

Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

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Person To Contact:
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Date:
May 15, 2017

Legend:

Foundation =
Company =
Trust =
Business =

Dear :

This letter responds to Foundation's October 20, 2016, request for a ruling that a proposed business holding will not constitute an excess business holding under section 4943 of the Internal Revenue Code (Code).¹

Facts

According to the information provided by Foundation, Foundation is a foreign organization recognized as exempt from federal income tax under section 501(c)(3) and as a private foundation. Foundation has received substantially all of its support (other than gross investment income) from sources outside the United States.

Consistent with the investment goals of its endowment, Foundation proposes to make an investment in Company, a foreign organization that expects to be treated as a corporation for U.S. federal income tax purposes. Company is not a disqualified person with respect to Foundation. Company will indirectly hold more than percent, and as much as 100 percent, of the voting stock in a foreign business entity (Business), which expects to be treated as a corporation for U.S. federal income tax purposes.

¹ Section 4943 of the Internal Revenue Code of 1986, as amended, to which all subsequent section references are made unless otherwise stated.

Foundation represents that Business is a “business enterprise” under section 4943 and Treas. Reg. § 53.4943-10.

Company and intermediate holding companies or partnerships through which Company holds its interest in Business are each expected to derive _____ percent or more of their gross income from passive sources, including dividends and capital gains from Business. Foundation represents that each of Company and such intermediate holding companies or partnerships is expected not to be a business enterprise within the meaning of Treas. Reg. § 53.4943-10(c).

Foundation will not hold any shares in Business directly (nor does it directly own any of the shares of any other entity owned or controlled by Company). No disqualified persons with respect to Foundation have ever held any stock in Company or any entity in which Company holds an interest, nor will any disqualified person with respect to Foundation hold, directly or indirectly, any stock in Business.

As part of Foundation’s ongoing effort to ensure that its investments comply with the excess business holdings rules, Foundation seeks to ensure that it holds, actually or constructively within the meaning of Treas. Reg. § 53.4943-8, no more than 20 percent of the voting stock of Business. Foundation will not hold, directly or indirectly, any stock in Business, other than through Company. Because its interest in Business is held indirectly through an interest in Company, Foundation seeks to ensure that it holds no more than 20 percent of the voting stock of Company.

Company has three classes of shares, one class of non-voting ordinary shares (“Non-Voting Shares”) and two classes, A and B, of voting fixed coupon preferred shares (“Voting Shares”). The holders of class A Voting Shares have the right to elect up to _____ A directors (or _____ % of Company’s directors) and remove those directors at any time, while Foundation, as the holder of all class B Voting Shares, has the right to elect up to _____ B director (or _____ % of Company’s directors) and to remove that director at any time. Directors serve indefinite terms until they resign or are removed by the pertinent holders of Voting Shares. If a director vacancy arises and the pertinent holders of Voting Shares do not appoint a replacement director, the remaining directors may appoint a replacement director, who may be removed only by the pertinent holders of Voting Shares.

The remaining _____ percent of the Voting Shares of Company (all of class A) are held by Trust, a foreign non-profit grant-making trust. Trust is unrelated to, and is not a disqualified person with respect to, Foundation. Trust has not applied for a determination letter from the IRS. Trust was formed and funded in _____ by an individual who is unrelated to, and not a disqualified person with respect to, Foundation. Foundation is not a beneficiary of Trust, and no trustee of either Foundation or Trust is a trustee of the other. The terms of Company’s articles of organization entitle Trust to elect and remove _____ percent of Company’s directors, including _____ percent of the initial directors. The articles provide that decisions of Company directors are made by a

majority, and that a director appointed by Foundation and a director appointed by Trust is needed for a quorum for a director's meeting.

At the present time, all of the directors of Company are also employees of Foundation, though % of these directors could be removed at any time by vote of Trust. There is not, and has never been, any restriction requiring director candidates to be Foundation employees. There are no separate shareholders' agreements or voting agreements relating to the voting of Company stock, though Trust and Foundation do discuss the management of Company and its investments in their capacity as shareholders.

Holders of Voting Shares of Company are entitled to a fixed amount of cash per share per year. Company must pay the accrued dividend on the Voting Shares before it can pay any amount to Foundation as the holder of the Non-Voting Shares, and Company's directors otherwise have full discretion regarding whether or not to pay any such amount to Foundation as the holder of the Non-Voting Shares. Upon liquidation of Company, the Voting Shares are entitled to a liquidation preference equal to the sum of any unpaid accrued dividend and a nominal amount equal to the original capital invested per Voting Share, after which the Nonvoting Shares are entitled to the remaining proceeds of liquidation.

Foundation holds a call option over the Voting Shares held by Trust that permits Foundation to purchase the voting stock of Company at fair market value upon months' notice. The call option has not been exercised.

Trust is not required to make capital contributions to Company. Foundation has a capital commitment to Company, a portion of which has been drawn down to date in connection with Company's prior portfolio investments.

Neither Foundation nor any disqualified person with respect to Foundation has any power of appointment over any interest in Business exercisable in favor of Foundation or a disqualified person.

Ruling Requested

Foundation requests a ruling that, for purposes of section 4943, it will own, directly or indirectly, no more than 20 percent of the voting stock of Business, and that it therefore will not have excess business holdings under section 4943, solely as a result of making and holding an investment in Business in the manner described above.

Law

Section 4943(a)(1) imposes a tax on the excess business holdings of a private foundation in a business enterprise during any taxable year which ends during the taxable period.

Section 4943(c)(1) generally defines “excess business holdings,” with respect to the holdings of any private foundation in any business enterprise, 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.

Section 4943(c)(2) generally defines the permitted holdings of a private foundation in an incorporated business enterprise 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.

Section 4943(d)(1) generally provides that in computing the holdings of a private foundation, or a disqualified person with respect thereto, in any business enterprise, any stock or other interest owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries.

Section 4943(d)(3)(B) 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. It also provides that, for this purpose, gross income from passive sources includes certain items that are excluded from unrelated business income. Among those items are dividends and capital gains that are excluded from unrelated business income by section 512(b)(1) and (5). See also Treas. Reg. §§ 53.4943-10(c)(1) and (2).

Section 4948 provides in part that Chapter 42 of the Code (other than section 4948) shall not apply to any foreign organization which has received substantially all of its support (other than gross investment income) from sources outside the United States. However, such a foreign organization’s exemption from taxation under section 501(a) may be revoked under section 4948(c)(1) if that organization engages in a prohibited transaction.

Section 4948(c)(2) provides that the term “prohibited transaction” includes any act or failure to act (other than with respect to section 4942(e)) which would subject a foreign organization described in section 4948(b) to liability for a penalty under section 6684 if such foreign organization were a domestic organization.

Section 6684 imposes a penalty if a person becomes liable for tax under Chapter 42 by reason of any act or failure to act which is not due to reasonable cause and either (1) such person has theretofore been liable for tax under such chapter, or (2) such act or failure to act is both willful and flagrant.

Treas. Reg. § 53.4943-3(b)(1)(ii) provides that the percentage of voting stock held by any person in a corporation is normally determined by reference to the power of stock to vote for the election of directors, with treasury stock and stock which is authorized but unissued being disregarded. Thus, for example, if a private foundation holds 20 percent of the shares of one class of stock in a corporation, which class is entitled to elect three directors, and such foundation holds no stock in the other class of stock, which is entitled to elect five directors, such foundation shall be treated as holding 7.5 percent of the voting stock because the class of stock it holds has 37.5 percent of such voting power, by reason of being able to elect three of the eight directors, and the foundation holds one-fifth of the shares of such class (20 percent of 37.5 percent is 7.5 percent). The fact that extraordinary corporate action (e.g., charter or by-law amendments) by a corporation may require the favorable vote of more than a majority of the directors, or of the outstanding voting stock, of such corporation shall not alter the determination of voting power of stock in such corporation in accordance with the two preceding sentences.

Treas. Reg. § 53.4943-3(b)(2)(i) generally provides that in addition to permitted holdings in voting stock, the permitted holdings of a private foundation in an incorporated business enterprise also include any share of nonvoting stock in the business enterprise, so long as the private foundation together with its disqualified persons hold no more than 20 percent of the business enterprise's voting stock. For this purpose, all equity interests which do not have voting power attributable to them are classified as nonvoting stock. Also under Treas. Reg. § 53.4943-3(B)(2)(i), evidences of indebtedness (including convertible indebtedness), and warrants and other options or rights to acquire stock shall not be considered equity interests.

Treas. Reg. § 53.4943-8(a)(2) provides that any interest in a business enterprise over which a foundation or a disqualified person has a power of appointment exercisable in favor of the foundation or a disqualified person shall be considered owned by the foundation or disqualified person holding such power of appointment.

Treas. Reg. § 53.4943-8(a)(3) provides generally that if an interest in a business enterprise owned by a corporation is constructively owned by a shareholder, each shareholder's proportion of ownership is generally computed on the basis of the voting stock each shareholder has in the corporation.

Treas. Reg. § 53.4943-8(a)(4) provides that if a private foundation, its disqualified persons, or both, own (directly or constructively) nonvoting stock of a parent corporation, the holdings of which are treated as constructively owned by its shareholders by reason of section 4943(d)(1) and Treas. Reg. § 53.4943-8, such nonvoting stock shall be treated as nonvoting stock of any corporation in which the parent corporation holds an interest for purposes of the limitation on the holding of nonvoting stock under section 4943(c)(2)(A) and Treas. Reg. § 53.4943-3(b)(2).

Treas. Reg. § 53.4943-10(c)(1) provides that for purposes of section 4943(d)(4), 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; except that if in the taxable year in question less than 95 percent of the income of a trade or business is from passive sources, the foundation may, in applying this 95 percent test, substitute for the passive source gross income in such taxable year the average gross income from passive sources for the 10 taxable years immediately preceding the taxable year in question (or for such shorter period as the entity has been in existence). 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 section 4943(d)(1).

Analysis

Although Foundation, as a foreign private foundation described in section 4948(b), is not subject to tax under section 4943, Foundation must comply with the requirements of section 4943 so as to avoid engaging in a “prohibited transaction” under section 4948(c)(2).

Under section 4943(c)(2), the pertinent interests in defining the permitted holdings of a private foundation in a corporation are the voting stock, and are generally limited to 20% of the voting stock. Given that Company (and any other intermediate holding company or partnership through which Foundation holds an indirect interest in Business) represents that it will receive at least percent of its gross income from passive sources (as dividends and capital gains), Company (and each other intermediate entity) is not a business enterprise under section 4943(d)(3)(B). Instead, Foundation is treated under section 4943(d)(1) as owning its proportionate share of any interests in any business enterprise, including Business, that is owned by Company (or other intermediate passive holding company). See also Treas. Reg. §§ 53.4943-8(a) and 53.4943-10(c)(1).

Under Treas. Reg. § 53.4943-8(a)(3), Foundation’s constructive ownership of Business is computed on the basis of the voting stock Foundation has in Company. Under Treas. Reg. §53.4943-3(b)(1)(ii), the Voting Shares in Company are the voting stock, because the percentage of voting stock held by any person in a corporation is normally determined by reference to the power of stock to vote for the election of directors, as is the case with the Voting Shares. Moreover, under Treas. Reg. §53.4943-3(b)(2)(i), Foundation’s option to purchase Trust’s voting stock in Company is not considered an equity interest. Accordingly, Foundation owns 20 percent of the voting stock of Company and thus constructively owns 20 percent of the interest of Company in Business. In addition, under Treas. Reg. § 53.4943-8(a)(4), even though Foundation owns nonvoting stock of Company, such nonvoting stock is treated as nonvoting stock of any corporation, including Business, in which Company holds an interest. Thus,

Foundation's 100% nonvoting stock of Company does not result in Foundation's constructive ownership of additional voting stock of Business.

Furthermore, as described above, no disqualified person of Foundation holds any interest in Company or Business, and Foundation holds no interest in Business other than through its interest in Company.

Under these circumstances, Foundation will not be treated as owning more than 20 percent of the voting stock of Company, and therefore will not be treated as owning more than 20 percent of the voting stock of Business, even if Company owns 100% of the interests in Business.

Ruling

Based solely on the facts and representations submitted by Foundation, we rule that, for purposes of section 4943, Foundation will own, directly or indirectly, no more than 20 percent of the voting stock of Business, and that Foundation therefore will not have excess business holdings under section 4943, solely as a result of making and holding an investment in Business in the manner described above.

The rulings contained in this letter are based upon information and representations submitted by or on behalf of Foundation and accompanied by a penalty of perjury statement executed by an appropriate party, as specified in Rev. Proc. 2017-1, 2017-1 I.R.B. 1, § 7.01(15)(b). This office has not verified any of the material submitted in support of the request for ruling, and such material is subject to verification on examination. The Associate Office will revoke or modify a letter ruling and apply the revocation retroactively if: (1) there has been a misstatement or omission of controlling facts; (2) the facts at the time of the transaction are materially different from the controlling facts on which the ruling is based; or (3) the transaction involves a continuing action or series of actions and the controlling facts change during the course of the transaction. See Rev. Proc. 2017-1, § 11.05.

No ruling is granted as to whether Foundation qualifies as an organization described in section 501(c) or section 509(a). Except as expressly provided above, no opinion is expressed or implied concerning the federal income tax consequences of any aspects of any transaction or item of income described in this letter ruling.

This letter is directed only to Foundation. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to each of Foundation's authorized representatives.

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,

Amy F. Giuliano
Senior Technician Reviewer
Exempt Organizations Branch 1
(Tax Exempt & Government Entities)

cc: