Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Number: **201630009**

Release Date: 7/22/2016

Index Number: 512.00-00, 4941.04-00, 4943.03-01, 4944.05-00

Person To Contact:

ID No.

Telephone Number:

Refer Reply To:
CC:TEGE:EOEG:EO3
PLR-134456-15

Date:
April 22, 2016

Foundation =
Year 1 =
State =
Decedent =
Date 1 =
X =
Y =

Dear :

This letter responds to a letter from your authorized representative dated October 6, 2015, and subsequent correspondence, requesting rulings under §§ 512, 4941, 4943, and 4944 of the Internal Revenue Code.

FACTS

Foundation was established in Year 1, pursuant to the laws of the State. Foundation is a tax-exempt organization described in § 501(c)(3) and classified as a private foundation under § 509(a). Foundation's exempt purpose is to receive funds, administer investments, and distribute funds to § 501(c)(3) organizations. Foundation's funding has come solely from Decedent. Historically, Foundation has invested in cash and publicly traded bonds and securities.

Decedent died on Date 1, leaving a will providing that Foundation receives, among other things, commercial real estate properties. The Executor intends to distribute these real estate properties to Foundation as single member limited liability companies.

Any debt encumbering the properties will be paid in full by the estate prior to, or simultaneously with, the transfer of the properties to Foundation.

The real estate properties are primarily office rental properties. The rent received is at least 95% for the use of real property and any remainder of the rent is attributable to personal property leased with the real property that is an incidental amount of the total rents that are received or accrued under various leases. No part of the rent paid depends in whole or in part on the income or profits derived by any person from the property leased.

At least in the near term, Foundation intends to continue to hold the properties as part of a diversified investment portfolio that will also contain cash and publicly traded securities. The decision to retain or sell any of the real estate properties will be made by Foundation's Board of Directors based on the relevant facts and circumstances and in accordance with their fiduciary duty to prudently manage Foundation's investments. The real estate properties will be held as income producing properties and not as inventory used in a trade or business. The decision to sell or keep any one of the individual real estate properties will be made on a property-by-property basis, taking into consideration Foundation's overall investment portfolio, investment strategy, and capital appreciation. Foundation may decide to make capital improvements to the real estate properties as needed, but the real estate properties will not be held for the primary purpose of improving the properties for immediate resale. Foundation anticipates that any sales of the real estate properties will be sporadic and occasional.

At this time, Foundation does not anticipate acquiring additional real property in its investment portfolio. Any such acquisitions will be made by the Board of Directors based on the relevant facts and circumstances and in accordance with the Board's fiduciary duty to prudently manage Foundation's diversified investment portfolio.

Foundation intends to form a new limited liability company, X, of which Foundation will be the sole member and which will be treated as a disregarded entity for federal income and excise tax purposes, to manage the properties Foundation received by bequest. Specifically, X will provide any of the following services with respect to the management of the real estate properties held for investment by Foundation:

1. contract negotiations;

2. cash management;

3. debt management including budgeting;

4. negotiation of financing;

5. review of loan agreements and expenditures;

6. accounting;

7. supervision of property operations and inspections;

8. advertising;

9. leasing and lease negotiations;

10. goodwill relations with tenants and communities;

11. interface with municipalities and compliance with new ordinances;

12. collection of rents;

13. supervision of personnel and human resources;

14. supervision and administration of legal and tax services and other incidental and ancillary activities associated with the ownership of passive rental real property; and

15. supervision and administration of a risk management program to frequently review Foundation's real estate investments, including identification and analysis of potential real estate acquisitions and services relating to the disposition of property.

X may hire and supervise third party vendors who are not disqualified persons to provide landscaping; perform capital improvement projects; and provide certain in-house maintenance services, all of which will be limited to common areas such as public entrances, exits, stairways, and lobbies. X itself will not perform these services. X will not provide or arrange for cleaning or janitorial services for the lessees.

Y, a management company owned partially by Decedent and partially by Decedent's family, managed the properties during Decedent's lifetime. Decedent's interest in Y will be redeemed upon approval by the Surrogate Court and will not pass to Foundation.

Y will share certain employees including manager, a disqualified person, with X to assist X with the enumerated property management services. X will enter into a separate contractual arrangement with each shared employee, based on a reasonable determination of the value of that employee's services to X, to provide reasonable compensation to that employee for services provided to X. The shared employees will only be compensated by X for work they perform for X, as confirmed by detailed time records which will require the shared employees to log the time spent for X and Y on a daily basis. Other than manager, the shared employees will not be disqualified persons.

Foundation will have sole authority to appoint the managers of X. Foundation expects to appoint one or more disqualified persons to act as the manager or managers of X and thereby manage Foundation's properties. The manager or managers will receive reasonable compensation for providing the property management services to Foundation through X.[1]

At least one such manager will be shared with Y. Any such manager will only be compensated by X for work done for X, as confirmed by detailed time records which will require the manager to log the time spent for X and Y on a daily basis. X and Y will maintain separate employee benefits, including retirement plans as well as health, dental and disability insurance.

Foundation represents that the property management services the manager or managers provide will be reasonable and necessary to carrying out Foundation's exempt purposes, and the compensation provided to manager or managers for services provided to X will not be excessive.

RULINGS REQUESTED

(1) Rental income received from the commercial real estate properties will be excluded from unrelated business taxable income.

(2) Income received as a result of the sale of these commercial real estate properties will be excluded from unrelated business taxable income.

(3) Contracting with X, managed by one or more disqualified persons, to provide certain real property investment management services will not constitute an act of self-dealing under § 4941.

(4) X and the limited liability companies constituting commercial real estate properties will not constitute excess business holdings under § 4943.

(5) The properties will not be considered jeopardizing investments described in § 4944.

(6) The sharing of employees, including managers, between X and Y will not constitute an act of self-dealing under § 4941, provided that the compensation paid by X to each such employee respectively is not excessive in relation to the services provided to X.

[1] There is no indication in the facts you provided that the manager or managers of X will provide any services in managing X that are separate from managing the real estate properties held for investment.

LAW AND ANALYSIS

Issue 1 – Whether rental income will be excluded from unrelated business taxable income

Section 511(a) imposes a tax for each taxable year on the unrelated business taxable income of every organization described in § 501(c), including those described in § 501(c)(3).

Section 512(a)(1) provides that the term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less the deductions allowed by Chapter 1 which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).

Section 512(b) contains modifications to the unrelated business taxable income rules of § 512(a)(1). Section 512(b)(3)(A) provides that, in the case of rents, all rents from real property and all rents from personal property leased with such real property if the rents attributable to such personal property are an incidental amount of the total rents received or accrued under the lease, and all deductions directly connected with such rents, are excluded from § 512(a).

Section 512(b)(3)(B)((ii) provides that if the determination of the amount of such rent depends in whole or in part on the income or profits derived by any person from the property leased (other than an amount based on a fixed percentage or percentages of receipts or sales), then the rent is not so excluded.

Treas. Reg. § 1.512(b)-1(c)(2)(ii)(b) provides that rents which are excluded from unrelated business income under § 512(b)(3)(A) include all rents from personal property leased with real property if the rents attributable to such personal property are an incidental amount of the total rents received or accrued under the lease, determined at the time that the personal property is first placed in service by the lessee. For purposes of the preceding sentence, rents attributable to personal property generally are not an incidental amount of the total rents if such rents exceed 10 percent of the total rents from all the property leased.

Treas. Reg. § 1.512(b)-1(c)(3) defines "real property" as all real property, including any property described in §§ 1245(a)(3)(C) and 1250(c) and the regulations thereunder.

Treas. Reg. § 1.512(b)-1(c)(5) states that payments for the use or occupancy of space where services are also rendered to the occupant does not constitute rent from real property.

Foundation's commercial real estate properties are defined as "real property" under Treas. Reg. § 1.512(b)-1(c)(3). The rental income is from rents of the real property or from personal property leased with the real property that will be an incidental amount of the total rents received or accrued under the lease. No part of the rent paid depends in whole or in part on the income or profits derived by any person from the property leased. Foundation will not provide services to the lessees. Thus, the income from the commercial real estate properties Foundation received by bequest consists of rent that is excluded from unrelated business taxable income by § 512(b)(3) and the regulations thereunder, provided no income results from debt-financed property.

Issue 2 – Whether income received as a result of the sale of these commercial real estate properties will be excluded from unrelated business taxable income

Section 512(b)(5) provides that there shall be excluded from the computation of unrelated business taxable income all gains or losses from the sale, exchange, or other disposition of property, other than from stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, or property held primarily for sale to customers in the ordinary course of the trade or business.

In Malat v. Riddell, 383 U.S. 569 (1966), the Supreme Court defined the standard to be applied in determining whether property is held primarily for sale to customers in the ordinary course of business. The Court interpreted the word "primarily" to mean "of first importance" or "principally." By this standard, ordinary income would not result unless a sales purpose is dominant.

Treas. Reg. § 1.512(b)-1 provides that whether a particular item of income falls within any of the modifications provided in § 512(b) shall be determined by all the facts and circumstances of each case.

Foundation intends to hold the real estate properties as part of a diversified investment portfolio that will also contain cash and publicly traded securities and intends to continue to hold the properties, at least in the near term. Foundation anticipates that any sales of the real estate properties will be sporadic and occasional. The decision to retain or sell any of the real estate properties will be made by Foundation's Board of Directors based on the relevant facts and circumstances and in accordance with their fiduciary duty to prudently manage Foundation's investments. Any such decision will be made on a property-by-property basis, taking into consideration the overall investment portfolio, investment strategy, and capital appreciation. Foundation may decide to make capital improvements to the real estate properties as needed, but the real estate properties will not be held for the primary purpose of improving the properties for immediate resale. The real estate properties will be held as income producing properties and not as inventory used in a trade or business. See Malat v. Riddell, supra. Accordingly, any

income from the sale, exchange, or other disposition of the commercial real estate properties you received by bequest will be excluded from the computation of unrelated business taxable income by § 512(b)(5), provided no income results from debt-financed property.

Issue 3 – Whether paying disqualified persons to provide certain property management services will constitute self-dealing under § 4941

Section 4941(a)(1) imposes taxes on each act of self-dealing between a disqualified person and a private foundation. Taxes are imposed on both the self-dealers involved in an act of self-dealing and on any foundation managers who knowingly participate in an act of self-dealing. Even though § 4941 does not impose a tax on a private foundation when an act of self-dealing occurs, a foundation with respect to which there has been an act of self-dealing is required to report it to the IRS on its annual information return, which is the Form 990-PF in this case.

Section 4946(a)(1) provides 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, (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 of any individual described in (A), (B), or (C); (E) a corporation of which persons described in (A), (B), (C), or (D) own more than 35 percent of the total combined voting power; (F) a partnership in which persons described in (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 (A), (B), (C), or (D) hold more than 35 percent of the beneficial interest.

Section 4941(d)(1)(D) defines "self-dealing" as any direct or indirect payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person.

Section 4941(d)(1)(E) provides that the term "self-dealing" includes any direct or indirect transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation.

Section 4941(d)(2)(E) and Treas. Reg. § 53.4941(d)-3(c)(1) provide that the payment of compensation (and the payment or reimbursement of expenses) by a private foundation to a disqualified person for personal services which are reasonable and necessary to carrying out the exempt purpose of the private foundation shall not be an act of self-dealing if the compensation (or payment or reimbursement) is not excessive.

Treas. Reg. § 53.4941(d)-3(c)(2) provides examples of "personal services" for purposes of Treas. Reg. § 53.4941(d)-3(c)(1). These include legal services, investment counseling services, and general banking services.

In Madden v. Commissioner, T.C. Memo 1997-395, the Tax Court ruled that maintenance, janitorial, and security services provided by a disqualified person to a private foundation are not "personal services" for purposes of the exception to self-dealing. Citing § 4941's legislative history, the Court noted that one of Congress's stated goals in enacting § 4941 was to minimize the need for an arm's length standard by generally prohibiting self-dealing transactions between private foundations and disqualified persons and that any exceptions to the self-dealing transactions rules should be construed narrowly. The Court stated that the regulations under § 4941 contemplate only personal services that are professional and managerial in nature, and concluded that maintenance, janitorial, and custodial services do not meet the definition of "personal services" allowed under § 4941.

Foundation will contract with X, managed by one or more of Foundation's disqualified persons, to manage Foundation's real estate properties. While the disqualified person manager or managers will be compensated by X, because X is a disregarded entity, for purposes of the analysis under § 4941, Foundation will be providing compensation to a manager or managers who are disqualified persons.

Payment of compensation by a private foundation to a disqualified person is an act of self-dealing under § 4941(d)(1)(D). However, § 4941(d)(2)(E) provides an exception to self-dealing for the payment of compensation by a private foundation to a disqualified person for personal services which are reasonable and necessary to carrying out the exempt purpose of the private foundation. Foundation received the real estate properties by bequest and, as such, they became part of Foundation's investment portfolio. Foundation does not intend to actively pursue other real estate investments which, historically, have not been part of Foundation's investments. Treas. Reg. § 53.4941(d)-3(c)(2) provides examples of allowable personal services that consist of legal services, investment counseling services, and general banking services. Additionally, Madden v. Commissioner, supra, indicates that services that are professional and managerial in nature are the types of personal services that are allowed under § 4941. The property management services provided to Foundation by one or more disqualified persons, through X as a disregarded entity, are professional and managerial services that, under the current facts, are reasonable and necessary to administering Foundation's investments and thus in carrying out Foundation's exempt purposes. Thus, the payment of compensation for these personal services to a manager who is a disqualified person will not be an act of self-dealing as long as the compensation is not excessive.

Issue 4 – Whether X and the limited liability companies constituting commercial real estate properties will constitute excess business holdings under § 4943

Section 4943 imposes a tax annually on the value of a private foundation's excess holdings in a business enterprise. Excess business holdings are generally determined with reference to a foundation's own holdings and the holdings of all of its disqualified persons, as defined in § 4946.

Section 4943(d)(3)(B) provides that the term "business enterprise" does not include a trade or business at least 95% of the gross income of which is derived from passive sources. Gross income from passive sources includes, among other things, items excluded from unrelated business taxable income by § 512(b)(3).

Foundation's gross income from the commercial real estate properties, owned and managed by limited liability companies that are disregarded entities, will be at least 95% passive rental income that is excluded from unrelated business taxable income by § 512(b)(3). Thus, under these facts, the limited liability companies (including X), which are disregarded entities, will not constitute business enterprises that could trigger excess business holdings under § 4943.

Issue 5 – Whether the limited liability companies constituting commercial real estate properties will be considered jeopardizing investments described in § 4944

Section 4944(a) imposes a tax on private foundations that invest any amount in such manner as to jeopardize the carrying out of any of its exempt purposes.

Treas. Reg. § 53.4944-1(a)(2)(ii)(a) provides that § 4944 shall not apply to an investment made by any person which is later gratuitously transferred to a private foundation.

Because Foundation received the commercial real estate properties by bequest, they will not be jeopardizing investments described in § 4944.

Issue 6 – Whether the sharing of employees, including managers, between X and Y will constitute an act of self-dealing under § 4941

Section 4941(a)(1) imposes taxes on each act of self-dealing between a disqualified person and a private foundation. Taxes are imposed on both the self-dealers involved in an act of self-dealing and on any foundation managers who knowingly participate in an act of self-dealing.

Section 4946(a)(1) provides 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, (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 of any individual described in (A), (B), or (C); (E) a corporation of which persons described in (A), (B), (C), or (D) own more than 35 percent of the total combined voting power; (F) a partnership in which persons described in (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 (A), (B), (C), or (D) hold more than 35 percent of the beneficial interest.

Section 4941(d)(1)(D) defines "self-dealing" as any direct or indirect payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person.

Section 4941(d)(1)(E) provides that the term "self-dealing" includes any direct or indirect transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation.

Y's employees are not disqualified persons but Y is a disqualified person because it is owned by decedent's family. X's time-sharing arrangements with Y for these employees to assist X with property management services, which are treated as Foundation's time-sharing arrangements since X is a disregarded entity, will provide each shared employee with compensation that is not excessive based on a reasonable determination of the value of that employee's services to X, confirmed by detailed time records logging the time spent for X and Y on a daily basis, and accompanied by separate benefit arrangements. Accordingly, the time-sharing arrangements and the compensation provided by X to the employees will not constitute self-dealing to Y under § 4941 because there will be no indirect benefit to Y.

The same is true of any managers of X that are shared with Y, even if the managers are disqualified persons with respect to Foundation. Since the time-sharing arrangement with Y provides the manager or managers will only be compensated by X for work done for X, as confirmed by detailed time records which will require the manager to log the time spent for X and Y on a daily basis and accompanied by separate benefit arrangements, the time-sharing arrangements and the compensation provided by X to any such manager will not constitute self-dealing to Y under § 4941 because there will be no indirect benefit to Y. The time-sharing arrangements and the compensation provided by X to any such manager will also not constitute self-dealing to the managers who are disqualified persons as long as the compensation is not excessive, for the reasons discussed above under Issue 3.

CONCLUSION

Based solely on the facts and representations submitted by the Trust, we conclude that:

(1) Rental income received from the commercial real estate properties will be excluded from unrelated business taxable income.

(2) Income received as a result of the sale of these commercial real estate properties will be excluded from unrelated business taxable income.

(3) Contracting with X, managed by one or more disqualified persons, to provide professional and managerial real property investment management services will not constitute an act of self-dealing under § 4941, provided that any compensation paid to a disqualified person for these personal services is not excessive.

(4) X and the limited liability companies constituting commercial real estate properties will not constitute excess business holdings under § 4943.

(5) The properties will not be considered jeopardizing investments described in § 4944.

(6) The sharing of employees, including managers, between X and Y will not constitute an act of self-dealing under § 4941, provided that the compensation paid by X to each such employee respectively is not excessive in relation to the services provided to X.

The rulings contained in this letter are based upon information and representations submitted by or on behalf of Foundation (accompanied by a penalty of perjury statement executed by an individual with authority to bind Foundation) and upon the understanding that there will be no material changes in the facts. This office has not verified any of the material submitted in support of the request for rulings, and such material is subject to verification on examination.

No ruling is granted as to whether Foundation qualifies as an organization described in §§ 501(c) or 509(a).

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 specifically described, and, except as expressly provided in this letter, no opinion is expressed or implied concerning the federal income tax consequences of any aspects of any transaction or item of income set forth above.

Because it could help resolve questions concerning federal income tax status, this ruling should be kept in Foundation's permanent records.

A copy of this letter must be attached to any tax return to which it is relevant. Alternatively, if Foundation files its return electronically, this requirement may be satisfied by attaching a statement to the return that provides the date and control number of this letter.

This ruling will be made available for public inspection under § 6110 after certain deletions of identifying information are made. For details, see the enclosed Notice 437, Notice of Intention 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 the Notice 437. If Foundation disagrees with our proposed deletions, it should follow the instructions in the Notice 437.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to Foundation's authorized representatives.

This letter is directed only to Foundation. Section 6110(k)(3) provides that it may not be used or cited as precedent by any other taxpayer, including disqualified persons, limited liability companies, and corporations.

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,

Virginia G. Richardson
Senior Tax Law Specialist
(Tax Exempt & Government Entities)

Encl.:
Notice 437, Notice of Intention to Disclose
Redacted copy of this letter

cc: