

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Number: **201723006**
Release Date: 6/9/2017

[Third Party Communication:
Date of Communication: Month DD, YYYY]

Index Number: 4941.00-00, 4941.04-00,
4943.00-00, 4943.03-00,
4943.04-03, 4946.00-00,
4946.01-00

Person To Contact:

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CC:TEGE:EOEG:EO1
PLR-127663-16

Date:
March 06, 2017

Foundation =
Founder =
First LLC =
Revocable Trust =
Irrevocable Trust =
New LLC =

Dear :

This letter responds to a letter from Foundation’s authorized representative dated August 17, 2016, requesting rulings on behalf of Foundation that:

(1) Founder’s proposed gift by means of a distribution from Revocable Trust upon Founder’s death to Foundation of the nonvoting interests in New LLC, the only asset of which is a promissory note from a disqualified person described in section 4946(a)(1)(G) of the Internal Revenue Code,¹ will not violate the prohibition against self-dealing under section 4941; and

(2) Foundation’s retention of the nonvoting interests in New LLC will not violate the restrictions on excess business holdings under section 4943.

FACTS

Foundation, which was created by Founder and her late husband, is a nonprofit corporation recognized as an organization described in section 501(c)(3) that is a

¹ Section 4946(a)(1)(G) of the Internal Revenue Code of 1986, as amended, to which all subsequent section references are made unless otherwise stated.

private foundation under section 509(a). Foundation has four directors, of which three are Founder and her two sons; the fourth director is an outside independent director.

Founder sold membership interests in First LLC to Irrevocable Trust in exchange for a promissory note. Founder's descendants are beneficiaries of Irrevocable Trust. Founder desires that, following her death, any part of the principal and interest on the promissory note which remains then unpaid be used to benefit Foundation.

To that end, Founder contributed and transferred the promissory note to New LLC in exchange for voting and nonvoting interests, which subsequently were transferred to Revocable Trust. Founder is the settlor and sole trustee of Revocable Trust and holds a revocation power in the form of a power to direct the trustee to distribute the assets of the trust to her during her lifetime. Founder's descendants are beneficiaries of Revocable Trust.

New LLC will hold and administer the promissory note and receive payments of interest and principal on the promissory note. New LLC's sole asset and source of income is, and will be, the promissory note. New LLC will not engage directly or indirectly in any trade or business activity that would constitute a "business enterprise" within the meaning of section 4943(d)(3) and Treas. Reg. §53.4943-10.

Power to manage the affairs of New LLC is vested in the manager, who is selected and may be removed by the members holding voting interests in New LLC. One of Founder's sons, who is also a director of Foundation, is the sole manager of New LLC. The members holding nonvoting interests possess no management rights or rights to vote on the manager of New LLC. New LLC may only be dissolved with written approval of all members, whether holding voting or nonvoting interests.

Founder proposes that at the time of her death, Revocable Trust (which will become irrevocable at that time) will distribute to Foundation all of the nonvoting interests in New LLC, which have a profit-sharing ratio of 99 percent. Revocable Trust will retain its voting interests in New LLC, which have a profit-sharing ratio of one percent.

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

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 the 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 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) 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. Thus, for example, 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.

ANALYSIS

Requested Ruling 1

Irrevocable Trust and Revocable Trust are disqualified persons under section 4946(a)(1)(G) with respect to Foundation because they are trusts in which Founder's descendants, who are disqualified persons under section 4946(a)(1)(D) with respect to Foundation, hold more than a 35-percent beneficial interest. Irrevocable Trust is the obligor of a promissory note that was held by Founder. Founder desires that, following her death, any unpaid principal and interest on the promissory note be used to benefit Foundation. An act of self-dealing would occur if Founder transferred the promissory note to Foundation, which would become creditor under the note. See Treas. Reg. §53.4941(d)-2(c).

Instead, Founder contributed and transferred her ownership of the promissory note to New LLC. At Founder's death, Foundation will acquire the nonvoting interests in New LLC, which have a profit-sharing ratio of 99 percent, by gift through a distribution from Revocable Trust, rather than through a self-dealing transaction. If Foundation will "control" New LLC within the meaning of Treas. Reg. §53.4941(d)-1(b)(5), then Foundation will be indirectly serving as the creditor under the note by reason of its ownership interest. See Treas. Reg. §53.4941(d)-1(b)(8), Example (1). However, Foundation will not "control" New LLC within the meaning of Treas. Reg. §53.4941(d)-1(b)(5) due to lack of voting power.

As holder of the nonvoting interests, Foundation will have no management rights or right to vote on the manager of New LLC. Revocable Trust (which will have become irrevocable at Founder's death) will own all of the voting interests, giving Revocable Trust the right to select and remove the manager of New LLC. As a holder of nonvoting interests, Foundation will have a right to receive distributions only if New LLC dissolves or chooses to make current distributions, but the timing and amount of such distributions will be uncertain and could not be compelled by Foundation. Only Revocable Trust as the holder of the voting interests may elect or remove the manager of New LLC, and such manager will have the sole power to manage the affairs of New LLC and determine the timing and amount of distributions. Thus, Foundation and Foundation's managers (acting only in such capacity) will not have sufficient votes or positions of authority to cause New LLC to engage in a transaction.

Additionally, Foundation will not have the power to compel dissolution of New LLC since New LLC may only be dissolved with written approval of all members, including Revocable Trust. The power associated with the nonvoting interests of New LLC as a necessary party to vote on the liquidation of the 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.

Accordingly, Foundation's receipt from Revocable Trust upon Founder's death of nonvoting interests in New 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) because Foundation will not acquire an interest in the promissory note; instead, Foundation will acquire nonvoting interests in New LLC, with respect to which it will not have any management rights or control over distributions.

Thus, Founder's proposed transfer of nonvoting interests in New LLC to Foundation will not constitute an act of self-dealing described in section 4941.

Requested Ruling 2

New LLC's sole asset will be the promissory note, which will generate passive income in the form of interest, as described in sections 4943(d)(3) and 512(b)(1). As such, New 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 New LLC will not be considered a "business enterprise," the restrictions on excess business holdings under section 4943 will not apply. Thus, Foundation's nonvoting interests in New LLC will not constitute excess business holdings under section 4943.

CONCLUSION

Based solely on the facts and representations submitted, we rule that Founder's proposed gift to Foundation by means of a transfer by Revocable Trust of nonvoting interests in New LLC, the sole asset of which is a promissory note from a disqualified person with respect to Foundation, will not constitute an act of direct or indirect self-dealing under section 4941. In addition, we rule that the nonvoting interests of New LLC to be held by Foundation will not constitute excess business holdings under section 4943.

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. 2017-1, 2017-1 I.R.B. 1, §7.01(15)(b). We have not verified any of the material submitted in support of the request for rulings, 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). No opinion is expressed regarding the value of the voting or nonvoting interests for estate tax purposes. See Ahmanson Found. v. United States, 674 F.2d 761 (9th Cir. 1981). Except as expressly provided above, no opinion is expressed or implied concerning the federal income or foundation excise tax consequences of any other 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. For details, see enclosed Notice 437, *Notice of Intent to Disclose*. A copy of this ruling showing the deletions that we intend to make on the version that will be made available to the public is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

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,

Amy F. Giuliano
Senior Technician Reviewer
Exempt Organizations Branch 1
Associate Chief Counsel
(Tax Exempt and Government Entities)

cc: