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Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
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Date:
June 17, 2019

Legend:

CLT =
Decedent =
A =
B =
C =
Corporation =
Investment Trust =
Revocable Trust =

Dear _____ :

This letter responds to the letter dated November 7, 2018, in which CLT’s authorized representative requested rulings under section 4941 and section 4943 of the Internal Revenue Code (Code)¹ regarding CLT’s receipt of a nonvoting interest in an LLC (LLC) as well as distributions from LLC of a proportionate share of payments of principal and interest from certain debt obligations held by LLC.

FACTS

Based on the documents and representations submitted, we construe the facts as follows:

CLT was designed to qualify as a charitable lead unitrust, the charitable interest in which is a right to receive a percentage of the net fair market value of the trust assets that will vary as the value of the trust changes from year to year, distributed annually for

¹ The Internal Revenue Code of 1986, as amended, to which all subsequent “section” references are made unless otherwise indicated.

a period of years to an organization described in sections 170(c), 2055(a), or 2522(a). The remainder interests in CLT benefit certain of Decedent's descendants. The trustees of CLT are A, B, and C, all of whom are family members of Decedent within the meaning of section 4946(d). CLT represents that it is subject to sections 4941 and 4943 pursuant to section 4947(a)(2).

During life, Decedent owned nonvoting shares in Corporation. Subsequent to acquiring such shares, Decedent formed Investment Trust and sold nonvoting shares in Corporation to Investment Trust in exchange for a promissory note (Note). The Note evidenced Investment Trust's obligation to pay Decedent interest annually for a period of years with principal and all accrued and unpaid interest due at the end of the term of the Note. CLT has represented that Investment Trust is a disqualified person with respect to CLT.

As part of Decedent's estate planning, Decedent executed a will and Revocable Trust. Pursuant to the terms of Decedent's will, upon Decedent's death, the residuary of Decedent's estate, including the Note, passes to Revocable Trust. Revocable Trust states generally that X percent of the residuary of Revocable Trust is to be distributed to CLT.

At Decedent's death, the Note became the property of Decedent's estate while the obligor of the Note continued to be Investment Trust. CLT has represented that an act of self-dealing under section 4941 will result if the Note is directly transferred to CLT because Investment Trust, a disqualified person with respect to CLT, is the obligor of the Note and pursuant to the terms of Decedent's will and the Revocable Trust agreement, CLT may become the creditor of the Note.

CLT proposes that Revocable Trust form LLC and contribute cash and the Note to LLC in exchange for 100% of LLC's ownership interests, 99% of which are nonvoting interests and 1% of which are voting interests. Revocable Trust will satisfy its distribution obligations by distributing to CLT an amount of nonvoting interests in LLC with a value equal to CLT's full distribution entitlement. The remaining undistributed nonvoting interests and all voting interests in LLC will be distributed to the other Revocable Trust beneficiaries, A, B, and C in their individual capacities, and not as trustees of CLT.

Pursuant to the LLC operating agreement, LLC will be managed by a single manager (Manager) who is selected and may be removed by a vote of the members holding a majority of the voting interests. The holders of the nonvoting interests will possess no management rights or rights to vote on the appointment or removal of Manager. An amendment to the LLC operating agreement or dissolution of the LLC requires the approval of all members, whether holding voting or nonvoting interests.

LLC will hold and administer the Note and receive payments of interest and principal on the Note. Aside from the cash initially contributed to LLC by Revocable Trust, LLC's

sole asset and source of income will be the Note. CLT will engage only in passive investment activities, and not in the operation of any business enterprise. At least 95% of CLT's gross income will be from passive investments including interest and dividends.

RULINGS REQUESTED

1. The receipt from Revocable Trust and continued ownership by CLT of the interest in LLC will not be an act of self-dealing under section 4941.
2. The receipt by CLT of distributions from LLC of a proportionate share of payments on the Note, and actions taken by LLC in connection with enforcement and collection of the Note, will not be an act of self-dealing under section 4941.
3. The receipt from Revocable Trust and continued ownership by CLT of the interest in LLC will not result in excess business holdings under section 4943.

LAW

Section 512(b)(1) excludes dividends, interest, payments with respect to securities loans (as defined in subsection (a)(5)), amounts received or accrued as consideration for entering into agreements to make loans, and annuities, and all deductions directly connected with such income from the calculation of unrelated business income tax.

Section 4941(a) imposes an excise tax on each act of self-dealing between a disqualified person and a private foundation and on the participation of any foundation manager, knowing that it is such an act.

Section 4941(d)(1)(B) defines self-dealing, in part, as including any direct or indirect lending of money or other extension of credit between a private foundation and a disqualified person.

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

Section 4943(c)(1) defines the term "excess business holdings" in reference to a private foundation, as the amount of stock or other interest in any business 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(d)(3) provides, in part, 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 is interest that is excluded from unrelated business income by section 512(b)(1).

Section 4946(a)(1) provides, in part, 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 section 4946(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 section 4946(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, and
- (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.

Section 4946(b)(1) defines the term “foundation manager” to include an officer, director, or trustee of a private foundation.

Section 4947(a)(2) provides in part that, in the case of a trust which is not exempt from tax under section 501(a), not all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B), and which has amounts in trust for which a deduction was allowed under sections 170, 545(b)(2), 652(c), 2055, 2106(a)(2), or 2522, certain Code provisions, including section 4941, shall apply as if such trust were a private foundation.

Treas. Reg. § 53.4941(d)-1(b)(4) 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) 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 person solely because of the ownership interest of such persons in such organization.

Treas. Reg. § 53.4941(d)-1(b)(5) provides, in part, 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. For these purposes, an organization will be considered to be controlled by a private foundation if the private foundation has the right to exercise veto power over the actions of such organization relevant to any potential acts of self-dealing.

In Treas. Reg. § 53.4941(d)-1(b)(8), Example (1), Private foundation P owns the controlling interest of the voting stock of corporation X, and as a result of such interest, elects a majority of the board of directors of X. Two of P's foundation managers, A and B, who are also directors of corporation X, form corporation Y for the purpose of building and managing a country club. A and B receive a total of 40 percent of Y's stock, making Y a disqualified person with respect to P under section 4946(a)(1)(E). In order to finance the construction and operation of the country club, Y requested and received a loan in the amount of \$4 million from X. The example concludes that the making of the loan by X to Y shall constitute an indirect act of self-dealing between P and Y.

Treas. Reg. § 53.4941(d)-2(c)(1) provides generally, 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. It further states that, generally, 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(a)(1) provides generally that the term "business enterprise" 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.

Treas. Reg. § 53.4943-10(c) 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. For these purposes, gross income from passive sources includes the items excluded by sections 512(b)(1) (relating to dividends, interest, and annuities) and 512(b)(3) (relating to rent) and any income classified as passive for these purposes does not lose its character merely because section 514 (relating to unrelated debt-financed income) applies to such income. 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

1. Self-Dealing and the Receipt and Continued Ownership by CLT of the Interest in LLC

As a split-interest trust described in section 4947(a)(2), CLT is subject to the requirements of section 4941 as if it were a private foundation.

A, B, and C are all disqualified persons with respect to CLT under section 4946(a)(1)(B) as “foundation managers” because they are trustees of CLT. Accordingly, Investment Trust is a disqualified person under section 4946(a)(1)(G) with respect to CLT because it is a trust in which A, B, and C, who are all disqualified persons for the reasons stated above, hold more than a 35 percent beneficial interest. As Investment Trust is the obligor of the Note, an act of self-dealing would occur if Revocable Trust transferred the Note to CLT, which would become creditor under the Note. See Treas. Reg. § 53.4941(d)-2(c)(1).

Instead, it is proposed that Revocable Trust will form LLC, transfer the Note to LLC for voting and nonvoting interests, and transfer nonvoting interests in LLC to CLT. CLT will acquire such nonvoting interests in LLC by gift rather than through a self-dealing transaction; however, if CLT would be considered to “control” LLC within the meaning of Treas. Reg. § 53.4941(d)-1(b)(5), then CLT would be considered to be the creditor, indirectly, under the Note by reason of its ownership interest in LLC. See Treas. Reg. § 53.4941(d)-1(b)(8), Example (1).

CLT will not “control” LLC within the meaning of Treas. Reg. § 53.4941(d)-1(b)(5) due to a lack of voting power. As holder of the nonvoting interests, CLT will have no management rights or right to vote on the manager of LLC. The other beneficiaries of Revocable Trust will own all of the voting interests, giving them the right to select and remove the manager LLC. As a holder of nonvoting interests, CLT will have a right to receive distributions only if LLC dissolves or chooses to make current distributions, but the timing and amount of such distributions will be uncertain and cannot be compelled by CLT. Only the other beneficiaries of Revocable Trust, as the holders of the voting interests, may elect or remove the Manager, who will have the sole power to manage the affairs of LLC and determine the timing and amount of distributions. Thus, CLT and CLT’s trustees (acting only in such capacity) will not have sufficient votes or positions of authority to cause LLC to engage in a transaction.

Additionally, CLT will not have the power to compel dissolution of LLC since LLC may only be dissolved with written approval of all members, including the holders of the voting interests. The power associated with the nonvoting interests of LLC as a necessary party to vote on the liquidation of LLC is not considered equivalent to a “veto power” within the meaning of Treas. Reg. § 53.4941(d)-1(b)(5) because the power cannot be exercised over an action relevant to any potential act of self-dealing. Consequently, CLT will not “control” LLC within the meaning of Treas. Reg. § 53.4941(d)-1(b)(5)

Accordingly, CLT's receipt of nonvoting interests in LLC from Revocable Trust will not constitute a loan or extension of credit between a "private foundation" and a "disqualified person" within the meaning of section 4941(d)(1)(B) and Treas. Reg. §53.4941(d)-2(c) because CLT will not acquire an interest in the promissory note; instead, CLT will acquire nonvoting interests in LLC, with respect to which it will not have any management rights or control over distributions.

Thus, CLT's receipt and continued ownership of nonvoting interests in LLC will not constitute an act of self-dealing described in section 4941.

2. Self-Dealing and the Receipt of Distributions from LLC and Actions Taken by LLC in Connection with Enforcement and Collection of the Note

Under Treas. Reg. § 53.4941(d)-1(b)(4), a transaction between a private foundation and an organization does not result in an act of self-dealing where the organization is neither controlled by the foundation nor does it have a disqualified person owning at least a 35% beneficial interest in the organization. Here, as explained above, CLT does not control LLC because CLT only holds nonvoting interests, with the only voting interests in LLC held by the other Revocable Trust beneficiaries. Although the other Revocable Trust beneficiaries may be trustees of CLT and thus disqualified persons, they own the voting interests in LLC in their individual capacities and not as foundation managers of CLT. Further, the other Revocable Trust beneficiaries only own an approximately 1% beneficial interest in LLC, below the 35% threshold.

3. Excess Business Holdings

LLC's sole asset will be the Note, which will generate passive income in the form of interest, as described in sections 4943(d)(3) and 512(b)(1). As such, LLC will not be considered a "business enterprise" for purposes of section 4943(d)(3) because at least 95 percent of its gross income will derive from passive sources. See also Treas. Reg. § 53.4943-10(c)(1). Because LLC will not be considered a "business enterprise," the restrictions on excess business holdings under section 4943 will not apply. Thus, CLT's receipt and continued ownership of nonvoting interests in LLC will not result in excess business holdings under section 4943.

CONCLUSION

Based solely on the facts and representations submitted by CLT, we rule as follows:

1. The receipt from Revocable Trust and continued ownership by CLT of the interest in LLC will not be an act of self-dealing under section 4941.
2. The receipt by CLT of distributions from LLC of a proportionate share of payments on the Note, and actions taken by LLC in connection with enforcement and collection of the Note, will not be an act of self-dealing under section 4941.

3. The receipt from Revocable Trust and continued ownership by CLT of the interest in LLC will not result in excess business holdings under section 4943.

The rulings contained in this letter are based upon information and representations submitted by or on behalf of CLT and accompanied by a penalty of perjury statement executed by an appropriate party, as specified in Rev. Proc. 2019-1, 2019-1 I.R.B. 1, § 7.01(16)(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. 2019-1, § 11.05.

No ruling is granted as to whether CLT 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, estate, gift, or foundation excise tax consequences of any aspects of any transaction or item of income described in this letter ruling.

This ruling will be made available for public inspection under section 6110 after certain deletions of identifying information are made.

This letter is directed only to CLT. 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 CLT's authorized representatives.

Sincerely,

Don R. Spellmann
Senior Counsel
Exempt Organizations Branch 3
Associate Chief Counsel
(Employee Benefits, Exempt Organizations, and
Employment Taxes)

cc: