

200444042



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

Date: August 5, 2004

Contact Person:

UIL: 4943.00-00  
4943.03-00

Identification Number:

Telephone Number:

T:EO:BR1

**Legend:**

T=  
A=  
B=

Dear :

This is in reply to your request for a ruling under section 4943 of the Internal Revenue Code.

**Facts**

T is exempt under section 501(c)(3) of the Code and is a private foundation. T's trustees ("Trustees") administers its affairs. T's charitable activities are financed with the returns from its investment portfolio consisting in large part of direct and indirect holdings of publicly traded stocks and securities. T also invests in certain private equity and equity-related securities. Recently, the Trustees acquired an indirect interest in an entity engaged in managing investments.

**Description of the Transaction**

T's Trustees acquired stock in a newly formed Delaware corporation, A ("Holding Company"). Some of the other investors in Holding Company (collectively with T, the "Investors") are also private foundations. The Investors formed Holding Company for the sole purpose of making and holding an investment in B, a limited liability company. Holding Company purchased its interest in B pursuant to a purchase agreement between Holding Company and B dated ("Purchase Agreement").

B manages, and acts as the general partner of, underlying private equity investment funds formed as limited partnerships, trusts and limited liability companies (the "Underlying Funds"). The Underlying Funds generally invest in debt and equity securities issued by corporations or partnerships ("Portfolio Companies"). In its capacity as a manager, B receives management fee income from the Underlying Funds and other clients. B makes capital contributions to each Underlying Fund and receives a return on that investment, as well as a disproportionate

("carried") interest in the profits of each Underlying Fund. Holding Company's interest in B is a non-managing member interest. T states Holding Company and T are not, nor will they be, in control of the management, policies or operations of B.

Holding Company's right to vote with the other members of B is limited to specific cases involving (1) the election, removal, or replacement of B's executive committee in certain narrow circumstances; (2) the sale of substantially all of B's assets or certain significant offers to purchase its interests; (3) B's conversion to a different form of entity; (4) the reduction of aggregate capital account balances below a set floor; and (5) certain amendment provisions. T states Holding Company's voting percentage in B will never exceed 20% and, therefore, Holding Company cannot unilaterally control the outcome of any of the limited B member votes in which Holding Company is permitted to participate.

At present, T states it owns less than 20% of the stock of Holding Company, both by vote and by value. Pursuant to the stockholders' agreement of Holding Company (the "Stockholders' Agreement," collectively with the Purchase Agreement and the Operating Agreement (the "Agreements"), each of the Investors will have the opportunity to exercise options to acquire additional stock of Holding Company and Holding Company will in turn exercise options to acquire additional interests in B. The exercise of such options could change the voting and ownership percentages in Holding Company if some but not all of the Investors exercise their options or if the options are exercised in differing proportions. In addition, in certain situations, Holding Company may redeem the stock of an Investor, which would result in a change in the voting and ownership percentages of Holding Company. If either of those events occurs, it is possible T could own more than 20% of the stock of the Holding Company.

## Law

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

Section 4943(d)(3)(B) of the Code provides 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. For purposes of subparagraph (B), gross income from passive sources includes the items excluded by section 512(b)(1), (2), (3), and (5).

Section 53.4943-1 of the Foundation and Similar Excise Tax Regulations provides generally, under section 4943, the combined holdings of a private foundation and all disqualified persons (as defined in section 4946(a)) in any corporation conducting a business which is not substantially related (aside from the need of the foundation for income or funds or the use it makes of the profits derived) to the exempt purposes of the foundation are limited to 20 percent of the voting stock in such corporation. In addition, the combined holdings of a private foundation and all disqualified persons in any unincorporated business (other than a sole proprietorship) which is not substantially related (aside from the need of the foundation for income or funds or the use it makes of the profits derived) to the exempt purposes of such foundation are limited to 20 percent of the beneficial or profits interest in such business.

Section 53.4943-10(c)(1) of the regulations provides that "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)(l)."

Section 53.4943-10(c)(2) of the regulations provides that income classified as passive does not lose its character merely because section 512(b)(4) or 514 (related to debt-financed income) applies to such income.

### **Rationale**

Holding Company will not have control over the management or operations of B, any Underlying Funds, any Portfolio Companies, or any other direct or indirect investments held by B. Holding Company's assets will consist solely of a limited partnership interest (or non-managing member interests) in B. Thus, Holding Company is a passive holding company, not an operating business. Since Holding Company cannot control or participate in the operations or management of B's business, Holding Company is not treated as a business enterprise for purposes of section 4943 of the Code. Further, T's interest in Holding Company is the governing factor in determining whether T holds any excess business holding.

### **Conclusion**

We rule as follows:

1. For purposes of section 4943 of the Code, Holding Company will not be a business enterprise.
2. Whether T holds excess business holdings will be determined by reference to T's proportionate share of any interests in a business enterprise (which could include but is not limited to B, any Underlying Fund and/or any Portfolio Company), in which Holding Company holds a direct or indirect interest.

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

This ruling is based on the understanding there will be no material changes in the facts upon which it is based. Any changes that may have a bearing on your tax status should be reported to the Service. This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described.

Please keep a copy of this ruling letter in your permanent records.

**200444042**

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

Sincerely,

Michael Seto  
Manager, Exempt Organizations  
Technical Group 1