securities loans (as defined in § 512(a) (5)), and royalties, but not including any such income to the extent included in computing the tax imposed by § 511.

I.R.C. § 4941 imposes a tax on each act of self-dealing between a disqualified person and a private foundation.

I.R.C. § 4941(d)(1) defines self-dealing as the furnishing of goods, services, or facilities between a disqualified person and a private foundation as well as the payment of compensation by a private foundation to a disqualified person.

I.R.C. § 4943(a) imposes a tax on the excess business holdings of any private foundation in a business enterprise during any taxable year which ends during the taxable period a tax equal to 10 percent of the value of such holdings.

I.R.C. § 4943(c)(1) defines excess business holdings as 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.

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. In any case in which all disqualified persons together do not own more than 20 percent of the voting stock of an incorporated business enterprise, nonvoting stock held by the private foundation shall also be treated as permitted holdings.

I.R.C. § 4943(c)(2)(C) provides that a private foundation shall not be treated as having excess business holdings in any corporation in which it (together with all other private foundations which are described in § 4946(a)(1)(H)) owns not more than 2 percent of the voting stock and not more than 2 percent in value of all outstanding shares of all classes of stock.

I.R.C. § 4943(c)(6) provides that if there is a change in the holdings in a business enterprise (other than by purchase by the private foundation or by a disqualified person) which causes the private foundation to have excess business holdings in such enterprise, the interest of the foundation in such enterprise (immediately after such change) shall (while held by the foundation) be treated as held by a disqualified person (rather than by the foundation) during the 5-year period beginning on the date of such change in holdings.

I.R.C. § 4943(c)(7) provides that the Secretary may extend for an additional 5-year period the period under paragraph (6) for disposing of excess business holdings in the case of an unusually large gift or bequest of diverse business holdings or holdings with complex corporate structures if--

(A) the foundation establishes that--

(i) diligent efforts to dispose of such holdings have been made within the initial 5-year period, and

(ii) disposition within the initial 5-year period has not been possible (except at a price substantially below fair market value) by reason of such size and complexity or diversity of such holdings,

(B) before the close of the initial 5-year period--

(i) the private foundation submits to the Secretary a plan for disposing of all of the excess business holdings involved in the extension, and

(ii) the private foundation submits the plan described in clause (i) to the Attorney General (or other appropriate State official) having administrative or supervisory authority or responsibility with respect to the foundation's disposition of the excess business holdings involved and submits to the Secretary any response received by the private foundation from the Attorney General (or other appropriate State official) to such plan during such 5-year period, and

(C) the Secretary determines that such plan can reasonably be expected to be carried out before the close of the extension period.

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, trustee, or officer; a corporation owned more than thirty-five percent by any of the previous persons; 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. § 1.501(c)(3)-1(c)(1) states an organization will be regarded as operated exclusively for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes. An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Treas. Reg. § 1.513-1(b) defines trade or business for purposes of § 513 as having the same meaning it has in § 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of services. Activities of producing or distributing goods or performing services from which a particular amount of gross income is derived do not lose identity as trade or business merely because they are carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization.

Rev. Rul. 81-76, 1981-1 C.B. 516, holds that when an employee stock ownership trust holds 30 percent of the stock in a corporation on behalf of the corporation's participating employees, who direct the manner in which the trust votes the shares, the trust will not be considered a disqualified person with respect to a private foundation merely because the corporation is a substantial contributor to the foundation.

In Moline Properties, Inc. v. Comm'r, 319 U.S. 436, 438-39 (1943), the Supreme Court said that "[t]he doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by

the corporation, the corporation remains a separate taxable entity.... In general, in matters relating to the revenue, the corporate form maybe disregarded where it is a sham or unreal. In such situations the form is a bald and mischievous fiction." In response to the argument that a corporation is a mere agent of its sole stockholder, the court said that "the mere fact of the existence of a corporation with one or several stockholders, regardless of the corporation's business activities, does not make the corporation the agent of its stockholders. *Id.* at 440.

Analysis:

RULING 1: You will have five years from the date your holdings in Company exceed two percent to reduce your entire holdings in Company to two percent or less to avoid the tax on excess business holdings under § 4943. Furthermore, if circumstances arise in which you are unable to reduce your holdings in Company to two percent or less during the initial five year period, you are eligible to request an additional five year disposition period to avoid the tax on excess business holdings via written request to the Secretary pursuant to § 4943(c)(7).

The termination of Trust will result in the contribution to you of greater than two percent of the shares of Company. Section 4943 imposes an excise tax on private foundations that hold greater than a de minimus amount of shares in a business enterprise where its holdings, combined with the holdings of disqualified persons as to that private foundation, exceed twenty percent. You have stated that Company is a business enterprise and that disqualified persons as to you will hold greater than thirty-five percent of the shares of Company. Section 4943(c)(6) provides a five year grace period for private foundations to reduce their holdings of shares exceeding the permitted holdings if those shares are contributed to the private foundation. Here, the shares in Company will not be purchased by you, but will be contributed by Trust to you as a gift. Since these shares are gifted to you, you will have five years where you will be able to reduce your holdings in Company over that time. Should you fail to reduce your holdings in that time, at least to an amount permitted under § 4943(c)(2)(C), then you can request an additional five years to dispose of your holdings provided you meet the requirements under § 4943(c)(7).

Under § 4943(c)(7), the Service may extend the initial five-year period for disposing of excess business holdings for an additional five years if a foundation establishes that: (i) it made diligent efforts to dispose of such holdings during the initial five-year period, and disposition within the initial five-year period has not been possible (except at a price substantially below fair market value) by reason of such size and complexity or diversity of holdings, (ii) before the close of the initial five-year period it submits to the Service and Attorney General (or other appropriate State official) having administrative or supervisory authority or responsibility with respect to the foundation's disposition of the excess business holdings involved a plan for disposing of all of the excess business holdings involved during the extension, and (iii) the Service determines that such plan can reasonably be expected to be carried out before the close of the extension period. We are making no representations as to whether you will qualify for such extension at this time.

RULING 2: You were organized and operated exclusively for exempt purposes pursuant to § 501(c)(3) and continue to qualify for exemption under § 501(c)(3) because the for-profit unrelated business operations of Company, regardless of the amount of unrelated business taxable income generated therefrom, will not be attributed to you.

As a result of the legislation, tax-exempt organizations described in § 501(c)(3) are allowed to be shareholders in an S corporation under § 1361(c)(6). Furthermore, under § 512(e), items of income or loss of an S corporation will flow through to tax-exempt shareholders as unrelated business

taxable income regardless of the source or nature of such income. In addition, gain or loss on the sale or other disposition of stock of an S corporation will be treated as unrelated business taxable income. These provisions, however, do not cause the for-profit activities of the S corporation to be attributed to the tax-exempt shareholder. See Moline Properties. Inc., 319 U.S. at 440. In determining whether the activities of a for-profit S corporation subsidiary is attributable to its tax-exempt parent, the separate identity principles annunciated in Moline Properties. Inc. v. Comm'r should apply lest the intent of Congress to remove barriers for investment in S corporations by tax-exempt entities be frustrated.

For federal income tax purposes, a parent corporation and its subsidiaries are treated as separate and distinct taxable corporate entities as long as each entity has a valid business purpose and engages in at least a minimal amount of business activity. See Moline Properties, Inc., 319 U.S. at 438; National Investors Corp., 144 F.2d at 468; Britt, 431 F.2d at 234. It is not the case here that the corporate structure of Company is a sham allowing the activities of Company to be attributed to you. Since the activities of Company cannot be attributed to you and the holding of shares of an S corporation, though resulting in unrelated business taxable income, does not constitute the performance of an unrelated trade or business, you are still described in § 501(c)(3).

The activities of a for-profit subsidiary will not be attributed to its tax exempt parent unless (1) the subsidiary lacks a business purpose, or (2) the subsidiary is an arm or agent of the parent.

Your relationship with Company does not fail the first prong., i.e. that the subsidiary have a business purpose and conduct some amount of business activity. Company has a valid business purpose as a broker-dealer and a registered investment advisor. Company has approximately 600 employees performing these tasks and does not use your resources to further its operations.

Your relationship with Company does not fail the second prong, i.e., that the parent not control the day-to-day operations of the subsidiary. Company maintains activities that are separate, distinct and independent from you. Company has its own corporate identity and interest, and its own independent board of directors, and has its own management and employees independent of you. At no point in time is it represented by Company that it represents you. Furthermore, you will not own more than ten to twenty percent of Company at any one time, thus you will never control Company or its Board. The activities of Company are not attributable to you.

RULING 3: Your income from Company's S corporation Schedule K-1 will not be taxed as net investment income under § 4940(c)(2), since it is treated as unrelated trade or business taxable income.

Section 4940 imposes a tax on each private foundation equal to two percent of the net investment income of such foundation for the taxable year. Section 4940(c)(1)) defines net investment income as the amount by which (A) the sum of the gross investment income and the capital gain net income exceeds (B) the deductions allowed. Finally, § 4940(c)(2) defines gross investment income as the gross amount of income from interest, dividends, rents, payments with respect to securities loans (as defined in § 512(a)(5)), and royalties, but not including any such income to the extent included in computing the tax imposed by § 511. For purposes of the tax imposed under § 4940 your income from your shares in Company, to the extent it is included in § 512(e), will not be a part of your gross investment income under § 4940(c)(2). Therefore, it will not increase your net investment income in calculating your two percent tax under § 4940.

RULING 4: The proposed purchase of your shares in Company by Company's ESOP will not be an act of self-dealing under § 4941.

In Rev. Rul. 81-76, supra, an ESOP owned thirty percent of the stock of a company that was a substantial contributor to the private foundation in that ruling. Section 4946(a)(1)(C) provides that an owner of more than twenty percent of the total combined voting power of a corporation or the profit interests of a partnership that is a substantial contributor is a disqualified person. In Rev. Rul. 81-76 the ESOP, if it were considered the owner of all of its stock would have been a disqualified person as to the private foundation. The ruling determined, however, that the ESOP was not a disqualified person because the stocks were considered to be owned by the employee participants in the plan rather than by the ESOP, therefore the ESOP did not own more than twenty percent of the company.

Given that here the employees are able to vote their shares of Company through the trustee of the ESOP, Rev. Rul. 81-76, supra, supports the conclusion that your ESOP is not a disqualified person as to you because it only holds Company stock in its capacity as trustee, and the real owners of the stock are the ESOP's participants. ESOP participants may be disqualified persons and any amount attributable to such disqualified persons would constitute a sale to a disqualified person. You have stated that no ESOP participants will be disqualified persons as that term is defined in § 4946, as to you. Therefore, your proposed sale of Company stock to the ESOP will not be an act of self-dealing within the meaning of § 4941.

Rulings:

1. You will have five years from the date your holdings in Company exceed two percent to reduce your entire holdings in Company to two percent or less to avoid the tax on excess business holdings under § 4943. Furthermore, if circumstances arise in which you are unable to reduce your holdings in Company to two percent or less during the initial five year period, you are eligible to request an additional five year disposition period to avoid the tax on excess business holdings via written request to the Secretary pursuant to § 4943(c)(7).

2. You were organized and operated exclusively for exempt purposes pursuant to § 501(c)(3) and continue to qualify for exemption under § 501(c)(3) because your ownership interest in Company, a for-profit subchapter S corporation, together with the flow through allocation of the Company's S tax items subject to the unrelated business income tax would have no effect on your tax exempt status as an organization described in § 501(c)(3).

3. Your income from Company's S corporation Schedule K-1 will not be taxed as net investment income under § 4940(c)(2), since it is treated as unrelated trade or business taxable income.

4. The proposed purchase of your shares in Company by Company's ESOP will not be an act of self-dealing under § 4941.

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. Specifically, this ruling does not reach any conclusion as to the qualifying distribution status of your proposed transfer under § 4942(g)(3). 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,

Mike Seto
Manager, Exempt Organizations
Technical

Enclosure
Notice 437