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

200134026

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

UIL 4943.03-01

Date: MAY 24 2001

Contact Person:

Identification Number:

Telephone Number:

T:EO:B3

Employer Identification Number:
EO Area Manager Office:

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Dear Sir or Madam:

This is in response to the letter of X's authorized representative dated December 29, 2000, as supplemented, requesting rulings under section 4943 of the Internal Revenue Code on behalf of X.

X has been recognized as exempt from federal income tax under section 501(c)(3) of the Code and classified as a private foundation under section 509(a). X is a state V nonprofit corporation with its principal office located in the state. X was created in 1959 by A, a member of the R family, and initially funded with a contribution of shares of T stock.

T was incorporated in T operates a business enterprise within the meaning of section 4943 of the Code. T has remained at all times a privately held corporation. T has one class of stock issued and outstanding, voting common shares. Prior to redemption and sales transactions described hereafter, X held stock representing x percent of the outstanding shares of T including all stock personally owned by all disqualified persons.

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On b and c, stock redemption and sale transactions occurred with respect to T. Through these transactions, T redeemed from R family members a significant number of shares of T stock, and T's Employee Stock Option Trust (ESOT), which is maintained in connection with a stock bonus plan described in section 401(a) of the Code, purchased additional significant shares of T stock from R family members. Additional but a significantly lesser number of shares of T stock held by family members were sold within the R family and to Directors of T.

One purpose behind the redemption and sale transactions was to permit the members of one branch of R family to dispose of their entire interest in T. The transaction was also structured to create an ongoing, stable management structure for T. Immediately following the redemption and sale transactions described above, on and after c, X owned shares of T stock representing y percent of the outstanding shares.

T has certain governance provisions designed to keep T privately held. The composition of the Board of Directors of T, the appointment procedures of the trustees of the ESOT and T's Pension Trust (Pension Trust), and the procedures of nomination for T's directors were designed to work together to ensure that the composition of the Board of Directors remains stable and that changes in membership or control are made by consensus. The provisions operate to make T's Board a cohesive group in control of T. This control differs from normal corporate governance function of a typical board of directors because of the Board's control of the ESOT and Pension Trust's trustees in the case of T.

T's Board of Directors has members. One director, is a member of the R family. directors are current professional managers of the business of T. directors are independent directors selected for their expertise and contributions to the governance of T. None of the directors is a disqualified person with respect to X within the meaning of section 4946 of the Code. The chair of the T Board is a of A, and thus not a disqualified person by virtue of section 4946(d). Nor is a foundation manager of X.

All directors are selected each January at the shareholder's meeting. Each director is elected by a simple majority of outstanding shares so that holders of 51 percent of the outstanding stock can elect a majority of the Directors. Nominations for T Directors are made by the Board of Directors pursuant to the Bylaws of T. The incumbent Board of Directors is required to present its slate of proposed directors on November 15. Any nominations made by shareholders outside of the Board of Directors' nominating procedure must be preceded by written notice of intent to make such nomination or nominations, received by the Secretary of T not later than the December 15 preceding the annual meeting. The Board of Directors thus has ample time to respond to any outside shareholder nominations.

The ESOT and the Pension Trust are major shareholders of T. Currently, the ESOT and the Pension Trust, together, own shares comprising ff percent of the outstanding stock of T. Under the agreements governing the ESOT and the Pension Trust, the Board of Directors has authority to appoint all of the trustees, to remove any trustee without cause, and to amend the trust agreements. Moreover, each agreement provides that any trustee who is a T employee will cease to be a trustee immediately upon termination of such employment. The trustees of the ESOT and the Pension Trust have sole authority to vote all shares of T held by such trustees in all corporate matters, including election of T's Directors, except for matters on which voting is passed to through the ESOT participants in accordance with section 409(e) of the Code. T's right to remove a trustee is absolute and immediate. A trustee has no right to contest the Board's decision

T's Directors currently own or control shares of T stock constituting cc percent of the outstanding shares individually and in their own right. These shares are in addition to any shares owned by employee-directors and held by the ESOT and the Pension Trust. The R family currently holds dd percent of the outstanding shares of T. Currently, X holds aa shares of T stock and disqualified persons with respect to T hold z percent. Unrelated persons hold ee percent of T stock.

X, with its disqualified persons, has never held more than 35 percent of the voting stock of T. At one time A held percent of the stock of T, but never transferred the entire amount to X.

X has requested the following rulings:

1. Effective control of the Corporation is in one or more persons who are not disqualified persons with respect to X within the meaning of section 4943(c)(2)(B) of the Code.

2. The permitted holdings of X in T are 35 percent of the voting stock reduced by the percentage of the voting stock owned by all disqualified persons with respect to X.

LAW AND ANALYSIS

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

Section 4943(c)(2)(B) of the Code provides, in general, that if (i) the private foundation and all disqualified persons together do not own more than 35 percent of the voting stock of an incorporated business enterprise, and (ii) it is established to the satisfaction of the Secretary that effective control of the corporation is in one or more persons who are not disqualified persons with respect to the foundation, -then section 4943(c)(2)(A) shall be applied by substituting 35 percent for 20 percent.

Section 4946 of the Code defines disqualified persons for purposes of sections 4941 and 4943 of the Code, and include foundation managers, substantial contributors, business entities of which disqualified persons have substantial ownership interests, and members of the families of disqualified persons.

Section 53.4943-3(b)(3)(ii) of the regulations defines the term "effective control" for purposes of section 4943 of the Code as meaning 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 contractual arrangements, or otherwise. It is the reality of the 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.

Rev. Rul. 81-111, 1981-1 C.B. 509 addresses the meaning of "effective control" in two situations. In the first, the private foundation and disqualified persons together hold 35 percent of the shares of the corporation. One individual, **C** who is not a disqualified person owns 65 percent of the stock. Since **C** clearly controls the corporation and has elected a majority of the board of directors in the past, the 35 percent rule is deemed to apply. The second hypothetical of this Ruling is just the opposite. The

remaining 65 percent ownership of the corporation is widely dispersed. Accordingly, under the second situation, there is no showing that an unrelated party effectively controls the corporation.

With respect to X's ownership in T, the Board of Directors of T, in reality, have the power to control the direction of the management and the business of T by virtue of the ability to elect directors through a combination of the right to nominate the new T directors each year, plus the right to control the voting of shares held by the ESOT and the Pension Trust. In addition to the power of appointment of trustees, the Board of Directors may further their control of the ESOT and the Pension Trust by virtue of the power to remove trustees without cause and to amend the trust documents for each. The ESOT and Pension Trust together hold ff percent voting power. The Board of Directors, in their own right, owns cc percent of the stock. Thus, by controlling the appointment of the trustees to the ESOT and the Pension Trust, the Board of Directors, in reality controls the ff percent voting block of these two trusts for purposes of electing directors. When the cc percent personal ownership of the Directors is added, control of the election of the Board of Directors is assured. Historically, this has been the case. Such voting block is not dissimilar to the voting control described in the first situation of Rev. Rul. 81-111.

The provisions of T's by-laws establishing procedures for the election of directors solidify the control of the Board. A principal purpose of the provisions of the by-laws was to protect T from a hostile takeover, not simply to consolidate voting control in the Board. All directors are elected each year at the annual meeting of shareholders. No candidates for a directorship may be nominated from the floor at the meeting. To be eligible for election, a candidate must either be on the slate proposed by the Board or be nominated by a shareholder who has given notice of intent to make the nomination not later than December 15 of the year preceding the meeting. This requirement of advance notice was intended to give the Board sufficient warning of an attempt to elect a competing director or slate of directors so that the Board could react to ensure election of its own slate. After notice of the nomination of a competing slate and prior to the annual meeting, the Board could, if it felt threatened, remove the current trustees of the ESOT and the pension trust, appoint individuals in the place of such trustees, and thus ensure that all of the pension and ESOT shares would be voted in favor of the Board's chosen candidates.

One cannot assume that the member Board of Directors of T will always act in concert. It is always possible that there may be splits or divisions. However, a closed group of individuals that is self-selecting can assume to be motivated by similar interests and objectives. An individual who had different primary motives than the majority of the Board would probably not be selected to join the group in the first place and would, after differences emerge, be excluded from the group at the earliest opportunity.

Section 409 of the Code requires that shareholder votes be passed through to participants in the ESOT with respect to certain matters affecting the organization and structure of the corporation. State V law gives the shareholders the right to vote for or against a dissolution of the corporation; a sale of substantially all of the corporate assets; a merger of the corporation with another corporation where the other corporation survives and an amendment of the articles of incorporation. In such a case, the Board of Directors of T would lose voting control. However, such situations are relatively rare for T. In the last 25 years, T has been faced within only one such vote (an amendment of its articles). Based on the particular facts and history of this corporation, the section 409 pass-through of the shareholder vote is not deemed sufficient to say that the Board does not have effective voting control of the corporation.

The ESOT Trustees have a fiduciary duty under section 404 of ERISA to exercise their duties "solely in the interest of participants and beneficiaries." Theoretically, the trustees could vote against T's Board of Directors when they believed it was their fiduciary obligation to do so. It would be a rare situation.

Rev. Rul. 81-111, supra, addresses contemporary facts and circumstances as to effective control. It does not address changes of the facts and circumstances. In situation one, if individual **C** executed a valid will leaving his 65 percent interest in the vote of the corporation equally to 35 dispersed and unrelated individuals, effective control would no longer exist in any one person when **C** dies. Those facts are not in Rev. Rul. 81-111. The operative facts in Rev. Rul. 81-111 demonstrate **C** has effective control. Similarly, based on the facts and representations, the Board of Directors of T exercises effective voting control of T within the meaning of section 53.4943-3(b)(3)(ii) of the regulations.

Accordingly, we rule as follows:

1. Effective control of T is in one or more persons who are not disqualified persons with respect to X within the meaning of section 4943(c)(2)(B) of the Code.

2. The permitted holdings of X in T are 35 percent of T voting stock, reduced by the percentage of the T voting stock owned by all disqualified persons with respect to X.

We are sending the original of this ruling letter to X's authorized representative listed on the power of attorney on file with this office.

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

Sincerely,

(signed) Robert C Harper, Jr.

Robert C. Harper, Jr.
Manager, Exempt Organizations
Technical Group 3