H. IRC 4943 - TRANSITIONAL RULES AND OTHER CURRENT TOPICS

1. Introduction

The most complicated of the major foundation excise tax provisions of Chapter 42, enacted by the 1969 Tax Reform Act (P.L. 91-172, 1969-3 C.B. 10), IRC 4943, has been one of the least applied provisions. This is generally due to the liberal grace or transitional divestiture periods provided for disposing of excess business holdings held by private foundations on May 26, 1969. In recent years, however, the IRC 4943 area has become much more active since the shortest of the grace periods, the 10 year period provided for in IRC 4943(c)(4)(B)(iii), expired for many private foundations on May 26, 1979, and the 15 year period provided for in IRC 4943(c)(4)(B)(ii) will expire on May 26, 1984. This topic includes a brief review of IRC 4943, a discussion of issues of potential current interest, and a discussion of the exception from IRC 4941 self-dealing for certain sales of private foundation excess business holdings, held on May 26, 1969, to disqualified persons.

Final regulations under IRC 4943 were published on July 5, 1977 (T.D. 7496, 1977-2 C.B. 390). The 1978 and 1979 EOATRI texts provided a general explanation of the IRC 4943 regulations. Certain portions of the regulations dealing with the 5-year transitional rules of IRC 4943(c)(6) and "purchase" transactions, certain corporate readjustments and acquisitions, and holding corporation issues have been reserved.

2. General and Permitted Holdings

Generally, IRC 4943 imposes a tax on the excessive business holdings in a business enterprise of a private foundation. Excess business holdings are those holdings which the private foundation would have to dispose of (or cause the disposition of) to a person other than a disqualified person in order for the remaining holdings of the private foundation to be permitted holdings. The initial tax is five percent of the value of the excess business holdings. If the excess holdings are not disposed of by the expiration of the correction period (as extended), the private foundation becomes liable for an additional tax equal to 200 percent of the remaining excess business holdings. See IRC 4961 and 4962.

The tax on excess business holdings does not apply to holdings in a functionally related business as defined in IRC 4942(j)(4), a program related investment as defined in IRC 4944(c), or to a trade or business that derives at least 95 percent of its gross income from passive sources, which include dividends, interest, annuities, rents described in IRC 512(b)(3), and capital gains described in IRC 512(b)(5). IRC 4943(d)(3). Regs. 53.4943-10(b) and 53.4943-10(c).

A functionally related business includes any trade or business which is not an unrelated trade or business as defined in IRC 513. Thus, businesses that satisfy the three exceptions in IRC 513(a)(1), (2) and (3) dealing with volunteer labor, convenience, and donated goods, will not be subject to the excess business holding rules. Similarly, bingo games described in IRC 513(f) are not subject to IRC 4943. Also, the fragmentation rule of IRC 513(c) is not applied under IRC 4943. Thus, for example, if a private foundation owns and publishes an educational magazine which carries commercial advertising, the advertising component is not treated as a business holding, even though it may be taxed as unrelated business income under IRC 513. See Reg. 53.4942(a)-2(c)(3)(iii).

Generally, in determining whether a trade or business derives at least 95 percent of its gross income from passive sources, its income during its last completed taxable year is considered. In case of a failure to meet the last completed year's test, Reg. 53.4943-10(c) provides a 10 year averaging rule that may be used to establish that an organization has derived its income primarily from passive sources. If the trade or business meets the 10 year rule, it will not be classified as a business enterprise subject to the IRC 4943 provisions.

However, the ten year rule applies only if the last completed year rule is not satisfied. For example, for purposes of the 101(l)(2)(B) savings provision, involving the sale of certain pre-May 27, 1969 excess business holdings to disqualified persons without such transactions being subject to the IRC 4941 self-dealing tax, arguments should not be entertained that the 10 year test may be used, in lieu of the last taxable year test, to characterize otherwise passive holdings as excess business holdings. The characterization of otherwise passive holdings as excess business holdings would, in such a case, allow sales to be made to disqualified persons in contravention of the IRC 4941 self-dealing provisions.

The rules for determining the permitted holdings of a private foundation in a business enterprise are presented in IRC 4943(c)(2) and 4943(c)(4). Basically, IRC 4943(c)(2) limits the combined holdings of a private foundation and all disqualified persons to 20 percent of the voting stock (or profits interest for

partnerships or joint ventures, and in all other cases, beneficial interest) in a business enterprise. Total holdings of 35 percent are allowed where one or more third persons, who are not disqualified persons, have effective control of the business enterprise.

The 35 percent rule was considered in Rev. Rul. 81-111, 1981-1 C.B. 509, which is extracted below:

> **Private foundations; excess business holdings; effective control. For purposes of computing the 35 percent permitted holdings rule of section 4943(c)(2)(B) of the Code, effective control in one or more persons who are not disqualified persons may be demonstrated by proving that some unrelated party or cohesive group of third parties, in fact, exercises control over the business enterprise. It is not enough to show that the private foundation and disqualified persons cannot exercise such control.**
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> **Rev. Rul. 81-111**
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> ISSUE
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> In the situations described below, is the 35 percent permitted holdings rule of section 4943(c)(2)(B) of the Internal Revenue Code applicable to the holdings of the private foundation?
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> FACTS
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> P is exempt from federal income tax under section 501(c)(3) of the Code and is a private foundation under section 509(a). Corporations M and N each have outstanding 100x shares of voting stock, with each share entitling the holder thereof to one vote. M and N are business enterprises within the meaning of section 4943(d)(4) of the Code and section 53.4943-10(a) of the Foundation Excise Tax Regulations.
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> Situation 1.
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> P holds 15x shares of M voting stock, and disqualified persons with respect to P, within the meaning of section 4946(a) of the Code, hold 20x shares of M voting stock. The remaining 65x shares of M voting stock are held by C, who is

not a disqualified person with respect to P. By virtue of C's ownership of 65 percent of the M voting stock, C has elected a majority of the board of directors of M.

Situation 2.

P holds 15x shares of N voting stock, and disqualified persons with respect to P hold 20x shares of N voting stock. The remaining 65x shares of N voting stock are held by a large number of individuals, none of whom is a disqualified person with respect to P. There does not exist any voting trust, contractual arrangement, or other similar agreement between any of these individuals relating to their stock voting rights. None of these individuals alone has sufficient voting stock holdings in N to direct or cause the direction of the management and policies of N, nor has one of them historically elected the majority of N's board of directors. P's holdings of N stock are not protected by any of the special transitional rules of sections 4943(c)(4), (5), and (6) of the Code.

LAW

Section 4943(a)(1) of the Code imposes a tax on the excess business holdings of a private foundation equal to 5 percent of the value of such holdings.

Section 4943(c)(1) of the Code states that the term "excess business holdings" means the amount of stock or other interest in a business enterprise that the foundation would have to dispose of to a person other than a disqualified person for its remaining holdings to be permitted holdings.

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

Section 4943(c)(2)(B) of the Code and section 53.4943-3(b)(3) of the regulations provide that section 4943(c)(2)(A) shall be applied by substituting 35 percent for 20 percent if--

(i) the private foundation and all disqualified persons together do not own, actually or constructively, more than 35 percent of the voting stock in the business enterprise, and

(ii) the foundation establishes to the satisfaction of the Commissioner that effective control of the business enterprise is in one or more persons (other than the foundation itself) who are not disqualified persons.

Section 53.4943-3(b)(3)(ii) of the regulations provides that the term "effective control" mean the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a business enterprise, whether through the ownership of voting stock, the use of voting trusts, or contractural arrangements, or otherwise. It is the reality of control which is decisive and not its form or the means by which it is exercisable. Thus, where a minority interest held by individuals who are not disqualified persons has historically elected the majority of a corporation's directors, effective control is in the hands of those individuals.

ANALYSIS

In Situation 1, C holds a majority of the voting stock of M, and C has elected a majority of the board of directors of M. Under these circumstances, P has established that effective control of M, within the meaning of section 4943(c)(2)(B) of the Code and section 53.4943-3(b)(3)(ii) of the regulations, is in the hands of C. Thus, since the holdings of P and all disqualified persons do not exceed 35 percent of the voting stock of M, the 35 percent permitted holdings rule of section 4943(c)(2)(B) of the Code is applicable. It follows that P is not in an excess business holdings position with respect to its holdings of M voting stock.

In Situation 2, on the other hand, none of the individuals holding the 65 percent of N voting stock, not in the hands of the foundation or disqualified persons, alone has sufficient voting stock holdings in N to direct or cause the direction of the management and policies of N, nor has one of these individuals historically elected the majority of N's board of directors. Also, none of these individuals has entered into any voting trust, contractural arrangement, or other similar agreement resulting in their combined control of

N. Under these circumstances, P has not established that effective control of N, within the meaning of section 4943(c)(2)(B) of the Code and section 53.4943-3(b)(3)(ii) of the regulations, is in the hands of third persons who are not disqualified persons with respect to P.

Even if P were to establish that P and its disqualified persons cannot exercise effective control of N because of their minority voting stock interest in N, and that they have not, in fact, exercised effective control over N, the 35 percent rule would not be applicable. Section 4943(c)(2)(B)(ii) of the Code and the regulations thereunder require affirmative proof by a private foundation that some unrelated third party, or a group of third parties does, in fact, exercise effective control over the business enterprise in question. Accordingly, the 35 percent permitted holdings rule of section 4943(c)(2)(B) of the Code is not applicable to Situation 2. Thus, because disqualified persons hold 20 percent of the N voting stock, P is in an excess business holdings position with respect to its 15 percent ownership of N voting stock.

HOLDINGS

In Situation 1, because private foundation P established that C, who is not a disqualified person, exercised effective control over the M corporation, the 35 percent permitted holdings rule of section 4943(c)(2)(B) of the Code is applicable.

In Situation 2, because P has not established that effective control of the N corporation is in one or more third persons who are not disqualified persons, the 35 percent rule of section 4943(c)(2)(B) is not applicable.

This revenue ruling indicates that the Service interprets the effective control requirement of IRC 4943(c)(2)(B) very strictly. Thus, it will apply in relatively few situations.

Non-voting stock (or capital interest in the case of holdings in a partnership or joint venture) is a permitted holding of a foundation in any case where disqualified persons hold no more than 20 percent (or 35 percent as described above) of the voting stock of the corporation. All equity interests in a corporation that are not voting stock are classified as non-voting stock. See Reg. 53.4943-3(b)(2). For example, if a debt instrument is classified as an equity interest under

IRC 385, it will generally be treated as non-voting stock. The Service is currently considering whether limited partnership interests, reflecting profits interest, should be treated the same as non-voting stock. Such interests are similar to non-voting stock as the limited partners generally exercise no management control over the partnership. On the other hand, the regulations, though not totally clear, could be read as requiring that all profits interests in partnerships be treated as voting stock.

A private foundation is not permitted any holdings in sole proprietorships that are business enterprises (not functionally related nor 95 percent passive in nature) unless they were held on May 26, 1969, or acquired by gift or bequest thereafter. See IRC 4943(c)(3)(B), Reg. 53.4943-3(c)(3) and Reg. 53-4943-10(e). This means, for example, that if a private foundation operates, by itself, a trade or business, such as a commercial manufacturing, sales, or service activity, the foundation may be in violation of the IRC 4943 provisions, unless protected by one of the transitional provisions. Some common fund-raising activities, such as the operation of a bingo game, would be prohibited by this provision unless they met the functionally related business exception discussed above.

3. <u>May 26, 1969 Excess Business Holdings - Transitional Rules</u>

IRC 4943(c)(4) provides special transitional rules for holdings held on May 26, 1969. Generally, the percentage of combined permitted holdings with respect to stock held on May 26, 1969, is equal to 50 percent, unless the actual holdings on that date are less than that. However, if the actual holdings exceed 50 percent, IRC 4943(c)(4) provides for phased reductions in the actual holdings in order to reduce the holdings to the 50 percent goal.

During the first phase, business interests owned by a private foundation on May 26, 1969, if the foundation has excess business holdings under the 20 or 35 percent rules of IRC 4943(c)(2) on that date, are treated as held by a disqualified person, rather than by the foundation. The first phase lasts 20 years if the May 26, 1969, holdings of a private foundation alone exceeded 95 percent of the voting stock of a business corporation. The first phase lasts 15 years if the combined holdings of a private foundation and all disqualified persons in a business enterprise exceed, on May 26, 1969, 75 percent of the voting stock or the value of all outstanding shares of stock of a corporation, or 75 percent of the profits or capital interests of an unincorporated business. In all other cases, i.e., between 20 percent and 75 percent holdings, the first phase is 10 years. Phase one is suspended during certain judicial proceedings. IRC 4943(c)(4)(C). Reg. 53.4943-4(c)(3). No

other provisions for the suspension of phase one are included in the Code or Regulations.

By the end of the first phase, the combined holdings must be reduced so that they do not exceed either 50 percent of the voting stock or 50 percent of the value of all outstanding shares of all classes of stock of a corporation (or 50 percent of comparable interests in an unincorporated enterprise). Combined holdings in excess of 20 percent but less than 50 percent need not be decreased during the first phase but also may not be increased.

The second phase is the 15 year period immediately following the first phase. In some cases, additional reductions in holdings may be required during the second phase. Specifically, if all disqualified persons together have holdings in excess of two percent of the voting stock of a business enterprise, then the holdings of the private foundation are limited to 25 percent of the voting stock and 25 percent of the value of all outstanding shares of all classes of stock of the business enterprise. See Rev. Rul. 81-22, 1981-1 C.B. 510. The foundation must reduce its holdings to the 25 percent levels as soon as the holdings of its disqualified persons exceed two percent. However, the combined holdings of the foundation and all disqualified persons can still equal 50 percent during the second phase.

The third phase is the entire period following the second phase. During the third phase the percentages of permitted holdings of a private foundation to which IRC 4943(c)(4) applies are the same as during the second phase, with one exception. If a foundation enters the third phase, and the 25 percent limitation of the second phase never applied because disqualified persons have never held over two percent of the voting stock of a business enterprise at any time during the second phase, then the total combined permitted holdings of the private foundation and all disqualified persons must be reduced to 35 percent by the beginning of the third phase. Also, if disqualified persons subsequently acquire more than two percent of the voting stock, then the allowable holdings are further limited to a total of 35 percent, of which not more than 25 percent of the voting stock and 25 percent of the value of all outstanding shares of all classes of stock can be held by the private foundation.

IRC 4943(c)(5) provides that certain holdings acquired pursuant to the terms of a trust which was irrevocable on May 26, 1969, or under the terms of a will executed on or before such date, which are in effect on May 26, 1969, and at all times thereafter, will be treated as if held by the private foundation on May 26, 1969. The 10 or 15 year first phase commences from the date of distribution, rather

than from May 26, 1969. Note that the 20 year first phase period is not applicable in the IRC 4943(c)(5) situation. See Reg. 53.4943-5. Rev. Rul. 81-119, 1981-1 C.B. 512, considers a situation where an interest in a business enterprise was bequeathed to a private foundation under the residuary clause of a will executed before May 26, 1969. After May 26, 1969, a second will expressly revoked the first will and increased the amounts of the specific bequests without changing the residuary clause. The revenue ruling holds that the interest in the business enterprise acquired by the foundation on the death of the testator comes within the special transitional rules under IRC 4943(c)(4) and (c)(5), as the new will was merely an amendment or republication of the original will; and the interest of the private foundation was not increased.

4. 101(l)(2)(B) - Dispositions of Excess Business Holdings

As discussed above, IRC 4943 limits the combined ownership of a business enterprise by a private foundation and all disqualified persons, and taxes any excess holdings of a private foundation which are not divested within specific periods of time.

A private foundation required to dispose of excess business holdings may have a number of alternative courses of action available including, for example, a sale to a non-disqualified person, a sale to a disqualified person, a redemption of corporate stock, a transfer of the holdings to another charitable organization, or a change in the nature of the business to a passive enterprise. Also, in appropriate circumstances, the foundation could attempt to persuade disqualified persons to dispose of their holdings in the business.

In the case of many closely-held companies, the only viable alternatives, short of a gift of the excess holdings to another charitable organization, are a sale to disqualified persons, or a redemption by the business. However, a sale to disqualified persons could constitute an act of self-dealing under IRC 4941 while a redemption could constitute a direct or indirect act of self-dealing.

Consequently, in order to allow private foundations to arrange their affairs through an orderly disposition of their excess business holdings, section 101(1)(2)(B) of the Tax Reform Act of 1969 and Reg. 53.4941(d)-4(b) provide an exception to the self-dealing rules allowing sales of excess business holdings to disqualified persons. Section 101(l)(2)(B) states:

> Section 4941 shall not apply to the sale, exchange, or other disposition of property which is owned by a private foundation on May 26, 1969 (or which is acquired by a private foundation under the terms of a trust which was irrevocable on May 26, 1969, or under the terms of a will executed on or before such date, which are in effect on such date and at all times thereafter), to a disqualified person, if such foundation is required to dispose of such property in order not to be liable for tax under section 4943 (relating to taxes on excess business holdings) applied, in the case of a disposition before January 1, 1975, without taking section 4943(c)(4) into account and it receives in return an amount which equals or exceeds the fair market value of such property at the time of such disposition or at the time a contract for such disposition was previously executed in a transaction which would not constitute a prohibited transaction (within the meaning of section 503(b) of the corresponding provisions of prior law).

This provision was amended by section 1309 of the Tax Reform Act of 1976 to extend the period during which dispositions could occur without taking into account IRC 4943(c)(4). The extension applies to dispositions occurring after the date of enactment (October 4, 1976) and before January 1, 1977. See the 1977 EOATRI textbook, at page 25, for further discussion of the 1976 Tax Reform Act extension.

Thus, the following requirements must be met for section 101(l)(2)(B) to be applicable:

a. The business holdings must have been owned by the private foundation on May 26, 1969, or be treated as so held under IRC 4943(c)(5) concerning holdings acquired (or to be acquired) through certain pre-May 26, 1969, wills and trusts.

   See Reg. 53.4941(d)-4(b)(3).

b. The private foundation must be required to dispose of the property in order not to be liable for tax under IRC 4943 (determined without regard to IRC 4943(c)(2)(C), the de minimis rule). However, dispositions prior to January 1, 1975, and between October 4, 1976 and January 1, 1977, may be made without regard to the present holdings rules of IRC IRC 4943(c)(4), but only if the

holdings exceed the holdings permitted under the general rules of IRC 4943(c)(2).

c. The private foundation must receive an amount which equals or exceeds the fair market value of the business holdings at the time of disposition or at the time a contract for such disposition was previously executed.

d. At the time the holding is valued per (c), the transaction must not constitute a prohibited transaction within the meaning of IRC 503(b) or the corresponding provisions of prior law if such provisions were applied at such time.

See Reg. 53.4941(d)-4(b).

It is important to emphasize that section 101(l)(2)(B) applies only to holdings held on May 26, 1969, or treated as so held by IRC 4943(c)(5). Accordingly, it is generally applicable only to dispositions under the three phases of IRC 4943(c)(4). Dispositions of holdings held during the transitional periods of IRC 4943(c)(6) and Regs. 53.4943-2(a)(ii), 53.4943-6 and 53.4943-11(b) (discussed in Part 5 of this topic) and any other required dispositions of excess business holdings can not take advantage of this special provision, unless the stock to be disposed was held by the foundation on May 26, 1969.

Also, while the statute refers to direct dispositions to disqualified persons, the section also protects sales, exchanges, or other dispositions which may constitute indirect acts of self-dealing. For example, private foundation P has held since May 26, 1969, 100 percent of the voting stock of Corporation X, and as a result of such interest, elects the board of directors of X. X has operated an active trade or business since May 26, 1969, which accounts for 10 percent of X's gross income. The remaining portion of X's gross income comes from passive sources. X plans to sell an appropriate portion of its active business so that it will, in the future, receive at least 95 percent of its gross income from passive sources and, therefore, no longer be classified as a "business enterprise" for purposes of IRC 4943(d)(4)(B). Generally, a sale of the active business by X to a disqualified person would constitute an indirect act of self-dealing. See Reg. 53.4941(d)-1(b)(8), Example (1). However, since after such a sale P would no longer be liable for tax under IRC 4943 with regard to its holdings of X, the sale would be protected by section 101(l)(2)(B), assuming, of course, that X receives an amount which equals or exceeds the fair market value of the business sold.

Section 101(l)(2)(B) is illustrated in Rev. Rul. 75-25, 1975-1 C.B. 359. The text of Rev. Rul. 75-25 is extracted below:

> **Private foundation's self-dealing; excess business holdings. In the proposed sale to a disqualified person of a private foundation's 15 percent interest in a corporation, in which the foundation and all disqualified persons with respect to the foundation have combined holdings of 45 percent of the voting stock as of May 26, 1969, the disqualified person would be subject to the tax on self-dealing imposed by section 4941 of the Code; in a similar situation in which the total combined holdings of the foundation and disqualified persons are 55 percent, the foundation has excess business holdings under section 4943(c)(4), and section 101(1)(2)(B) of the Tax Reform Act of 1969 would apply to except the proposed sale from the provisions of section 4941.**
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> **Rev. Rul. 75-25**
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> Advice has been requested whether private foundations may sell their business holdings under the circumstances described below without taxes being imposed on disqualified persons with respect to such private foundations under section 4941 of the Internal Revenue Code of 1954.
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> Situation 1. On May 26, 1969, and continuously thereafter, Private Foundation M held 15 percent and disqualified persons with respect to the foundation held 30 percent of the voting stock of Corporation X, for total combined holdings of 45 percent. Private Foundation M proposes to sell its 15 percent interest in Corporation X on January 2, 1975, to A, a disqualified person.
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> Situation 2. On May 26, 1969, and continuously thereafter, Private Foundation N held 15 percent and disqualified persons with respect to the foundation held 40 percent of the voting stock of Corporation Y, for total combined holdings of 55 percent. Private Foundation N proposes to sell its 15 percent interest in Corporation Y on January 2, 1975, to B, a disqualified person.
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> Section 101(1)(2)(B) of the Tax Reform Act of 1969 provides that section 4941 of the Code shall not apply to the

sale, exchange, or other disposition of a private foundation's business holdings to a disqualified person if the private foundation is required to dispose of such property in order not to be liable for tax under section 4943 and if the private foundation receives in return an amount which equals or exceeds the fair market value of the property in a transaction which is not a prohibited transaction within the meaning of section 503(b). It further provides that section 4943(c)(4) shall not be taken into account if the sale, exchange, or other disposition is made before January 1, 1975.

Section 53.4941(d)-4(b)(1) of the Foundation Excise Tax Regulations provides that the determination of whether a private foundation is required to dispose of property in order not to be liable for tax under section 4943 is to be made without regard to section 4943(c)(2)(C) (relating to the 2 percent de minimis rule) and as if every disposition by the foundation were made to a disqualified person.

Section 4943(a)(1) of the Code imposes a tax on the excess business holdings of a private foundation equal to 5 percent of the value of such holdings. Section 4943(c)(1) of the Code states that "excess business holdings" is the amount of stock or other interest in a business enterprise that the foundation would have to dispose of to a person other than a disqualified person for its remaining holdings to be "permitted holdings."

Section 4943(c)(2) of the Code provides generally that the permitted holdings of a private foundation in an incorporated business enterprise are 20 percent of the voting stock reduced by the percentage of voting stock held by all of the foundation's disqualified persons.

Section 4943(c)(4) of the Code provides special rules in cases where the combined holdings of a private foundation and its disqualified persons in a business enterprise on May 26, 1969, exceeded 20 percent of the voting stock. With respect to such cases, section 4943(c)(4)(A) provides generally that the permitted percentage of business holdings will be equal to the combined holdings of the private foundation and its disqualified persons on May 26, 1969, subject however to the limitation that such permitted percentage in any event will not exceed 50 percent. (In the event of a decrease in holdings with respect to business holdings on May 26, 1969,

the permitted percentage is subject to further limitations not material here.) Thus, if a private foundation had an interest in a business corporation on May 26, 1969, and the combined holdings of the private foundation and its disqualified persons in the voting stock of such corporation amounted to more than 50 percent, the private foundation would be in an excess business holdings position for purposes of section 101(1)(2)(B) of the Tax Reform Act.

Section 4943(c)(4)(B) of the Code provides that if, as of May 26, 1969, any interest of a private foundation constitutes excess business holdings (determined under the permitted percentages of section 4943(c)(4)(A), all of the private foundation's holdings are treated as held by a disqualified person for a 20, 15, or 10 year period (whichever applies, depending upon the holdings of the parties on May 26, 1969). Section 4943(c)(4)(B) thus provides a grace period which effectively suspends imposition of the excess business holdings tax to permit private foundations to make orderly dispositions of the May 26, 1969 holdings in cases where the permitted percentage is exceeded.

The date of the proposed sales in both Situation 1 and Situation 2 is January 2, 1975. This date is not before the January 1, 1975, date provided in section 101(1)(2)(B) of the Tax Reform Act. Therefore, the special rules of section 4943(c)(4) of the Code must be taken into account in determining whether the foundations are in an excess business holdings position.

In Situation 1, Private Foundation M and all disqualified persons have combined holdings in Corporation X of 45 percent. This percentage does not exceed the 50 percent limitation on permitted holdings provided in section 4943(c)(4) of the Code. Therefore, the foundation is not in an excess business holdings position for purposes of section 101(1)(2)(B) of the Tax Reform Act and is not required to dispose of any of its holdings in Corporation X in order not to be liable for tax under section 4943. Accordingly, section 101(1)(2)(B) would not apply to except the proposed sale from the provisions of section 4941 and A would be subject to the self-dealing tax imposed by section 4941. However, if Private Foundation M held 30 percent and disqualified persons with respect to the foundation held 15 percent of the voting stock of Corporation X, section 101(1)(2)(B) would

apply to except the sale of 5 percent of the stock from the provisions of section 4941.

In Situation 2, Private Foundation N and all disqualified persons have combined holdings in Corporation Y of 55 percent. This percentage exceeds the 50 percent limitation on permitted holdings provided in section 4943(c)(4) of the Code. Therefore, the foundation is in an excess business holdings position under section 4943(c)(4) even though it will not be subject to tax on these excess business holdings during the period specified in section 4943(c)(4)(B). The foundation must dispose of its excess business holdings in Corporation Y prior to the end of the section 4943(c)(4)(B) period in order not to be liable for tax under section 4943. Accordingly, section 101(1)(2)(B) of the Tax Reform Act would apply to except the proposed sale from the provisions of section 4941 and B would not be subject to the self-dealing tax imposed by section 4941.

Since the holdings of Private Foundation N and its disqualified persons are aggregated in determining the private foundation's excess business holdings position, if any portion of the holdings are sold to its disqualified persons, it would remain in an excess business holdings position for purposes of section 101(1)(2)(B) until the last scintilla of such holdings are sold. Therefore, the entire holdings of Private Foundation N in Corporation Y are excess business holdings and may be disposed of under the exception to section 4941(a) tax provided in section 101(1)(2)(B) of the Tax Reform Act.

In interpreting Rev. Rul. 75-25, it is important to determine, in each situation, the permitted percentage of business holdings and the effect of the proposed disposition on this percentage. In Situation 1, the holdings of private foundation M and all disqualified persons are equal to 45 percent of the X stock on May 26, 1969, with M holding less than 25 percent of the stock of X. In this circumstance, no reductions in business holdings are required by IRC 4943. Thus, section 101(l)(2)(B) could not be applied to protect a sale by M to a disqualified person except in the following situation:

Section 101(l)(2)(B) provides that dispositions may be made prior to January 1, 1975, and between October 4, 1976, and January 1, 1977, (pursuant to the 1976 Tax Reform Act amendment), without regard to the present holdings rules of IRC 4943(c)(4). In such cases,

> it must be determined whether there are excess business holdings under the general rules of IRC 4943(c)(2). Since the combined holdings of M and all disqualified persons in X exceed 20 percent in this example, M would be in an excess business holdings position under the rules of IRC 4943(c)(2). Thus, a sale by M to a disqualified person of all of M's holdings in X, as described above, prior to January 1, 1975, would be excepted from the self-dealing rules by section 101(l)(2)(B).

Suppose, however, that a disqualified person purchased one share of the voting stock of X. This would place the foundation in an excess business holdings position as the combined holdings would now exceed 45 percent. It appears then that M could sell all of its holdings in X to a disqualified person, following the rationale of Situation 2, and that this would be protected by 101(l)(2)(B). See Private Letter Ruling 8034143. Note that since the excess business holdings resulted from a purchase by a disqualified person, the foundation would have only 90 days to dispose of the stock. See Part 5a. of this topic.

Situation 1 of Rev. Rul. 75-25 also discusses another circumstance in which private foundation M holds 30 percent and all disqualified persons hold 15 percent of the X stock on May 26, 1969. In this case, since disqualified persons own more than 2 percent of the X voting stock, the permitted business holdings in X are 45 percent, of which not more than 25 percent shall be stock held by M. See IRC 4943(c)(4)(D)(i). Thus, M must reduce its holdings to 25 percent of the X stock. Consequently, a sale of five percent of the X stock by M to a disqualified person is protected by section 101(1)(2)(B).

In Situation 2 of Rev. Rul. 75-25, private foundation N holds 15 percent and all disqualified persons hold 40 percent of the stock of Y, for total holdings of 55 percent. Because this exceeds the 50 percent limitation of IRC 4943(c)(4)(A), N is in an excess business holdings position. While a sale of 5 percent of the Y stock by N or by a disqualified person to a non-disqualified person would satisfy IRC 4943 since the total holding of X by N and all disqualified persons would equal 50 percent after the sale, a sale of 5 percent of the stock to a disqualified person would leave N in an excess business holdings position, as the total holdings would still exceed 50 percent. Thus, to avoid tax under 4943 through a sale to a disqualified person, N must sell all but two percent of its holdings of Y. Also, since the de minimis rule, IRC 4943(c)(2)(C), is ignored for section 101(1)(2)(B) purposes, a sale of the last two percent of the holdings of Y is also permitted by the Revenue Ruling.

See also Private Ruling Letters 7714003, 7824022 and 7835059 for additional illustrations of 101(1)(2)(B).

Another problem dealing with the application of section 101(1)(2)(B) has arisen in the following situation: Private Foundation P owned 15 percent of the stock of Y on May 26, 1969. Disqualified persons owned 85 percent. However, from 1969 through 1980, Y received over 95 percent of its gross income from passive sources and thus was not classified as a business enterprise. In 1981, Y's source of income changed so that it now received over 5 percent of its income from active sources and thus it became a business enterprise during 1981. In this situation, it appears that section 101(1)(2)(B) would apply to allow P to sell stock to disqualified persons even though Y was not a business enterprise in 1969. By its terms, section 101(l)(2)(B) merely requires that the stock be owned by the foundation in 1969, and that the foundation is required to dispose of the stock to avoid, at some point in time, the IRC 4943 tax. Those conditions are satisfied here. See Private Letter Ruling 8121148.

Another alternative method of disposing of excess business holdings arises in the following example: X, a private foundation owns 100 percent of the voting stock of M. M proposes to recapitalize, creating two classes of stock, voting Class A and nonvoting Class B. X will acquire, in exchange for its stock, all of the Class B stock which has a fair market value equal to the stock given up in the exchange. The class A voting stock will be sold by M to non-disqualified persons. As a result of this transaction, X's holdings will constitute permitted holdings under the nonvoting stock rule of IRC 4943(c)(2), since disqualified persons will not own more than 20 percent of the voting stock of M, even though X will retain a substantial equity interest in M. See Private Letter Ruling 8223073.

5. Additional Transitional Periods

a. 90 Day Rule

Reg. 53.4943-2(a)(ii) provides that where a private foundation acquires excess business holdings, other than as a result of a purchase by the foundation, the foundation will not be subject to IRC 4943 taxation if it no longer has such excess business holdings within 90 days from the date on which it knows, or has reason to know, of the event which caused it to have such excess business holdings. This provision is generally intended to cover those situations in which a disqualified person purchases business holdings, the purchase of which causes a private

foundation's holdings to become excess business holdings. This 90 day period may be extended when required by federal or state securities laws. Reg. 53.4943-2(a)(iii).

b. Acquisitions Other Than By Purchase Rule

IRC 4943(c)(6) and Reg. 53.4943-6 provide a 5 year period for the disposition of excess business holdings acquired by a private foundation after May 26, 1969, other than by purchase by the foundation or a disqualified person, such as though a gift or bequest to the private foundation. (This is distinguished from bequests from certain pre-1970 wills, etc., discussed above, which fall under the 10 and 15 year first phase periods, per IRC 4943(c)(5)). The foundation's business holdings are treated as being held by a disqualified person, rather than by the foundation itself, during the 5 year period beginning on the date the foundation obtains the holdings.

This provision may also apply to increases in business holdings resulting from a merger, recapitalization, or other reorganization involving one or more business enterprises. For example, private foundation P holds 10 percent of the voting stock of corporation X, and disqualified persons hold 10 percent of the voting stock of X. Neither P, nor its disqualified persons, or both together have effective control over X. During 1979, X redeems 20 percent of its total outstanding voting stock from shareholders who are not disqualified persons. As a result of this redemption, P's holdings in X are increased to 12.5 percent of the voting stock, and the disqualified person's holdings are similarly increased to 12.5 percent of the voting stock. Since the total holdings of X and all disqualified persons exceed the 20 percent limitation of IRC 4943(c)(2) after the redemption, P is now in an excess business holdings position. However, since the increase in holdings did not result from a purchase of stock by P or a disqualified person, the provisions of IRC 4943(c)(6) are likely applicable, and the holdings of P in X would be treated as held by disqualified persons during a 5 year transitional period. P must dispose of its excess business holdings, in this case 5 percent, prior to the end of the 5 year period in order to avoid taxation under IRC 4943.

Another situation in which IRC 4943(c)(6) might apply is where an interest in a corporation or partnership that is not presently an interest in a business enterprise becomes at sometime in the future an interest in a business enterprise. For example, private foundation M owns 25 percent of the voting stock of corporation Y. Disqualified persons own 15 percent of the voting stock of Y. A, an individual who is not a disqualified person, owns the remaining 55 percent of the Y

stock and exercises effective control over Y's activities. Y has received, in each year since 1969, over 95 percent of its gross income from passive sources. Consequently, it is not a "business enterprise" for purposes of IRC 4943. However, during 1979, economic conditions change and Y received less than 95 percent of its income from passive sources. Consequently, it is not a "business enterprise" for purposes of IRC 4943. However, during 1979 economic conditions changed and Y received less than 95 percent of its income from passive sources. Consequently, and assuming that the 10 year averaging rule of Reg. 53.4943-10(c) will not alter the result, Y is treated as a "business enterprise" for IRC 4943 purposes beginning in the year 1979. As a result, M is in an excess business holdings position. However, since the creation of the excess business holdings did not arise from a purchase by M or any disqualified person, IRC 4943(c)(6) is likely applicable, giving M a 5 year grace period to dispose of its excess business holdings in Y. Since the 35 percent rule of IRC 4943(c)(2)(C) would apply, M would have to dispose of 5 percent of the Y voting stock.

Also, it is interesting to note here that even if M and the disqualified persons had held their interests in Y since May 26, 1969, M probably could not take advantage of the present holdings rules of IRC 4943(c)(4). Rather, the permitted holdings would likely have to be determined by applying the general rules of IRC 4943(c)(2). This result arises because Y was not a "business enterprise" on May 26, 1969. Consequently, M did not have excess business holdings on May 26, 1969, as is required before IRC 4943(c)(4) becomes applicable.

The examples above share in common the fact that the foundation and its disqualified persons do not control the business enterprises considered, at least by weight of combined voting power. Where the facts indicate that control by the foundation or disqualified persons exists, and changes, reorganization, etc., result in increases of voting power or stock value, the IRC 4943(c)(6) five year rule may be inapplicable under some circumstances.

The regulations under IRC 4943 defining the term "purchase" and related matters, involving issues similar to the issues discussed above are reserved. It is expected, however, that final regulations in the "purchase" area may have only prospective effect. Cases involving this issue should be sent to the National Office.

c. Post-1969 and Pre-1973 Acquisition Rule

A third transitional period is provided for in Reg. 53.4943-11(b). This provides that in the case of any acquisition, i.e., a purchase of excess business

holdings after the enactment of IRC 4943 and prior to February 2, 1973, taxation under IRC 4943 will not be incurred if correction is completed within a period ending 90 days after July 5, 1977, (the date of publication of final IRC 4943 regulations) extended (prior to the expiration of the original period) by any period which the Commissioner determines is reasonable and necessary to bring about such correction.

Authority to extend the period under the transitional rule of Reg. 53.4943-11(b) has been delegated to the key District Directors, Chief Counsel, Regional Counsel, and the Regional Directors of Appeal. Del. Order No. 139 (Rev. 6), 1982-24 I.R.B. 59.

6. Extensions of Correction Period

If a private foundation fails to dispose of its excess business holdings during the applicable transitional period, as discussed above, or if a private foundation acquires excess business holdings in a transaction not protected by the transitional rules, the foundation becomes liable for the initial 5 percent tax, and the 200 percent second tier tax. The second tier tax will be abated if the foundation disposes of its excess business holdings during the correction period. The correction period ends after the date of mailing of a notice of deficiency under IRC 6212 with respect to the second teir tax. This period can be extended while the private foundation files a claim for a refund of the initial tax, and for any period which the Commissioner determines is reasonable and necessary to permit orderly disposition of excess business holdings. IRC 4962(e). Authority to extend the correction period under Reg. 53.4943-9(b) has been delegated to the key District Directors, Chief Counsel, Regional Counsel, and the Regional Directors of Appeal by Del. Order No. 139 (Rev. 6), noted above.

7. Conclusion

The discussion above indicates that IRC 4943 is a difficult, complex provision. In the past, primarily because of the liberal transitional rules provided under IRC 4943, relatively few cases have dealt with its provisions. However, as the transitional periods have begun to expire, an increase in activity has occurred. Consequently, it is important to develop a general understanding of IRC 4943 so that it can be adequately enforced.