TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

Number: **200611034**
Release Date: 3/17/06
235862/SE:T:EO:RA:T:2

Date: December 19, 2005

Contact Person:

Uniform Issue List

Identification Number:

4943.03-01
4943.04-00
4943.04-03

Telephone Number:
(202)

Employer Identification Number:

Legend:

M =
N =
O =
P =
Q =
R =
x =

Dear :

We have considered your ruling request dated January 13, 2005, wherein you request, on behalf of M, that the investment partnerships described below will not constitute "business enterprises" and, therefore, will not cause M to have excess business holdings under section 4943 of the Internal Revenue Code.

FACTS

M is a nonprofit corporation formed under the laws of the State of N. It has been determined by the Internal Revenue Service to be exempt from federal income tax as an organization described in section 501(c)(3) of the Code and it has also been classified as a private foundation under section 509(a).

M's mission is to improve the health of all Americans and its grant-making is designed to accomplish the following four goals: (1) to assure that all Americans have access to quality health care at a reasonable cost; (2) to improve the quality of care and support for people with chronic health conditions; (3) to promote healthy communities and lifestyles; and (4) to reduce

the personal, social, and economic harm caused by substance abuse – tobacco, alcohol, and illicit drugs. During , M awarded 927 grants and contracts supporting charitable work totaling over $, making it the largest source of charitable funding for health-related programs.

M has committed to invest $ as a limited partner in two "fund-of-funds" limited partnerships (each individually a "Fund-of-Funds", and collectively the "Funds-of-Funds") which are being formed by O, an N based investment firm serving institutional investors. O is staffed by experienced investment advisors and is completely unrelated to M and its disqualified persons.

The Funds-of-Funds are organized as P limited partnerships. The sole activity of each Fund-of-Funds is to invest as a limited partner in several other limited partnerships. The two Fund-of-Funds are Q, which will focus on real estate investments, and R, which will focus on energy investments. Q will have a maximum capitalization of $ and R will have a maximum capitalization of $. M's $ investment will be allocated $ to Q and $ to R.

O or an affiliate of O will be the general partner of both Q and R (the "General Partner") and will have the sole power to manage and make investments on behalf of the Funds-of-Funds. In addition, O, in its capacity as General Partner of Q and R, will establish an advisory board composed of limited partner representatives selected by the General Partner, one of whom will be a representative designated by M and a majority of whom will be unaffiliated with the General Partner. The advisory board will provide such advice and counsel as is requested by the General Partner in connection with the Funds-of-Funds investments, potential conflicts of interest, and other matters.

O seeks investment managers that typically possess specialized knowledge or capabilities that could lead to a sustainable competitive advantage in their markets or geographic regions and generate attractive investment opportunities. O intends to commit capital to investment funds wherever it determines that the people, the market, the assets and the particular strategy are well positioned to produce the desired returns. The primary focus is on searching for strategies where inefficiencies have been identified and can be exploited or where an opportunity has been identified and value can be added in response to changing market conditions.

Q expects to invest in 10 to 15 underlying real estate investment partnerships with the objective of achieving overall net returns to investors of 12 to 15 percent per year. Q will seek out investments in underlying investment partnerships that principally target investments in existing U.S. properties with reasonable value-added prospects. Its approach is to seek out underlying investment managers who primarily focus on quality assets in major U.S. metropolitan markets that have some discernible barrier to entry (mainly the degree of difficulty in developing new supply) with a diversified economy driving growth.

R intends to invest in 5 to 10 underlying energy investment partnerships with the objective of achieving overall net returns to investors ranging from 10% to 12% per year. R will seek out investments in underlying investment partnerships that principally target U.S. onshore and offshore investments in producing oil and gas reserves with a modest component of

exploratory and development drilling.

Q and R had an initial closing with M as the sole limited partner and the General Partner as the sole general partner (the "Initial Closing"). Upon the Initial Closing, O commenced investment activities and is actively seeking to make commitments on behalf of Q and R to lower-tier partnerships. M's commitment to Q and R will be drawn down as needed with at least 10 days (5 days in the case of the first capital call) prior written notice.

O will have up to 12 months after the date of the Initial Closing to raise up to an additional $ of commitments for Q and $ of commitments for R from new investors. O will provide M with quarterly written reports regarding the status of its commitment-raising efforts. If O is unable to raise at least $ of additional commitments for Q and R, collectively, within 12 months after the date of the Initial Closing, then M will have the right to remove O as the General Partner.

In the event that M notifies O that it will not exercise the General Partner removal option, O will commit a total of $ within 30 days after the end of the 12 period months described above. Such commitment will be allocated between Q and R on a pro rata basis based on the total amount of commitments made to Q and R.

Depending on the amounts invested by other investors, M will ultimately own between 41.7% and 66-2/3% of the interests in Q and R. Q and R may remain in existence if O is able to raise an additional $ of commitments over M's $ commitments. If O is able to raise only the minimum amount, M will own 66-2/3% of the interest in each Fund-of-Funds. If O is able to obtain commitments up to the maximum allowable by each Fund, then M will own 41.7% of the limited partner interests.

To the extent that O has made commitments on behalf of Q and R to any lower-tier partnership, and M has funded capital calls related to these commitments prior to final closing, then any new investors will be required to pay the particular Fund-of-Funds their pro rata share of such prior capital calls, plus interest at the prime rate plus 2% on the amounts so funded. Any such amounts paid to Q and R will be returned to M and any other partners who have made previous capital contributions on a pro rata basis.

The Investment Period for Q and R will last from the date of the Initial Closing until the earlier of the 30 month anniversary of such date or the date upon which all commitments have been invested. After the end of the Investment Period, all partners of the respective Funds-of-Funds will be released from any further obligation with respect to their unfunded commitments, except to the extent necessary to (1) cover management fees, expenses, liabilities, and obligations of the Funds-of-Funds; (2) complete investments by the Funds-of-Funds in transactions that were in process as of the end of the Investment Period; and (3) fund existing commitments, including such Funds-of-Funds' commitments to existing lower-tier partnerships. Subject to the foregoing, the General Partner may call commitments at any time during the life of the Funds-of-Funds.

Net proceeds attributable to the disposition of investments in lower-tier partnerships, distributions of securities in-kind from lower-tier partnerships, and any dividends and interest income received from lower-tier partnerships will be distributed from Q and R to the partners in

the following order of priority:

(1) 100% to partners in proportion to their invested capital until each receives 100% of its invested capital;

(2) 100% to the partners in proportion to each partner's invested capital until each partner receives an annual compounded rate of return on its invested capital of 6% (plus the CPI Rate) for Q and 5% (plus the CPI Rate) for R;

(3) 100% to the General Partner until it receives 3% of all amounts previously distributed to the partners pursuant to (1) and (2); and

(4) 97% to the limited partners and 3% to the General Partner.

The amounts received by the General Partner pursuant to (3) and (4) above are referred to as the "Carried Interest". In addition to the above distributions, the General Partner may receive tax distributions to satisfy tax liabilities arising from allocations attributable to its Carried Interest.

Beginning with the fourth anniversary of the Investment Period expiration date, the above distributions will be adjusted to provide a reduction in the amounts otherwise payable to the General Partner and an increase in the amounts otherwise payable to M (but never in excess of the amounts that would otherwise be payable to the General Partner) in an amount equal to the cumulative annual management fees actually paid by M during this period.

M and O have agreed upon the terms of a separate, binding "Letter Agreement" containing specific provisions necessary to accommodate M's tax status and charitable mission. Section 4 of the Letter Agreement contains the following language to ensure that Q and R will qualify for the passive source exception to "business enterprise" contained in section 53.4943-10(c)(1) of the Foundation and Similar Excise Taxes Regulations:

> Avoidance of Non-Passive Income. Except as otherwise provided in this section, the General Partner shall use best efforts to cause each [Fund-of-Funds] to fall within the exception from qualification as a "business enterprise" under Treas. Reg. (sec.) 53. 4943-10(c)(1) by (a) making investments that produce only those types passive source income that are specifically named in Regulation section 53.4943-10(c)(2) or that are held as such in guidance issued by the IRS or other binding legal precedents so that the "gross income from passive sources" in a taxable year will equal at least 95% of each [Fund-of-Funds'] gross income in that taxable year, or (b) if failing to meet the test in the immediately preceding clause (a) in any taxable year, making investments that produce only those types of passive source income that are specifically named in Regulation section 53.4943-10(c)(2) or that are held as such in IRS guidance or other binding legal precedents so that the average "gross income

> from passive sources" for the immediately preceding 10 taxable years (or such shorter period that each [Fund-of-Funds] has been in existence) will equal at least 95% of the gross income of each [Fund-of-Funds] in that taxable year. If for any reason a [Fund-of-Funds] fails to meet at least one of the two tests above in any taxable year, (M) may treat its entire investment in such [Fund-of-Funds] as a Permitted Excuse in accordance with the procedures set forth in Section 3(a)(iii). The obligations of the General Partner pursuant to this section shall immediately expire upon the issuance by the Internal Revenue Service of a private letter ruling finding that the [Funds-of-Funds] will continue to qualify for the exception to "business enterprise" contained in Regulation section 53.4943-10(c) after they invest as limited partners in [lower-tier partnerships] that are engaged in the active conduct of a trade or business or that (M's) holdings in the [Funds-of-Funds] will not constitute excess business holdings under Code section 4943 after the [Funds-of-Funds] make such investments.

RULING REQUESTED

M requests a ruling that after the investment by Q and R as limited partners in lower-tier partnerships that are engaged in the active conduct of a trade or business, Q and R will continue to qualify for the exception to "business enterprise" contained in section 53.4943-10(c)(1) of the regulations for entities with 95% passive source income, and, consequently, M's 41.7% or more holdings in Q and R will comply with the section 53.4943-10(c)(1) requirements for avoiding excess business holdings under section 4943 of the Code.

LAW

Section 4943(a) of the Code imposes an excise tax on a private foundation's excess business holdings in a business enterprise. Subparagraph (c) defines excess business holdings as the amount of stock or other interest in an enterprise, which the foundation would have to dispose of in order for its remaining holdings in that enterprise to be permitted holdings.

Section 4943(c)(2)(A) of the Code and section 53.4943-3(b) of the regulations provide that the permitted holdings of a private foundation in an incorporated business enterprise is 20% of the voting stock reduced by the percentage of voting stock owned by all disqualified persons. If all disqualified persons together do not own more than 20% of the voting stock, then nonvoting stock held by the private foundation shall also be treated as permitted holdings.

Sections 4943(c)(2)(B) of the Code and section 53.4943-3(b)(3) of the regulations provide that if a foundation and all disqualified persons together own no more than 35% of the voting stock in an incorporated business enterprise and effective control of the corporation is in one or more persons who are not disqualified persons with respect to the foundation, then the permitted holdings of a private foundation will be 35% of the voting stock of the enterprise reduced by the percentage of voting stock owned by all disqualified persons.

Section 4943(c)(3)(A) of the Code and section 53.4943-3(c)(2) of the regulations provide that in the case of a partnership (including a limited partnership) or joint venture, "profits interest" shall be substituted for "voting stock" and "capital interest" shall be substituted for "nonvoting stock". The regulation also provides that the interest in profits of a foundation or a disqualified person shall be determined in the same manner as its distributive share of partnership income under section 704(b) of the Code. In the absence of a provision in the partnership agreement, the capital interest of a foundation or a disqualified person in a partnership shall be determined on the basis of its interest in the assets of the partnership which would be distributable to such foundation or disqualified person upon its withdrawal from the partnership or upon liquidation of the partnership, whichever is greater.

Section 4943(d)(1) of the Code provides that in computing the holdings of a private foundation or a disqualified person 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 53.4943-10(a)(1) of the regulations defines the term "business enterprise" to include 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 of the Code.

Section 53.4943-10(c)(1) of the regulations sets forth the following exception to "business enterprise":

> [T]he term "business enterprise" does not include a trade or business at least 95% 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).

Section 53.4943-10(c)(2) of the regulations defines gross income from passive sources as including the items excluded by section 512(b)(1) (relating to dividends, interest, and annuities), section 512(b)(2) (relating to royalties), section 512(b)(3) (relating to rent), and section 512(b)(5) (relating to gains or losses from the disposition of certain property that are recognized in connection with the organization's investment activities). Any income so classified as passive income does not lose its character as such merely because section 512(b)(4) or 514 (relating to unrelated debt-financed income) applies to such income.

ANALYSIS

M will own 41.7% or more of the profits interest in each Q and R. Accordingly, M's holdings in these partnerships will constitute excess business holdings if Q and R are considered "business enterprises" within the meaning of section 53.4943-10(a) of the regulations. However, neither Q nor R will constitute "business enterprises" for purposes of section 53.4943-10(a) because they will meet the exception contained in section 53.4943-10(c)(1). In this regard, pending the issuance of a favorable ruling, section 4 of the Letter Agreement requires that the General Partner invest only in lower-tier partnerships that produce those categories of passive income identified in section 53.4943-10(c)(2). Thus, Q and R will undoubtedly meet the requirements of section 53.4943-10(c)(1).

If Q and R invest as limited partners in one or more partnerships that are engaged in the active conduct of a trade or business, the exception to "business enterprises" stated in section 53.4943-10(c)(1) should continue to apply because the distributions that Q and R will receive from the lower-tier partnerships in their capacity as limited partners should constitute gross income from passive sources within the meaning of section 53.4943-10(c)(2).

While section 53.4943-10(c)(2) of the regulations does not specifically list limited partner distributions as passive source income, it does not preclude limited partnership interests from giving rise to passive source income; the specific items listed are not an exclusive list. Limited partner interests are passive investments that are comparable to stock and securities. As with a holder of corporate stock, a limited partner does not participate in the trade or business. In this vein, your brief points out that, "Instead, he is primarily an investor who contributes capital in return for the right to share in the profits of the partnership. His return is dependent on the efforts of others, and he does not take part in the management of the partnership's business. He also limits his liability, thereby avoiding the risks generally involved in operating a trade or business."

Section 53.4943-10(c)(2) of the regulations specifically identifies stock dividends as passive source income. Based on the noted similarities between an investment in stock and an investment made by a limited partner, limited partner distributions should also be viewed as passive source income.

We also conclude that the policies underlying the enactment of Code section 4943 support the characterization of limited partner interests as giving rise to passive source income. One of the concerns of lawmakers was that foundation managers paid too much attention to the maintenance and improvement of business interests to the detriment of the time and energy expended on their charitable duties. See H.R. Rep. No. 413 (Part 1), 91st Cong., 1st Sess. 27 (1969); S. Rep. No. 552, 91st Cong., 1st Sess. 38-39 (1969). It would not be consistent with this Congressional concern to treat Q and R as business enterprises. From all indications, it appears that a fund-of-funds partnership may actually result in less business involvement or the diversion of the private foundation managers' attention toward investment activities than would otherwise be the case. Accordingly, M should be able to invest in the lower-tier partnerships directly, provided that it, along with disqualified persons, did not exceed the 20% or 35% limitation (whichever is applicable). Further, in light of Congressional policy, there is no good reason why M should not be permitted to hold such limited partnership interests indirectly through Q and R, so long as M's proportionate share of the lower-tier partnership does not

exceed the 20% or 35% limitation (whichever is applicable).

RULING

Based on the representations made in your ruling request, and the applicable law, we rule that the investment by Q and R as limited partners in lower tier partnerships that are engaged in the active conduct of a trade or business will continue to qualify for the exception to "business enterprise" contained in section 53.4943-10(c)(1) of the regulations for entities with passive source income, and consequently, M's 41.7% or more of holdings in Q and R will comply with the section 53.4943-10(c)(1) requirements for avoiding excess business holdings under section 4943 of the Code.

The ruling takes no position as to whether M's investments in lower tier partnerships will constitute excess business holdings by reason of exceeding the 20% limit in section 4943(c)(2)(A) of the Code or the 35% limit in section 4943(c)(2)(B).

Any changes that may have a bearing upon M's tax status should be reported to the Ohio Tax Exempt and Government Entities (TE/GE) Customer Service Office. The mailing address is: Internal Revenue Service, TE/GE Customer Service, P.O. Box 2508, Cincinnati, OH 45201. The telephone number there is 877-829-5500 (a toll free number).

If there are any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

This ruling is directed only to M and the parties that requested the ruling. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Thank you for your cooperation.

Sincerely,

Andrew F. Megosh, Jr.
Acting Manager, Exempt
Organizations Technical Group 2

Enclosure
Notice 437

cc: