TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

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Contact Person:

Identification Number:

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Dear :

This responds to a letter from M's authorized representatives requesting rulings under section 4943 of the Internal Revenue Code on M's behalf.

Facts:

M is recognized as a tax-exempt organization described in section 501(c)(3) of the Code. M is classified as a private foundation within the meaning of section 509(a). B is the chairman of the board of directors of M and its president.

N is a for-profit corporation. On , B donated shares of N Class A voting common stock to M. At the time of the gift, the shares donated to M constituted percent of N Class A voting common stock and percent of all outstanding N stock. M still owns shares of N stock which currently represent percent of N Class A voting stock and percent of all outstanding N stock.

When the N stock was donated to M on , N and its subsidiaries (collectively, the "N Companies") were engaged in diversified businesses. Business operations included

and direct sales of various types of consumer products.

N, itself, did not produce or sell any products. Instead, N provided financial and administrative support to its operating subsidiaries. N had two wholly owned subsidiaries: Q and R. Q and R, in turn, controlled 12 additional subsidiaries.

Q focused on the individual consumer market. Q's division published approximately 15 newsletters focusing on personal finance and investment. Q's group published . It also directly sold products by mail, telephone, and the Internet to consumers through an 80% owned subsidiary.

R

and provided certain related technical and professional services.

In 1998, N retained an investment banking firm for a controlled auction of the N Companies. Over 100 prospective bidders expressed interest and received copies of the placement memorandum. Although 36 preliminary bids were received, none of the bidders submitted a final purchase contract.

In late 1999, an investment fund contacted the N Companies with an unsolicited expression of interest in acquiring the division. N signed a letter of intent with this fund and negotiated the terms of a final purchase agreement. Before the final terms of a contract were agreed upon, the prospective buyer substantially reduced the amount of the offered purchase price, which led to a breakdown in sale negotiations.

The N Companies then received another unsolicited expression of interest from an Internet company in purchasing the business. N and its shareholders executed a stock purchase agreement with the company. However, the company failed to fully fund the deposit called for under the agreement and defaulted on its obligations under the stock purchase agreement.

After the sale to the Internet company failed, the N Companies management terminated the employment of C, the president of Q. The shareholders agreement between C and N required N to redeem the stock and pay for the options upon termination of C's employment. C instituted legal action against N as a result of his termination. This action was not resolved until May 2001, at which point the parties entered into a settlement agreement under which all of C's stock was redeemed and all of C's options were purchased. After C's termination, other Q officers were promoted to higher management positions.

As a result of the unsuccessful sale attempts and ensuing litigation, there were no viable buyers for any shares of N stock. M first approached directors, officers, and other individuals who were familiar with N and its operations but was unable to elicit any potential purchaser. The lack of interest by N directors and officers was attributable in part to their holding unexercised options which allowed them to purchase N stock at a per-share price set many years earlier, and far below current value. M's managers also contacted individuals who were less closely associated with N regarding M's desire to sell its N stock, but they were unsuccessful in finding any buyer. N's status as a closely held company that was dominated by one individual, its history of litigation with key employees, the several unsuccessful sales efforts, the disparate nature of its operating divisions, its lack of dividend paying history, the potential liabilities that were the main source of its net revenue and other risk and control factors made minority stock in N an unattractive target for investment.

The N Companies were successful in finding a buyer for R in 2000. Negotiations with an investment fund resulted in the sale of R's business. Substantially all of the operating assets of R and its subsidiaries were sold and R and its subsidiaries were subsequently dissolved.

In 2000, the N Companies were substantially restructured in an effort to sell the N Companies and their businesses. N formed three subsidiary entities: (1) S; (2) T, and (3) U. S had one 80%-owned subsidiary; T had one 80%-owned subsidiary: V.

S took over Q's division, and T took over Q's division. U is not actively engaged in business operations. U's sole function is to provide finance, information technology, human resources, administrative and other support to S and T.

During , disputes arose between V and one of its minority shareholders, the C Children Trust ("C Trust"), about the value of V stock and certain operational issues. In , V filed suit against the C Trust seeking resolution of certain issues by declaratory judgment, and in , the C Trust filed counterclaims against V and the other N Companies. These disputes were finally resolved by settlement in .

Faced with the absence of prospective buyers of its N stock, M determined that its best chance for disposing of its excess business holdings was to rely on the efforts of the management of N to sell off N in pieces. After Q transitioned to new management, the legal actions against the terminated Q officers and related parties were resolved, and the corporate structure was simplified by the formation of S and T, the N Companies decided to resume sale efforts. In 2003, the N Companies retained an investment banker to conduct a controlled auction of T. A placement memorandum was distributed to 60 interested parties and expressions of interest were procured from 31 companies. N narrowed the prospective buyers to two companies. Each company submitted a draft purchase and sale agreement, but by January 2004 neither prospective buyer was willing to submit a final contract and the offers were withdrawn.

Subsequently, the investment bankers re-contacted prospects whom they had previously rejected. As a result, N was able to negotiate terms of sale of a substantial portion of the T business. The sale conveyed to the buyers all of the operating assets of the T business other than the rights to the J product. A substantial portion of the sales proceeds was applied by N to pay off debt and employee incentive compensation which became due as a result of the sale. Subsequent to the sale, N declared a dividend to its shareholders. M's share of the distribution was $2.26x.

The buyers did not acquire the rights to the J product. Instead, they entered into a separate agreement which gives them an option to buy J after have been received and evaluated. It is anticipated that the will be completed before the end of 2005. If are successful, it is anticipated that the buyers will elect to buy J at a price not exceeding $35x. If are not completely successful, it is anticipated that N will sell J at a greatly reduced price. After any sale of J, N intends to distribute the net sales proceeds to its shareholders, including M.

As a result of the sale of T, the only material assets that are still held by N consist of: (i) approximately $50x of cash, much of which will be applied to pay corporate taxes attributable to the T sale, (ii) all of the membership interests in S, and (iii) J.

In early 2005, N intends to distribute to its shareholders, including M, any cash in excess of its anticipated business needs.

Having arranged for the sale of T, N is now turning its attention to the sale of S. Upon the sale of S, N will liquidate and distribute all remaining cash and any other assets to its shareholders. N's management is hopeful that between $30x and $50x will be available as the liquidating distribution to N shareholders after the sale of S. To date, M has received distributions totaling $3,674x from N attributable to N's sale of assets.

Plans to Dispose of Excess Business Holdings

M intends to retain an investment advisor that is experienced in the sale of minority interests in privately held companies to assist M in disposing of its excess business holdings. M intends to require the investment advisor to develop, and help implement, a plan for the disposition of N stock. This plan will include:

1. The advisor's valuation of M's excess business holdings;
2. The advisor's opinion regarding the value of the N stock owned by M and the percentage discount at which M's holdings of N stock could be expected to sell; and
3. The advisor's plan for disposing of M's excess business holdings. M anticipates that this will include identifying potential purchasers, preparing materials for presentation to them, arranging for presentations to them, and undertaking negotiations for sale of the N stock with such potential purchases.

M agrees to provide the Service with the investment advisor's plan by , in the event that the investment advisor advises that M may not be able to dispose of all of its excess business holdings by , and M contemplates requesting an extension of time beyond that date.

Law:

Section 4943(a) of the Code imposes a tax on the excess business holdings of any private foundation in a business enterprise during any taxable year which ends during the taxable period.

Section 4943(b) of the Code provides for the imposition of an additional tax in any case in which an initial tax is imposed under subsection (a) with respect to the holdings of a private foundation in any business enterprise, if, at the close of the taxable period with respect to such holdings, the foundation still has excess business holding in such enterprise.

Section 4943(c)(1) of the Code 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(c)(2)(A) of the Code provides, generally, that the permitted holdings of any private foundation in an incorporated business enterprise are: (i) 20 percent of the voting stock, reduced by (ii) the percentage of the voting stock owned by all disqualified persons.

Section 4946(a)(1) of the Code provides that the term “disqualified person” means, among other things, a person who is (A) a substantial contributor to the foundations; (B) a foundation manager, or (G) a trust or estate in which persons described in (A) and (B) hold more than 35 percent of the beneficial interest.

Section 4946(b)(1) of the Code provides that the term “foundation manager” means an officer, director, or trustee of a foundation.

Section 4943(c)(2)(C) of the Code provides that a private foundation shall not be treated as having excess business holdings in a corporation in which it (together with all other private foundations which are described in section 4946(a)(1)(H)) owns not more than 2 percent of the voting stock and not more than 2 percent in value of all outstanding shares of all classes of stock.

Section 4943(c)(6)(A) 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 or by a disqualified person) which causes the private 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 (other than by the foundation) during the 5-year period beginning on the date of such change in holdings.

Section 4943(c)(7) of the Code provides that the Secretary may extend for an additional 5-year period the initial 5-year period for disposing of excess business holdings in the case of an unusually large gift or bequest of diverse business holdings or holdings with complex corporate structures if—

(A) The foundation establishes that: (i) diligent efforts to dispose of such holdings have been made within the initial 5-year period, and (ii) disposition within the initial 5-year period has not been possible (except at a price substantially below fair market value) by reason of such size and complexity or diversity of holdings,

(B) Before the close of the initial 5-year period: (i) the private foundation submits to the Secretary a plan for disposing of all of the excess business holdings involved in the extension, and (ii) the private foundation submits the plan to the Attorney General (or other appropriate State official) having administrative or supervisory authority or responsibility with respect to the foundation’s disposition of the excess business holdings involved and submits to the Secretary any response received by the private foundation from the Attorney General (or other appropriate State official to such plan during such 5-year period, and

(C) The Secretary determines that such plan can reasonably be expected to be carried out before the close of the extension period.

<u>Analysis</u>:

M is subject to section 4943 of the Code which imposes a tax on the excess business holdings of private foundations. Generally, a private foundation together with disqualified persons with respect to the private foundation are permitted to hold twenty percent of the voting stock in a business enterprise with any excess constituting excess business holdings. In the event that a private foundation and disqualified persons own more than twenty percent of the voting stock in a business enterprise, the private foundation shall not be treated as having excess business holdings in the business enterprise if it owns not more than two percent in value of the voting stock and not more than two percent in value of all outstanding shares of all classes of stock.

B is the trustee and primary beneficiary of P. P is a disqualified person with respect to M because P is a trust described in section 4946(a)(1)(G) of the Code in which a person described in section 4946(a)(1)(A) and (B), that is, B, holds more than a 35 percent beneficial interest. P and M, combined, hold 93.2887 percent of N voting stock.

M has excess business holdings in N because M and a disqualified person with respect to M, that is, P, own more than 20 percent of the voting stock of N and M itself owns more than two percent in value of both the voting stock and all outstanding shares of all classes of stock of N.

If a private foundation acquires holdings in a business enterprise other than by purchase which causes the foundation to have excess business holdings, the interest of the foundation in such business enterprise shall be treated as held by a disqualified person for a five-year period beginning on the date such holdings were acquired by the foundation.

M acquired its holdings in N other than by purchase on . Thus, M's interest in N is treated as held by a disqualified person until . On , M requested an additional five-years for disposing of its excess business holdings in N.

Because the gift of N stock to M was unusually large and represented shares in a closely held corporation with numerous subsidiaries and lines of business, the Service may extend the initial five-year period for disposing of excess business holdings for up to five additional years under section 4943(c)(7) of the Code if M establishes that it made diligent efforts to dispose of its holdings within the initial five-year period but was unable because of the size and complexity of such holdings, and the Service determines that such plan can reasonably be expected to be carried out before the close of the extension period.

The information submitted shows that M, unable to find a buyer for its N stock, reasonably determined that its best chance for disposing of its excess business holdings in N was to rely on N management to liquidate N in an orderly manner, and that N management made diligent efforts during the initial five-year period to liquidate N. To that end, N was reorganized so that each of the separate divisions could operate as a stand-alone business and be sold separately. N's efforts have produced the successful sale of R and T, which were the largest operating divisions of N. All that remains of N is one product, J, and one division, S, with a value one-tenth of the value N once had.

With the sale of J expected this year, M believes that it can dispose of its excess business holdings by . We determine that it is reasonable to expect M to dispose of its excess business holdings by , and, therefore, agree to extend the period for M to dispose of its excess business holdings to that date.

If, prior to , M's investment advisor determines that M may not be able to dispose of its excess business holdings by , M understands that it must present a plan, developed by its investment advisor, to the Service as a condition for requesting any further extensions of time for disposing of its excess business holdings. M is reminded that, under section 4943(c)(7)(B)(ii) of the Code, any plan submitted to the Service must also be submitted to the Attorney General or other appropriate State Official having administrative or supervisory authority over M.

Conclusion:

Accordingly, based on the information submitted we rule as follows:

The Service will extend the period for M to dispose of its excess business holdings in N to .

This ruling is made on the understanding that there will be no material changes in the facts upon which it is based.

Except as specifically ruled upon above, no opinion is expressed concerning the federal income tax consequences of the transactions described above under any other provision of the Code.

Pursuant to a Power of Attorney on file in this office, a copy of this letter is being sent to M's authorized representative. A copy of this letter should be kept in M's permanent records.

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.

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,

Jane Baniewicz
Manager, Exempt Organizations
Technical Group 2