Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Contact Person: No Third Party Contact
XXXXXXXXXXXXXXXX
Telephone Number: XXXXXXXXXXXX
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In Reference to:
T:EO:RA:T:3
Date: DEC 14 1999

Employer Identification Number: XXXXXXXXX

Legend:

Y= XXXXXXXXXXXXXXXXXXXXXXXXX
X= XXXXXXXXXXXXXXX
Z= XXXXXXXXXXXXXXXX
T= XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
P1= XXXXXXXXXXXXXXXX
P2= XXXXXXXXXXXXXXXXXXXXXXXXXXXXX
P3= XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
P4= XXXXXXXXXXXXXXXXXX
P5= XXXXXXXXXXXXXXXXXX
P6= XXXXXXXXXXXXXXXXXXXXXXX
P7= XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
P8= XXXXXXXXXXXXXXXXXX
P9= XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
x= XXXX
y= XXXX
z= XXXX

Dear Applicant:

This is in reply to your letter of November 24, 1998, as subsequently revised, amended, and supplemented by correspondence dated February 5, 1999, March 18, 1999, April 2, 1999, April 19, 1999, and July 27,1999, in which you request certain rulings under sections 501(c)(3), 514, 4941,. and 4943 of the Internal Revenue Code. More specifically you request us to rule that:

1. The receipt and continued ownership by you of the partnership interests owned by X at his death and distributed by Y to you will not jeopardize your exempt status as a tax-exempt private foundation under section 501(c)(3) of the Code.

2. Pursuant to the exception in section 514(c) (2(B)) of the Code, the mortgages encumbering the properties which are owned by some of the partnerships will not constitute "acquisition indebtedness" as defined in section 514(c)(l) of the Code for the ten-year period

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commencing on the date of the transfer of the partnership interests to you.

3. The receipt and continued ownership by you of the partnership interests owned by X at his death and distributed by Y to you will not constitute acts of self-dealing between you and a disqualified person under section 4941 of the Code.

4. Pursuant to section 4943(c)(6) of the Code, the receipt and continued ownership by you of the partnership interests in "business enterprises" owned by X at his death and distributed by Y to you will not constitute excess business holdings as defined in section 4943 of the Code for the five-year periods commencing on the dates of the transfer of the partnership interests to you.

Facts:

You were formed by X in 1991, and were recognized as exempt from federal income tax under section 501(c)(3) of the Code by determination letter dated November 5, 1992. You were classified as a private foundation within the meaning of section 509(a) of the Code.

X died in 1994 leaving no issue. X's only living relatives were two sisters, to whom he left specific monetary bequests.

X's Estate is still under administration. The rest and residue of the Estate of X (hereafter known as Y) was left to you. Such rest and residue consists primarily of X's interests in 9 Partnerships (P1, P2, P3, P4, P5, P6, P7, P8, and P9), and two mortgages.

On his death, X had a 37.5% interest in P1, P2, P5, P7, P8, and a 75% interest in P9 and P3. Also, X had a 25% interest in, P4 and a 46.25% interest in P6. Also, as a result of the termination of a testamentary trust, X's two sisters acquired an ownership interest in P1, P2, P4, P6, P7, P8 in 1994. Z, an unrelated party to X, owns a 25% interest in 8 of the above Partnerships and a 43.75% interest in P5. Further, Z is designated as the managing partner in several partnership agreements. In addition, Z owns and operates T, which manages the Partnerships' properties for a management fee.

You state that neither Z nor T, nor X's two sisters have ever made any contributions to you. Thus, none of these individuals are substantial contributors to you within the

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meaning of sections 4946(a)(l)(A) and 507(d) of the Code. Also, neither Z nor X's two sisters are foundation managers.

P1, P2, P4, P6, P7, and P8 each own real estate properties. Further, P3, P5, and P9 each own undeveloped land. P6, and P9 also carry on active business enterprises.

In addition to receiving partnership interests in the 9 Partnerships, Y received X's interest in two mortgages (i) and (ii), as shown below, and the liability of P6 in mortgage (iii) shown below:

(i) A mortgage in the approximate amount of $11,000x secured by property owned by P6.

(ii) A mortgage between P6 and X by which X loaned $1,500x to P6 in November of y.

(iii) A mortgage between P6 and Z, by which Z loaned $1,000x to P6 in November of y.

In respect to (i), at the time the loan evidenced by the promissory note was originally made X, P6 had outstanding a mortgage loan obligation of approximately $11,000x. The balance of the mortgage loan has been reduced to approximately $4,000x. With P6's amortization of the mortgage loan balance and resulting substantial increase in P6's equity in its real estate project, the risk that the loan evidenced by the promissory note was reduced substantially. Furthermore, you will own a 55% partnership interest in P6 once Y is wound up. By extending the due date of the promissory note, Y has reduced the likelihood that P6 would have a substantial cash crunch which could have adversely affected your interest in P6.

The payment on loans (ii) and (iii) has been extended to December 31, z. Amendment Five to P6's Partnership Agreement makes clear that no distributions will be made to the Partners until these loans and any other loans from Partners have been repaid.

Law

Section 501(c)(3) of the Internal Revenue Code provides, in part, for the exemption from federal income tax of organizations organized and operated exclusively for charitable purposes.

Section 511(a)(1) of the Internal Revenue Code imposes a tax on the unrelated business taxable income of organizations

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described in section 501(c).

Section 512(a) (1) of the Code defines the term "unrelated business taxable income" as the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less allowable deductions for expenses incurred in carrying on the trade or business.

Section 512(b) (3) of the Code excludes from the definition of gross income all rents from real property and all rents from personal property if the rent attributable to such personal property is an incidental amount of the total rents received or accrued under the lease.

Section 512(b)(4) of the Code includes in gross income the rental income and the gain or loss from the sale of property, if the property is "debt-financed property."

Section 514(b) (1) of the Code defines "debt-financed property" as any property which is held to produce income and with respect to which there is an acquisition indebtedness at any time during the taxable year (or, if the property was disposed of during the taxable year, with respect to which there was an acquisition indebtedness at any time during the 12-month period ending with the date of such disposition).

Section 514(c) (1) of the Code defines "acquisition indebtedness," with respect to any debt-financed property, as the outstanding amount of (1) the indebtedness incurred in acquiring or improving the property, (2) the indebtedness incurred before the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement and (3) the indebtedness after the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement and the incurrence of such indebtedness was reasonably foreseeable at the time of such acquisition or improvement.

Section 514(c) (2) (A) of the Code provides that where property is acquired subject to a mortgage or other similar lien, the amount of indebtedness secured by such lien or mortgage shall be considered as an indebtedness of the property acquired even if the organization did not assume or agree to pay the indebtedness.

Section 514(c) (2) (B) of the Code, excepts from the rule, as set out in section 514(c) (2) (A) of the Code, property subject to a mortgage that is acquired by an organization by bequest or devise. In such case, the indebtedness secured by

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the mortgage is not treated as acquisition indebtedness during the ten years following the date of the acquisition. This exception does not apply if the organization, in order to acquire the equity in the property by bequest or devise, assumes and agrees to pay the indebtedness incurred by the mortgage, or if the organization makes any payment for the equity in the property owned by the decedent or the donor.

Section 1.514(c)-l(b) (3) of the Income Tax Regulations states that for purposes of section 514(c) (2) (B), the "date of acquisition" is the date an organization receives the property.

Section 4941(a) (1) of the Code imposes a tax upon any act of self-dealing between a private foundation and any of its disqualified persons as defined in section 4946.

Section 4941(d) (1) of the Code provides, in pertinent part that the term "self-dealing" means any direct or indirect---

> (A) sale or exchange, or leasing of property between a private foundation and a disqualified person.
>
> (B) lending of money or other extensions of credit between a private foundation and a disqualified person.

Section 4941(d) (2) (A) of the Code provides in pertinent part that the transfer of real or personal property by a disqualified person to a private foundation shall be treated as a sale or exchange . . . if [the property] is subject to a mortgage or similar lien which [the] disqualified person placed on the property within a lo-year period.

Section 53.4941(d)-l(a) of the Foundation and Similar Excise Tax Regulations defines the term "self-dealing" to mean any direct or indirect transaction described in section 53.4941(d)-2 of the regulations. For purposes of this section, it is immaterial whether the transaction results in a benefit or a detriment to the private foundation.

Section 4943(a) (1) of the Code imposes on the excess business holdings of any private foundation in a business enterprise a tax equal to five percent of such holdings.

Section 4943(c)(l) of the Code states 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

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foundation in such enterprise to be permitted holdings.

Section 4943(c)(2) (A) of the Code provides, in part, that the permitted holdings of any private foundation in an incorporated business enterprise are 20 percent of the voting stock reduced by the percentage of the voting stock owned by all disqualified persons.

Section 4943(c) (6) of the Code provides that if there is a change in the holdings in a business enterprise (other than by purchase by the private foundation) which causes the foundation to have excess business holdings in such enterprise, the interest of the foundation in such enterprise (immediately after such change) shall (while held by the foundation) be treated as held by a disqualified person (rather than by the foundation) during the five-year period beginning on the date of such change in holdings.

Section 53.4943-3(c)(1) of the regulations provides that the permitted holdings of a private foundation in any business enterprise which is not incorporated shall, subject to the provisions of subparagraphs (2), (3), and (4) of this paragraph, be determined under the principles of paragraph (b) of this section.

Section 53.4943-3(c)(2) of the regulatjons provides that in the case of a partnership (including a limited partnership) or joint venture, the terms "profits interest" and "capital interest" shall be substituted for "voting stock" and "nonvoting stock," respectively, wherever those terms appear in paragraph (b) of this section. The interest in profits of such foundation (or such disqualified person) shall be determined in the same manner as its distributive share of partnership taxable income. See section 704(b) (relating to the determination of the distributive share by the income or loss ratio) and the regulations thereunder. In the absence of a provision in the partnership agreement, the capital interest of such foundation (or such 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 such disqualified person) upon its withdrawal from the partnership, or upon liquidation of the partnership, whichever is the greater.

Example (2) (i) of section 53.4943-3(d) of the regulations assumes that if, under section 704(b) of the Code, F's distributive share of P taxable income is determined to be 20 percent, and assuming that, A and B are determined to have a 4-percent distributive share each of P taxable income, F holds a 20-percent profits interest in P, and A and B hold an

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E-percent profits interest in P. Assuming that the provisions of section 4943(c)(2) (B) do not apply, the permitted holdings of F in P are 12 percent of the profits interest in P, determined by subtracting the percentage of the profits interest held by A and B in P (i.e., 8 percent) from 20 percent. (20 percent-8 percent=12 percent.) F, therefore, holds a percentage of the profits interest in P in excess of the percentage permitted by Sec. 53.4943-3(b)(1). The excess business holdings of F in P are a percentage of the profits interest in P equivalent to such excess percentage, or 8 percent of the profits interest in P, determined by subtracting the permitted holdings of F in P (i.e., 12 percent) from the percentage of the profit interest held by F in P (i.e., 20 percent) (20 percent-12 percent=8 percent.)

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.

Section 53.4943-10(c) (1) of the regulations provides, that, for purposes of section 4943(d) (4), 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; 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 4946(a) (1) of the Code states, in pertinent 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;

(C) an owner of more than 20 percent of- (i) the total combined voting power of a corporation, or

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of the profits interest of a partnership or unincorporated enterprise, which is a substantial contributor to the foundation;

(D) certain members of the family of any individual described in sub-paragraph (A),(B),or (C);

(E) a corporation in 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 total combined voting power.

Section 4946(d) of the Code provides, *in* relevant part, that for purposes of section 4946(a) (1) of the Code, the family of an individual shall include his\her spouse, ancestors, children, grandchildren, great-grandchildren, and the spouses of children, grandchildren, great-grandchildren.

Rev. Rul. 76-448, 1976-2 C.B. 368, holds that an act of self-dealing will not result from the exchange of securities between a private foundation and a corporation in which a disqualified person previously owned more than 35 percent of its total combined voting power. The foundation's foundation manager owned more than 35 percent of the total combined voting power of the corporation. The foundation manager resigned 5 years prior to the exchange, and did not participate in planning the exchange offer while in his capacity as foundation manager.

Rationale:

X was a substantial contributor and disqualified person to you. He left his interests in P1, P2, P3, P4, P5, P6, P7, P8, and P9 to you. At the time of his death, X had a 37.5% interest in Partnerships Pl, P2, P5, P7 and, P8, a 75% interest in P3 and P9, and a 46.25% interest in P6.

Therefore, since X owned in excess of 35% of P1, P2, P3, P5, P6, P7, P8, and P9, we conclude that, during X's lifetime, P1, P2, P3, P5, P6, P7, P8, and P9 were disqualified persons to you.

Pursuant to section 4946(d) of the Code, siblings are not included as *"members* of the family." Further, since X's two sisters are not substantial contributors to you, nor foundation managers they are not disqualified persons.

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Z has made no contributions to you and it appears that Z will not make any contributions to you in the future. Z has at least a 25% partnership interest in P1, P2, P3, P4, P5, P6, P7, P8, and P9. Since Z is not a member X's family, within the meaning of section 4946(d) of the Code, and is not a foundation manager or a substantial contributor to you, we conclude that Z is not a disqualified person to you.

Section 501(c)(3) does not preclude you from receiving partnership interests from X that were owned by X during his lifetime.

The next issue is whether P1, P2, P3, P4, P5, P6, P7, P8, and P9 are business enterprises within the meaning of section 4943(d)(3) of the Code. You furnished a copy of the 1997 Form 1065 Partnership returns for P1, P2, P3, P4, P5, P6, P7, P8, and P9. The Partnership returns for P1, P2, P3, P4, P5, P7 and P8 reflect that these Partnerships only receive passive rental Income. However, the Partnership returns for P6 and P9 reflect that these Partnerships receive income from trade and business activities. P6 receives both passive rental income, and income from trade and business activities. The passive income derived constitutes less than 95% of P6's gross income. P9 only receives income from trade and business activities.

Consequently, P1, P2, P3, P4, P5, P7 and P8 are not "business enterprises" within the meaning of section 4343 of the Code and you are not precluded from holding these interests. However, P6 and P9 are "business enterprises" within the meaning of section 4943 of the Code. You have a 46.25% interest in P6 and a 75% interest in P9.

Since you will acquire your interests in P6, and P9 by bequest, we conclude that pursuant to section 4943(c)(6) of the Code, these interests will be treated as held by a disqualified person for 5-year periods from the dates you receive the interests in these two partnerships.

Secondly, the next question concerns whether you will have debt financed income. P2, P6 and P7 have debt financed property. Section 514(c)(2)(B) of the Code, provides, in effect, that if property subject to a mortgage is acquired by either bequest or devise, such indebtedness is not treated as acquisition indebtedness during the 10-year period following the date of acquisition. Thus, you will not be treated as having debt financed income for this lo-year period.

Finally, the last question concerns whether, upon the distribution of X's estate to you by Y, you will engage in acts of self-dealing with disqualified persons.

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In addition to receiving partnership interests in the 9 Partnerships, Y received X's creditor interest in mortgages (i) and (ii), as shown below, and the liability of P6 in mortgage (iii), as shown below:

(i) A mortgage in the amount of approximately $11,000x secured by property owned by P6. It is represented that there is a current balance on this mortgage of approximately $4,000x.

(ii) A mortgage between P6 and X by which X loaned $1,500~ to P6 in November of y.

(iii) A mortgage between P6 and Z, by which Z loaned $1,000~ to P6 in November of y.

X was a disqualified person to you during his lifetime. P6 was a disqualified person since X had over a 35% interest in P6. X loaned money to P6 on which there are current balances due. If X had transferred his creditor interests in these loans to you during his lifetime, these loans would have constituted extensions of credit by you to P6, a disqualified person, and would have been acts of self-dealing within the meaning of section 4941(d)(1)(B) of the Code and section 53.4941(d)-2(c) of the regulations. However, the partnership interest in P6 is no longer held by X, since X is deceased, and is presently held by Y, and will be held be you in the future. Therefore, we conclude that, at the time the partnership interest in P6 and creditor interests in the two loans between X and P6 are distributed by Y to you, P6 will not be a disqualified person to you and any extensions of credit to P6 would not be acts of self-dealing within the meaning of section 4941(d)(1)(B) of the Code.

Because Z is not a disqualified person to you, P6's payments of the November y loan would not result in acts of self-dealing within the meaning of section 4941(d)(1)(B) of the Code.

Accordingly, based upon the information submitted and the representations made we rule that:

1. The receipt and continued ownership by you of the partnership interests owned by X at his death and distributed by Y to you will not jeopardize your exempt status as a tax-exempt private foundation under section 501(c)(3) of the Code.

2. Pursuant to the exception in section 514(c)(2(B)) of the Code, the mortgages encumbering the properties

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which are owned by some of the partnerships will not constitute "acquisition indebtedness" as defined in section 514(c)(l) of the Code for the ten-year period commencing on the date of the transfer of the partnership interests to you.

3. The receipt and continue&ownership by you of the partnership interests owned by X at his death and distributed by Y to you will not constitute acts of self-dealing between you and a disqualified person under section 4941 of the Code.

4. Pursuant to section 4943(c) (6) of the Code, the receipt and continued ownership by you of the partnership interests in "business enterprises" owned by X at his death and distributed by Y to you will not constitute excess business holdings as defined in section 4943 of the Code for the five-year periods commencing on the dates of the transfer of the partnership interests to you.

This ruling does not purport to rule under other provisions of Chapter 42 of the Code, or any other section of the Internal Revenue Code.

This ruling letter is directed only to the organization that requested it. Section 6110 of the Code provides that it may not be used or cited as precedent. We are sending a copy of this ruling letter to your key District Director and to your attorney.

Sincerely yours,
(signed) Robert C. Harper, Jr.

Robert C. Harper
Manager, Exempt Organizations
Technical Group 3