

**Internal Revenue Service**

Department of the Treasury  
Washington, DC 20224

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Person To Contact:  
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Telephone Number:

Refer Reply To:  
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PLR-110517-20

Date:  
October 14, 2020

Foundation =  
Donors =  
Irrevocable Trust =  
LLC =  
Management Trust =

Dear :

This letter responds to a request from Foundation’s authorized representatives dated April 16, 2020, and subsequent correspondence, for rulings under sections 4941 and 4943 of the Internal Revenue Code.<sup>1</sup> Foundation, recognized as a tax-exempt organization under section 501(c)(3) and classified as a private foundation under section 509(a), will receive nonvoting units in a newly incorporated LLC from Donors or Donors’ estate and potential distributions from LLC. Such distributions will be a proportionate share of payments of principal and interest from certain debtors under the terms of certain debt obligations held by LLC.

Foundation represents the facts as follows:

**FACTS**

Foundation will receive the net assets of Donors’ estate under The Last Will and Testament of Donors. Under the proposed transaction at issue, Donors plan to sell assets to a newly formed Irrevocable Trust in exchange for a promissory note, which entitles the holder to payments of principle and interest at defined terms. At least of the beneficial interest in Irrevocable Trust will be held directly or indirectly by descendants of Donors. Irrevocable Trust will be treated as a grantor trust for federal

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<sup>1</sup> Sections 4941 and 4943 of the Internal Revenue Code of 1986, as amended, to which all subsequent section references are made unless otherwise stated.

income tax purposes during the joint lives of Donors, and for one-half of the trust at the death of one of Donors.

Donors propose to transfer the promissory note and \_\_\_\_\_ in cash to LLC in exchange for \_\_\_\_\_ of the ownership interests of LLC: \_\_\_\_\_ of which would be nonvoting units and \_\_\_\_\_ of which would be voting units. This transfer results in LLC holding the promissory note and receiving the principle and interest payments due under the note. LLC's sole asset and source of income will be the contributions from Donors and payments under the promissory note. Prior to or at their deaths, Donors will distribute the nonvoting units in LLC to Foundation. The voting units in LLC will be contributed to Management Trust. Foundation will not be beneficiary of Management Trust.

The power to manage LLC will be conferred to one or more managers, who will be appointed by holder(s) of the voting units. Nonvoting unit holders neither possess management rights nor the right to vote on the appointment or removal of manager. The manager holds authority to make distributions to both voting and nonvoting unit holders after considering the needs of LLC and the manager's fiduciary obligations to all unit holders. Any such distributions, and all allocation of profits and losses, will be made in proportion to the number of units held by each voting and nonvoting member. LLC may be dissolved only upon the written approval of all unit holders. Thus, as a nonvoting unit holder, Foundation would have the right to receive distributions from LLC on a proportionate basis but does not have the right to compel distributions in any way under the proposed transaction.

Upon any default on the promissory note, LLC must take all immediate actions to foreclose on and collect payment from Irrevocable Trust. Foundation cannot be compelled to make any capital contributions to or transfer any property to LLC and generally cannot be held liable for actions taken by LLC.

## **RULINGS REQUESTED**

Based on the stated facts and representations, Foundation specifically requests rulings that:

1. The receipt and continued ownership of nonvoting units in LLC from Donors or Donors' estate will not constitute an act of self-dealing under section 4941 of the Code;
2. The receipt of distributions from LLC of a proportionate share of the payments of principal and interest, and any actions taken by LLC in connection with enforcement and collection of these payments, will not constitute acts of self-dealing under section 4941 of the Code; and

3. The receipt from Donor or Donors' estate and continued ownership of the nonvoting units will not result in excess business holdings under section 4943 of the Code.

## LAW

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 a tax on the excess business holdings of any private foundation in a business enterprise in any taxable year that ends during the taxable period.

Section 4943(c)(1) 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(d)(3) provides, in part, that the term "business enterprise" does not include a trade or business at least 95 percent for 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). See also Treas. Reg. §§ 53.4943-10(c)(1) and (2).

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(a)(2) provides that the term “substantial contributor” means a person who is described in section 507(d)(2) (i.e., a person who contributed or bequeathed an aggregate amount of more than \$5,000 to the private foundation if such amount is more than 2 percent of the total contributions and bequests received by the foundation before the close of the taxable year of the foundation in which the contribution or bequest is received by the foundation from such person; and, in the case of a trust, the creator of the trust).

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

Section 4946(d) provides, for purposes of section 4946(a)(1), the family of any individual shall only include the individual’s spouse, ancestors, children, grandchildren, great grandchildren, and the spouses of children, grandchildren, and great grandchildren.

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) restates the general rule under section 4941(d)(1)(B) that, generally, 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(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 section 4943(d)(1).

## **ANALYSIS**

### *Requested Rulings 1 and 2*

Under section 4946(a)(1), certain parties would be deemed disqualified persons with respect to Foundation including substantial contributors, foundation managers, and family members of these individuals. Donors are disqualified persons as both substantial contributors under section 4946(a)(2) and foundation managers under section 4946(b)(1) and, accordingly, certain relatives of Donors are disqualified persons under section 4946(d) as members of Donors’ family. Additionally, Irrevocable Trust is a disqualified person under the section 4946(a)(1)(G) provisions.

An act of self-dealing would occur if any of these parties directly transferred the promissory note to Foundation. Foundation would become creditor under the note to a disqualified person. See Treas. Reg. § 53.4941(d)-2(c)(1). Under the proposed transaction, Donors assign the promissory note to LLC in exchange for nonvoting and voting units in LLC. Foundation then receives the nonvoting units in LLC from Donors through a gift (or by a testamentary devise or bequest from Donors’ estate) rather than through a direct self-dealing transaction. Any direct payments the Foundation receives in connection with this transaction would be provided by the LLC and not by a disqualified person.

Self-dealing may also be present if any of the above parties indirectly transferred the promissory note and Foundation is deemed to “control” LLC under Treas. Reg. § 53.4941(d)-1(b)(5). Under this situation, Foundation would be indirectly serving as the creditor under the note by reason of its ownership interest in LLC. See Treas. Reg. § 53.4941(d)-1(b)(8), Example (1).

However, as holder of only nonvoting units, Foundation does not control LLC within the meaning of Treas. Reg. § 53.4941(d)-1(b)(5). Foundation lacks management rights and the right to vote on the manager(s). This is particularly noteworthy as the manager holds the power to manage the affairs of LLC and determine the timing and amount of potential distributions. Only the holder(s) of the voting units in LLC, anticipated to be Management Trust, has the ability to elect and remove the manager. Foundation simply

holds a right to receive distributions if the manager chooses to make current distributions or in the event LLC dissolves.

Furthermore, Foundation does not have the power to compel dissolution of LLC. Foundation is only able to prevent such a dissolution as LLC may be dissolved with written approval of all unit holders, both voting and nonvoting. The power associated with the nonvoting units of LLC as a necessary party to vote on the entity's liquidation 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 including the power to compel distributions from LLC or influence the managerial decisions of LLC in any way.

It follows that Foundation's receipt of nonvoting units in LLC 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) and Treas. Reg. § 53.4941(d)-2(c)(1) since Foundation will not acquire an interest in the promissory note. Instead, Foundation will acquire nonvoting units in LLC with respect to which it will not have any management rights or control over potential distributions from the promissory note. The timing and amount of any such distributions is uncertain and cannot be compelled in any way by Foundation. Consequently, the proposed transaction will not constitute an act of direct or indirect self-dealing between Foundation and a disqualified person under section 4941.

### *Requested Ruling 3*

In order for Foundation's nonvoting unit holdings in LLC to constitute excess business holdings under section 4943(c)(1), LLC must qualify as a business enterprise under section 4943(a). The term business enterprise under section 4943(d)(3) does not include a business having at least 95 percent of its gross income derived from passive sources as set forth in sections 512(b)(1), (2), (3), and (5). LLC's only active holding is the note, which generates interest – a passive source under section 512(b)(1). Therefore, LLC will not be considered a business enterprise for purposes of section 4943(d)(3) as at least 95 percent of its gross income will derive from passive sources in the form of interest. See Treas. Reg. § 53.4943-10(c)(1).

Since LLC is not deemed a business enterprise, and it holds no interest in any business enterprise, Foundation's holdings of non-voting units in LLC are not interests in a business enterprise and would not constitute excess business holdings under section 4943.

## **RULINGS**

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

1. Foundation's proposed receipt from Donors or Donors' estate of nonvoting units in LLC will not constitute an act of direct or indirect self-dealing under section 4941.
2. Foundation's proposed receipt from Donors or Donors' estate of distributions from LLC, and actions taken by LLC in connection with enforcement and collection of such payments, will not constitute an act of direct or indirect self-dealing under section 4941.
3. Foundation's ownership of non-voting units in LLC from Donors or Donors' estate will not constitute a violation of the prohibition against ownership of excess business holdings under section 4943 as LLC is not deemed a business enterprise for such purposes.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party, as specified in Rev. Proc. 2020-1, 2020-1 I.R.B. 1, §7.01(16)(b). We have not verified any of the material submitted in support of the request for a 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. 2020-1, §11.05.

Except as expressly provided above, no opinion is expressed or implied concerning the federal income, estate, gift, or foundation excise tax consequences of any other aspects of any transaction (or combination of transactions) or item of income described in this letter ruling, including whether any transactions are completed transfers. No opinion is expressed regarding the valuation of any assets described in this ruling request for estate or gift tax purposes.

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

This letter ruling is directed only to the taxpayer requesting it. 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 your authorized representatives.

Sincerely,

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Theodore Lieber  
Senior Tax Law Specialist  
Exempt Organizations Branch 1  
Associate Chief Counsel  
(Employee Benefits, Exempt  
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cc: