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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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Contact Person:

Identification Number:

Telephone Number:

UIL Index
4943.00-00

Legend:

B =
C =
M =
N =
P =
Q =
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S =
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Dear :

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

Facts:

In year u, B, the founder of N and owner of P, executed mirror wills with his spouse, C. B's will left essentially all of his estate to a marital trust, the income of which was to be paid to C. Upon the death of C, the residue of the estate was to be distributed in such manner as C was to direct through a power of appointment.

On the day they executed their mirror wills, B and C signed a reciprocal will agreement under which each agreed not to revoke or modify any term or provision of their wills and to exercise the general power of appointment granted to each other in their reciprocal wills in favor of the charitable trust to be established under the provisions of the survivor's will.

B died on date w.

Subsequent to C's death on date y, protracted and complex litigation against the Estate and Testamentary Trust of B prevented the distribution of the estate assets to M. The state Attorney General (AG) took an active role in each of the lawsuits. The AG appeared in the litigation through its various deputy attorney generals and was a party of record as the overseer of charitable trusts and foundations. In addition, the actions of the trustees of the testamentary trust and of the executor of C's estate were overseen by the AG. During the litigation, the AG received periodic reports on the status of P's operations and financial condition.

The litigation was resolved favorably to the testamentary trust and estate. On date z, the probate court created M through the entry of an order settling the account of the executor and a decree of distribution which resulted in the distribution of all estate assets to M. Through the decree, M is deemed to have received all outstanding shares of N. N's assets include all outstanding shares of P. Since N is a passive holding company, M is treated as owning its proportionate share of N's interest in P, that is, M is treated as owning a 100 percent share in P

M is exempt from federal income taxation under section 501(a) of the Code as an organization described in section 501(c)(3). M is classified as a private foundation within the meaning of section 509(a).

N is a complex and diversified real estate company. N, through its affiliated companies, owns, manages, and operates several commercial shopping centers, industrial properties, and residential apartment buildings, all encumbered under various loan agreements. There are several constituent subsidiary b corporations which N holds through P or through a real estate holding company.

P, a wholly-owned subsidiary of N, markets c under a number of labels. During the five years that the estate was in litigation, P was experiencing operational and financial constraints because of difficult conditions in the b industry. In 1997 and 1998, P experienced substantial financial difficulties and faced the prospect of bankruptcy, due in large measure to declining market share and revenues. In 1999, P, in the hope of reversing its deteriorating financial condition, acquired certain assets of S and sold certain real estate assets and two products to T. P financed the S acquisition through a $37x loan from a syndication of banks. The 1999 Credit Agreement (“CA”) contained substantial negative and affirmative covenants and required N to provide a broad guaranty of the debt and contribute $4x in the form of equity. The $4x was obtained from a loan using unencumbered N commercial property that was transferred to a newly formed bankruptcy remote single purpose entity, all of the shares of which were required by the banks to be pledged as security for the loan.

The transactions involving P, S, and T were reviewed by the state AG in its capacity as the supervisor of charitable trusts. The AG retained a financial advisor which made an analysis of the S transaction. The financial advisor concluded that if P did not acquire S, P might not survive. Accordingly, the financial advisor opined to the AG that the transaction was not unreasonable and the price that P was paying for the S assets was fair and reasonable to the shareholders. The AG issued a “no opposition” letter and the transaction closed.

Within a few months of the S asset purchase, P management realized that some of its financial assumptions had been too aggressive. As a result, P found itself short of cash and sought to obtain an additional $4x. An Amended and Restated Credit Agreement (“ARCA”) was signed which required N to provide additional security in the form of second deeds of trusts in two shopping centers when and if such shopping centers were refinanced. Like the CA, the ARCA had significant affirmative and negative covenants. Soon after the signing of the ARCA, P breached certain financial covenants and was deemed in default of the ARCA.

P’s financial performance continued to decline throughout 2000. The senior secured debt under the ARCA required substantial principal payments, which P would not be able to make. Sales of c also continued to decline substantially. P retained interim management and tried to cope with a number of financial problems, including the payment of more than $7x in past due trade payables to its supplier. P also retained a advisor to assist it in selling the company. Soon after a preliminary review of P’s financial condition, the advisor concluded that it would be difficult to find a buyer until P’s balance sheet was restructured and certain operating changes were made. Because of P’s continuing deteriorating condition, its board of directors consulted bankruptcy counsel to advise it as to its debtor remedies and to structure a liquidation strategy.

M’s trustees recognized the P’s high risk of failure because of declining sales and extremely high debt. A strategic decision was made to concentrate on the sale of P because, in the business judgment of the trustees, this course would maximize the value of M’s remaining assets, its real estate holdings.

In the fall of 2000, M's trustees took steps to market P and to maximize the value of M's assets. Permanent management for P was recruited and retained and the boards of directors of P and N were expanded. In addition, various legal and financial experts were retained to advise the trustees and the boards about their legal and financial alternatives. The new management, along with financial and legal advisors, began examining the operations of the company and concluded that P's overall debt burden was severely depressing its value.

In 2002, after nine months of planning and discussions with P's secured lenders and subordinated debt holders, the new management renegotiated and restructured P's secured and unsecured debt. P obtained a new senior secured loan and revolver. As a result of the debt restructuring, P reduced its unsecured debt by approximately $14x, making P a more attractive sale candidate.

In the winter of 2002, and immediately following the successful completion of the debt refinance and restructure, the P board appointed a committee to explore divestiture opportunities. The board retained Q as its financial advisor in connection with the sale of P. The Refinance/Restructuring Committee approached a number of potential buyers, including one of the more likely b company buyers, and explored a number of strategic alternatives including the outright sale of P. However no resolution was ever reached.

Between October 2003 and July 2004, Q conducted a significant market search for potential P buyers. A total of ten strategic buyers and fifty-one financial buyers were contacted. Forty parties executed confidentiality agreements with P. Ultimately Q received indications of interest from four parties. Three parties dropped out after their due diligence. The remaining party attempted to structure a potential transaction and has remained in frequent contact with Q, but to date has not provided P with a binding letter of intent.

Early in 2004, the P board began exploratory discussions with Q regarding the feasibility of an initial public offering for P or a newly formed company with certain select c labels. These discussions are ongoing.

Even though M's trustees have engaged in and explored a number of alternatives for disposing of M's excess business holdings in P, the disposition of M's P shares continues to be hampered by the size of those holdings and P's highly leveraged position, due, in large part to its debt and its unfunded pension and health and welfare retiree benefit liabilities. P's historical erosion in volumes has had a negative impact on sales efforts. In addition, the competitive business environment in which P operates has further impeded the trustees' ability to dispose of the P shares within the initial five-year period. However, recent sales trends of certain P brands may provide an opportunity to capture the resident value of P.

The trustees believe that a forced sale of the P business in the current market would hinder their efforts to obtain the highest value for P and undermine the trustees' goal of building a sustaining and enduring endowment fund to carry on M's charitable goals. If N were forced to dispose of P in the near future, the proceeds of such sale would not cover the loan obligations and P's pension and health benefit obligations to its retirees.

M's Plan for Compliance with Section 4943 During the Extension Period

The trustees are currently exploring at least four options:

1. M, through P's management, will continue discussions with a potential buyer in the expectation that a sale transaction can be completed during the extension and will continue to work through its financial advisors at Q to structure a sale on terms and conditions that are fair and reasonable.

2. R has been advising the directors of P about the feasibility of an initial public offering (IPO). It is contemplated that P would become the subject of an IPO with M disposing of a substantial percentage of its holdings. Following the IPO, M would divest itself of the remaining P stock in an orderly fashion through the established public markets. In the event that M were unable to divest itself of the remaining shares during the extension period, the trustees might choose to donate the remaining stock to various colleges, universities, and hospitals in fulfillment of outstanding pledges. The completion of an IPO is highly dependent on future market conditions.

3. The trustees are also considering Q's recommendation that P continue to run its business on a standalone basis. With further improvements in the operating performance of P and the continued reduction of its senior secured debt, P may become a more attractive acquisition target in the future at a price that would be acceptable to the trustees and fair and reasonable to the charitable beneficiaries.

4. In the event that M is unable to dispose of P through any of the above means within the extension period, the trustees will continue to assess the market with the aid of its financial advisors, and may sell various brands if feasible under current loan arrangements. The trustees believe that the most efficient approach to capturing the full value of P is to sell the entire business as a unit. Ultimately, if after exhausting all possibilities M continues to have excess business holdings in P, the trustees may, in keeping with M's mission, donated the P stock to various public charities that are colleges, universities, and hospitals.

Submission of Plan the Attorney General ("AG")

M's trustees have submitted their plan to the AG having administrative or supervisory authority or responsibility with respect to M's disposition of its excess business holdings.

M has provided the Service with the AG's response to M. In its response, the AG states:

> Based on this information, the Attorney General supports [M]'s request for a five-year extension. Since its creation … [M] appears to have made a diligent effort to dispose of its excess business holding. The plan for disposition of these holdings set forth in [M]'s … letter appears to be reasonable and consistent with [M]'s charitable purposes. The granting of [M]'s extension request, which will allow [M] to carry out its disposition plan, is necessary to protect its charitable assets.

Law:

Section 4943(a) of the Internal Revenue 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 that, in general, 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 4943(d)(3) of the Code provides 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. Gross income from passive sources includes the items excluded by section 512(b)(1), (2), (3), and (5), and income from the sale of goods if the seller does not manufacture, produce, physically receive or deliver, negotiate sales of, or maintain inventories in such goods.

Section 512(b)(1) of the Code excludes from the term "unrelated business taxable income" all dividends, interest, payments with respect to securities loans (as defined in section 512(a)(5)), amounts received or accrued as consideration for entering into agreements to make loans, and annuities, and all deductions directly connected with such income.

Section 53.4943-10(c)(1) of the Foundation and Similar Excise Taxes Regulations provides 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. 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 4943(d)(1) of the Code provides that, in computing the holdings of a private foundation in any business enterprise, any stock or other interest owned, directly or indirectly, by or for a corporation, partnership, estate, or trust, shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries.

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 is permitted to hold twenty percent of the voting stock in a business enterprise with any excess constituting excess business holdings. However, 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.

On date z, M received all outstanding shares of N through a Decree of Distribution. As a result, as of date z, M is deemed to own 100 percent of the stock of P, a business enterprise. For purposes of section 4943 of the Code, M's interest in P is treated as held by a disqualified person for five years beginning on date z. At the close of the five-year period, M will be subject to tax under section 4943 for any excess business holdings in P.

Because the distribution of N stock to M under the Decree of Distribution was unusually large, including, as it did, the entire interest in P, and because N is a passive holding company with diverse business holdings, under section 4943(c)(7) of the Code, the Service may extend the initial five-year period for disposing of excess business holdings for an additional five years if M establishes that: (i) 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, (ii) it submits a plan for disposing of all excess business holdings in the extension period and submits such plan to the Attorney General having authority or responsibility with respect to M's disposition of excess business holdings, and (iii) the Service determines that such plan can reasonably be expected to be carried out before the close of the extension period.

The information submitted by M shows that the disposal of its holdings in P during the initial five-year period was not reasonably possible owing to P's poor financial condition and highly leveraged position, and because of a slump in the c industry and P's declining share in such industry.

M has shown that it made diligent efforts to dispose of its holdings in P during the initial five-year period. Efforts were made to improve the operating performance, financial conditions, and salability of P. These include recruiting new management for P and expanding P's board of directors, retaining legal and financial advisors, and renegotiating and restructuring P's debt.

M's trustees have explored a variety of options for disposing if M's holding in P. These include the sale of P itself, divesting P stock through an initial public offering and subsequent structured sales of stock on the public market, and the sale of certain P brands.

Prior to the close of the initial five-year period, M submitted to the Service a viable plan for disposing of its interest in P during an additional five-year period. Such plan includes improving the operating, financial, and debt positions of P, continuing efforts to either sell P, conducting an initial public offering of P, selling certain P brands, or disposing of holdings through contributions to public charities.

M has submitted its plan to the appropriate AG who has opined that M's plan appears to be reasonable and consistent with M's charitable purposes.

We determine that M's plan can reasonably be expected to be carried out before the end of a five-year extension period, based on P's efforts to improve its financial and market position and the improving sales of some of P's brands.

Conclusion:

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

> Because M has met the requirements set forth in section 4943(c)(7) of the Code for extending the initial five-year period for disposing of excess business holdings, we rule that the period M has to dispose of its excess business holdings in P is extended to June 30, 2010.

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.

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 they 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