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INTERNAL REVENUE SERVICE

NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

E.O. Exams Programs and Review
Internal Revenue Service
1100 Commerce Street
MC 4900 DAL
Dallas, TX 75242

April 10, 2008

UIL Code: 4946.01-00, 4943.03-00

Taxpayer's Name

Taxpayer's Address

Taxpayer's Identification Number

Tax Years Involved

Date of Conference:

Legend:

M =
Q =
R =
S =
T =

U =
U1 =
U2 =
U3 =
U4 =

V =
W =
X =
Y =
Z =
MM =

A =
B =
C =
D =
E =
F =
G =
H =
J =

a =
b =
c =
d =
e =
f =
g =
h =

Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Date 7 =
Year =

ISSUES:

1. Is S a disqualified person with respect to Q as a substantial contributor under section 4946(a)(1)(A) of the Internal Revenue Code?
2. Is S a disqualified person with respect to Q as a private foundation as described in section 4946(a)(1)(H)?
3. Is any part of Q's ownership of W and R an excess business holding under section 4943?

FACTS:

Q is a private foundation that was created in Date 1 as a result of contributions from E and G. Q is exempt from Federal income tax as an organization described in section 501(c)(3) of the Code. Q is a private foundation as described in section 509(a). The three current trustees of Q are: A, C¹, and H². D³ is Executive Director.

The majority of Q's income is from S, a charitable remainder trust. S was established in Year pursuant to the Last Will and Testament of G, dated Date 2. S is described in § 4947(a)(2) of the Code. Under the terms of the trust instrument of S, the income was to be distributed to a number of family members for life, in various proportions. S's remainder beneficiaries are charities, including Q, and S's income beneficiaries are largely also charities, including Q. The grantor of S designated 10 lifetime beneficiaries to receive its income. As each beneficiary died, that family member's share of the income would henceforth be paid to the charitable remainder beneficiaries pro rata, 75% of his or her share of income to Q and 25% to X, a public charity. Upon the death of the last lifetime beneficiary, S terminates and the corpus of S will be distributed 75% to Q and 25% to X. As of _____, 2002, A and J were the only lifetime beneficiaries still living.

Several years after S was established, G's spouse (F) died. Thereafter, there was litigation between F's Estate, S, and certain beneficiaries of S. In settlement of the litigation, the Estate purchased the life interests of several beneficiaries and distributed those interests to Q.

In a private letter ruling on Date 3 regarding whether Q could sell its shares in M to a disqualified person without being subject to the tax on self-dealing under section 4941 of the Code, the Service indicated that any sale by Q during the 15-year time period beginning May 26, 1969 to disqualified persons would not represent self-dealing.

Q requested and received a Date 4 ruling that S is not a disqualified person with respect to Q as a substantial contributor. In ruling that S is not a substantial contributor, the Service reasoned that the amounts distributed by S to Q pursuant to Q's interests received from the settlement of the litigation were not "contributions" to Q, because Q received its right to these amounts from the Estate, which paid adequate consideration for the interests, "regardless of whether or not these amounts were eligible for the [section 642(c)] deduction."

One of the principal assets held by S is a shares (37.575%) of stock in W, a business enterprise. It is the largest block of W stock held by a single entity. The next largest block is held by Q, b shares (23.695%).

1 Son of A and beneficiary of U3

2 Mother of A and grandmother of C and D.

3 Daughter of A and beneficiary of U4.

M is Trustee of S and it is also a disqualified person with respect to Q because the majority of interest in M is indirectly owned by U, the collective name for the following trusts: U1, U2, U3, and U4. Each of these trusts is for the benefit of one of A's children. The four trusts are governed by a single Trust Indenture and various amendments executed by A. In a private letter ruling, the four trusts were held to be disqualified persons to Q under section 4946(a)(1)(G) of the Code.

A is a trustee of Q as well as a descendent of a substantial contributor, and is therefore a disqualified person under both section 4946(a)(1)(B) of the Code as Foundation Manager and section 4946(a)(1)(D) for a familial relationship. A has generally served as President, Chief Executive Officer, etc. of M from at least the early 80's until the present time, although his exact positions have varied somewhat over time. During 1998, he was Chairman of the Board and a director of M. A is currently the Chairman of the Board of M. A attends the meetings of M Trust Committee as Chairman. He votes on matters affecting all trusts administered by M, including S. A is given a proxy each year to vote all of W stock administered by M.

As of May 26, 1969, over 85% of the corpus of both Q and S was from G and H, their families and their estates.

The National Office held in a private letter ruling on Date 4 (with a supplemental request) that S was not a disqualified person to Q under section 4946(a)(1)(A) of the Code as a substantial contributor, or under section 4946(a)(1)(G). With respect to stock currently held by Q, Phase I under section 4943(c)(4)(B) of the Code would run for a ten-year period beginning on May 26, 1969; In addition, with respect to W stock held by S, during the period May 26, 1969 to the date of distribution by the Trust, 25% of the stock will be considered to be held by X and the remainder will be considered to be held by S. Finally, the stock considered to be held by S would be treated as held by S from May 26, 1969, until the date of distribution.

The discussion in the Date 4 private letter ruling centers on whether S is a "substantial contributor" to Q and concludes that it does not meet the definition. The ruling does not discuss whether S could be a disqualified person to Q on some basis other than "substantial contributor" status.

A supplemental private letter ruling addressed whether S was a disqualified person to Q under section 4946(a)(1)(G) of the Code. This was based on a representation by Q that disqualified persons held a 37.25 percent life interest in the income from S and no remainder interest and that, on an actuarial basis, disqualified persons held only a 10.613 percent interest.

Neither the original private letter ruling nor the supplemental discuss whether S is a disqualified person to Q under section 4946(a)(1)(H) of the Code. The ruling does acknowledge that S is the type of trust described in section 4947(a)(2).

The ruling held that W stock held by S would not be attributed to Q until such time as it is actually distributed to Q because it was contributed to S before May 26, 1969. Under the terms of the Trust instrument, the stock would not be formally distributed until after the death of both A and J, the only two lifetime income beneficiaries of S still living. Upon their deaths, the corpus of S will be distributed 75% to Q and 25% to X and S will be dissolved.

At the time the private letter rulings were requested, S owned a shares of W, or 30.1502% of the c shares outstanding at that time. S currently owns a shares of W, but the percentage of ownership is now 37.57%. Due to redemption of W shares, the total shares outstanding have decreased, thus increasing S's percentage of ownership.

R, a business enterprise, was originally a family owned entity. As of May 26, 1969, it was owned 50% by Q and 50% by S, a split-interest trust as defined by section 4947(a)(2)(C) of the Code. The ownership was unchanged, as of Date 5; a private letter ruling was requested as to whether the entity represented an excess business holding. The request states that since disqualified persons own no stock in R, it did not represent an excess business holding as of the date of the request. The National Office concurred with this line of reasoning.

Owner	# of Shares Owned	Percentage
<u>S</u>	<u>d</u>	50.2%
<u>Q</u>	<u>e</u>	34.0%
<u>I</u>	<u>f</u>	15.8%
	_____	_____
Total	<u>g</u>	100%
	===	===

The Date 5 private letter ruling concluded that Q's 50% ownership interest in R did not represent an excess business holding at that time. However, it did not entitle them to own 50% indefinitely without paying section 4943 tax. Rather it allowed Q to own 50% only during what is termed the "First Phase"⁴ and "Second Phase." The ruling holds that by the end of the "Second Phase" Q must have reduced its holdings in R to no more than 35% in both voting

⁴ IRC §4943(c)(4) provides for a transitional phase in which up to 50% of shares in a company may be owned, provided they were owned as of May 26, 1969. In this case the first phase would have been ten years under subsection (4)(B), followed by a second phase of 15 years.

stock and total value, provided that disqualified persons do not own more than 2% of the voting stock.

On or about Date 6, Q transferred h shares of R stock to T. This reduced the stock held in their name to e shares or slightly under 35%.

T is a tax-exempt organization as described in section 501(c)(3) of the Code and is classified as under section 509(a)(3) as a supporting organization for Y. T receives a substantial amount of its funding directly from and indirectly through Y from M. Y also receives a substantial amount of its public support from Q. T's Amended Articles of Incorporation provides for a three member board of directors, currently composed of: A as lifetime director, and B and D as the other two directors.

A ruling request dated Date 7 was obtained that holds that T is classified as a supporting organization under section 509(a)(3) of the Code. The ruling further holds that A, B and D are not disqualified persons to T (other than by virtue of being foundation managers) because they are not "substantial contributors" to T within the meaning of section 507(d)(2). As such, the ruling holds that T is not controlled directly or indirectly by one or more disqualified persons other than foundation managers and Y.

According to Q, on Date 6, Q transferred h shares of R to Y as part of a grant. On , 1992, Y transferred its h shares of R to T. In turn, T sold one share to S on , 1992. Per the 1998 minutes of T, a proxy to vote R stock was given to A.

According to the Minutes of R, A received the proxies in a fiduciary capacity from each of Q, S, and T each year for several years for the sole purpose of authorizing him to vote their R shares on their behalf at the annual shareholders meeting in 1999, 2000, 2001 and 2002. A also serves on the board of R and was its chairman in 1999 and 2000.

According to the operations policy manual of M, voting and non-voting of proxies is the responsibility of the Trust Committee. The manual further states that the primary objective is for M, in its fiduciary capacity, to represent and vote for the best long-term interest of its beneficiaries. M acknowledges that it has followed such policies when voting R and W stock owned by S as well as when voting W stock owned by T. Meeting minutes of the Trust Committee indicate that it is department policy to give an officer, director, or trust committee member of M, the proxy to vote the R and W stock in person and with complete discretion. The trust department has followed this policy for at least 41 years. In addition, the person receiving the proxy generally follows M's policy of voting, which includes voting for the slate of directors approved by the board.

Q directly owns 23.70% of W stock. Six other shareholders who are disqualified persons to Q own approximately an additional 1.67%. In addition to the shares directly owned by Q and disqualified persons. Disqualified persons also own stock indirectly through U, Z.

and MM. Z, which holds 1.9%, is a partnership that is owned 1% by A as general partner and 99% by H, as limited partner. Both are disqualified persons to Q. A votes 100% of W stock held by the partnership. MM is a trust, which holds approximately 4.362%. A is one of the seven beneficiaries and holds a proxy to vote W stock. U holds approximately 0.03607%. In addition to the stock held above, additional shares are held by S and T. S holds approximately 37.58% and T holds 2.95%.

W has a nine member Board of Directors. During the time periods at issue, the Board of Directors included: A, D, E, and J, all of whom are disqualified persons to Q pursuant to section 4946(a)(1)(D) of the Code.

LAW:

Section 507(d)(2)(A) of the Code defines a substantial contributor as any person who contributed or bequeathed an aggregate amount of more than \$5,000 to a 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. In the case of a trust, the term substantial contributor also means the creator of the trust.

Section 1.507-6(c)(1) of the Income Tax Regulations provides that the term "contribution" shall, for purposes of section 507(d)(2), have the same meaning as such term has under section 170(c) and also include bequests, legacies, devises, and transfers within the meaning of section 2055 or 2106(a)(2). Thus, for purposes of section 507(d)(2), any payment of money or transfer of property without adequate consideration shall be considered a contribution. Where payment is made or property transferred as consideration for admissions, sales of merchandise, performance of services, or furnishing of facilities to the donor, the qualification of all or any part of such payment or transfer as a contribution under section 170(c) shall determine whether and to what extent such payment or transfer constitutes a contribution under section 507(d)(2).

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

Section 4943(c)(1) of the Code defines the term "excess business holdings" as the amount of stock or other interest in a business enterprise that a private foundation would have to dispose of, to a person other than a disqualified person, for its remaining holdings to be permitted holdings.

Section 4943(c)(2)(A) of the Code provides that a foundation and its disqualified persons may not hold more than 20% of the voting stock of a corporation conducting a business that is not substantially related to the exempt purpose of the foundation.

Section 4943(c)(2)(B) of the Code and section 53.4943-3(b)(3) of the Foundation and Similar Excise Taxes Regulations provide that the 20% limitation may be raised to 35% if: (i) the private foundation and all disqualified persons together do not own, actually or constructively, more than 35 percent of the voting stock in the business enterprise, and (ii) the foundation establishes to the satisfaction of the Commissioner that effective control of the business enterprise is in one or more persons (other than the foundation itself) who are not disqualified persons.

Section 4943(c)(4) of the Code provides an exception that allows private foundations with holdings in excess of 20% or 35% of the voting stock on May 26, 1969, a period of time to dispose of the excess holdings before becoming subject to the excise tax provided in section 4943(a).

Section 53.4943-3(b)(3)(ii) of the regulations defines the term "effective control" as the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a business enterprise, whether through the ownership of voting stock, the use of voting trusts, or contractual arrangements, or otherwise. It is the reality of control, which is decisive, and not its form or the means by which it is exercisable. Thus, where a minority interest held by individuals who are not disqualified persons has historically elected the majority of a corporation's directors, effective control is in the hands of those individuals.

Section 4946(a)(1)(A) of the Code defines the term "disqualified person" with respect to a private foundation as including a substantial contributor to the foundation.

Section 4946(a)(2) of the Code provides that for purposes of section 4946(a)(1), the term "substantial contributor" means a person who is described in section 507(d)(2).

Section 4946(a)(1)(H) of the Code includes in the definition of "disqualified person," for purposes of section 4943, a private foundation which is effectively controlled (directly or indirectly) by the same person or persons who control the private foundation in question, or substantially all of the contributions to which were made (directly or indirectly) by the same person or persons described in subparagraph (A)⁵, (B)⁶, or (C)⁷, or members of their families (within the meaning of subsection (d)⁸), who made (directly or indirectly) substantially all of the contributions to the private foundation.

5 IRC 4946(a)(1)(A) a substantial contributor to the Foundation

6 IRC 4946(a)(1)(B) a foundation manager (within the meaning of subsection (b)(1))

7 IRC 4946(a)(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.

8 IRC 4946(d) For purposes of subsection (a)(1), the family of any individual shall include only his spouse, ancestors, children, grandchildren, great grandchildren, and the spouses of children, grandchildren, and great grandchildren.

Section 4947(a)(2) of the Code provides that a trust is described in this section if: it is not exempt under section 501(a); its income and assets are not completely devoted to charitable purposes described in section 170(c)(2)(B); and it has amounts in trust for which a charitable deduction was allowed. Generally, section 4941 (relating to taxes on self-dealing), section 4943 (relating to taxes on excess business holdings) except as provided in subsection (b)(3), section 4944 (relating to investments which jeopardize charitable purpose) except as provided in subsection (b)(3), and section 4945 (relating to taxes on taxable expenditures) apply to such trust as if it were a private foundation. However, section 4947(a)(2)(C) excludes amounts transferred in trust prior to May 27, 1969 from application of the private foundation provisions.

Section 53.4947-1(c)(5)(i) of the regulations provides that for this purpose, an amount shall be considered to be transferred in trust only when the transfer is one that meets the requirements for the allowance of a charitable deduction. Income and capital gains that are derived at any time from amounts transferred in trust before May 27, 1969, shall also be excluded from the application of the chapter 42 rules. If an asset that was transferred in trust before May 27, 1969, is sold or exchanged after May 26, 1969, any asset received by the trust upon the sale or exchange shall be treated as an asset that was transferred in trust before May 27, 1969.

In Peters v. U.S., 624 F.2d 1020 (Ct. Cl. 1980), the trust established prior to May 27, 1969 argued that it was not subject to the private foundation rules. However, the court disagreed and held that the trust was a trust under section 4947(a)(1) of the Code and subject to the private foundation rules since all the non-charitable interests had expired.

In Hammond v. U.S., 764 F.2d 88 (2d Cir. 1985), the Second Circuit held a trust to be a split-interest trust described in section 4947(a)(2) of the Code rather than a non-exempt charitable trust under section 4947(a)(1) under the facts and circumstances, and therefore not treated as a private foundation, because it was formed before 1969.

RATIONALE:

Issue 1: Is S a substantial contributor to Q under section 4946(a)(1)(A)?

If S is a disqualified person with respect to Q as a substantial contributor, then S's business holdings would need to be aggregated with Q's to determine whether Q has excess business holdings. Q has received a private letter ruling that S is not a substantial contributor with respect to Q. We have considered this ruling and determined that it is correct.

A key question is whether S's mandatory distributions to Q under the terms of the trust instrument should be treated as "contributions" under section 1.507-6(c)(1) of the regulations. A trust beneficiary, like a shareholder of a corporation, receives distributions of amounts to which it is entitled. As the taxpayer argues, these amounts arguably are distinguishable from

"contributions or gifts," though they are treated as charitable contributions for purposes of the charitable deduction allowed to trusts under section 642(c).

We think the taxpayer's argument applies with greater force in the case of mandatory distributions from a trust organized prior to 1969. As a pre-1969 split-interest trust, S could not have been drafted to evade the restrictions imposed by the Tax Reform Act of 1969 upon private foundations, and we rely on this fact in upholding the ruling. For this reason, pre-TRA-69 split-interest trusts were generally not made subject to the Chapter 42 restrictions on private foundations and certain trusts. If this pre-1969 Trust had made discretionary distributions to Q, there might be a basis to contend such distributions were contributions for purposes of considering whether S was a substantial contributor.

Issue 2: Is S a disqualified person with respect to Q under section 4946(a)(1)(H)?

Section 4946(a)(1)(H) of the Code and section 53.4946-1(b) of the regulations provides that for section 4943 purposes only, the term "disqualified person" includes a "private foundation" which is controlled by the same person or persons who control the private foundation in question or substantially all the contributions were made (directly or indirectly) by the same person or persons described in subparagraphs (A), (B), or (C) or members of the families within the meaning of subparagraph (D). Does a "private foundation" for this purpose include a split-interest trust under section 4947(a)(2), especially one whose amounts were transferred in trust before May 27, 1969?

First, we note that section 4947(a)(2) of the Code is the only provision that treats a split-interest trust as a private foundation for any purpose; if excepted there, there is no other basis for treating it as a private foundation. Insofar as the Trust is a pre-1969 split-interest trust, it is not subject to section 4943. Peters, 624 F.2d at 1024, involved non-exempt charitable trusts described in section 4947(a)(1) that were formed before 1969 and contested being treated as private foundations; the court held they were properly treated as private foundations. Peters is inapplicable because there is no grandfather rule under section 4947(a)(1) as there is under section 4947(a)(2). Of more relevance is Hammond, 764 F.2d at 95, which held a trust to be a split-interest trust described in section 4947(a)(2) rather than a non-exempt charitable trust under section 4947(a)(1) under the facts and circumstances, and therefore not treated as a private foundation, because it was formed before 1969.

Second, the language of section 4946(a)(1)(H) of the Code limits the organizations described therein to certain private foundations. The fact that a split-interest trust is subject to several of the private foundation excise taxes, including section 4943, does not make the trust a private foundation relative to another private foundation for purposes of section 4946(a)(1)(H). If Congress wanted to include controlled section 4947(a)(2) trusts as private foundations under section 4946(a)(1)(H), it would have drafted the provision to make this clear.

Therefore, S is not a disqualified person with respect to Q under section 4946(a)(1)(H) of the Code.

Issue 3: Is any part of Q's ownership of R and W an excess business holding under section 4943?

Because we conclude that S is not a disqualified person with respect to Q, its holdings are not included with Q's ownership of R or W stock for purposes of section 4943 of the Code and therefore, no part of Q's ownership of R or W is an excess business holding under section 4943.

CONCLUSION:

1. S is not a disqualified person with respect to Q as a substantial contributor under section 4946(a)(1)(A).
2. S is not a disqualified person with respect to Q as a private foundation as described in section 4946(a)(1)(H).
3. As S is not a disqualified person with respect to Q, none of its holdings are included with Q's ownership and therefore no portion of Q's ownership of W and R is an excess business holding under section 4943.

A copy of this memorandum is to be given to the Taxpayer. Section 6110(k)(3) of the Internal Revenue Code provides that it may not be used or cited as precedent.

-END-