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Date:
August 24, 2018

Legend:

Foundation =
Trust =
Trustor =
Spouse =
Corp1 =
Corp2 =
Corp3 =
LLC1 =
LLC2 =
LLC3 =
Date1 =
Date2 =
Date3 =

Dear :

This letter responds to Foundation's March 1, 2018, request for rulings regarding unrelated business income tax and excise tax issues under sections 512, 514, 4941, 4943, and 4947[1] in connection with the termination of Trust and receipt of Trust property.

Facts

[1] All section references are to the Internal Revenue Code of 1986, as amended, unless otherwise stated.

According to the information provided by Foundation, Trust is an irrevocable trust created under a revocable living trust agreement dated Date1 by Trustor, as amended by a first amendment dated Date2 (together, the "Trust Agreement"). Trust was created after the death of Trustor. Executors of Trustor's estate elected to treat all the assets of Trust as qualified terminable interest property (QTIP) pursuant to section 2056(b)(7)(B)(v). No deductions were claimed under sections 170, 545(b), 642(c), 2055, 2106(a)(2), or 2522 with respect to any assets transferred to Trust at Trustor's death.

Under the Trust Agreement, Trustor's spouse (Spouse) is entitled to receive during Spouse's lifetime all the net income of Trust and distributions from principal within the discretion of the trustees for Spouse's care, support, health, and maintenance. The assets of Trust remaining at Spouse's death are distributable to Foundation. At Spouse's death, all the assets of Trust will be includible in Spouse's gross estate pursuant to section 2044 and, if the requirements are satisfied, will be deductible from Spouse's gross estate pursuant to section 2055.

Under the Trust Agreement, the trustees of Trust have the authority to sell or exchange trust property and to acquire by purchase or exchange such property as the trustees may deem advisable.

Foundation is recognized as exempt from federal income tax under section 501(c)(3) and as a private foundation. Foundation was created under a charitable trust agreement dated Date3 by Trustor and Spouse as donors.

Corp1 is a domestic stock corporation wholly owned by Trust and an S corporation for federal income tax purposes. Spouse, as the sole income beneficiary of Trust, made a timely election to treat that portion of Trust holding the stock of Corp1 as a qualified subchapter S trust under section 1361(d)(2)(A).

Corp2 is a domestic stock corporation wholly owned by LLC1, which is a domestic single-member limited liability company wholly owned by Corp1 and a disregarded entity for federal tax purposes.

Corp3 is a domestic stock corporation wholly owned by Corp2 and manages residential real estate properties. Corp2 and Corp3 are qualified Subchapter S subsidiaries of Corp1 under section 1361(b)(3) and thus are not treated as separate corporations from Corp1 for federal tax purposes.

LLC2 is a domestic limited liability company treated as a partnership for federal tax purposes in which Trust and Corp2 own a large minority interest; Corp2 also manages LLC2.

LLC3 is a domestic limited liability company treated as a partnership for federal tax purposes and majority-owned by Trust. LLC3 owns an apartment complex with parking spaces available for no additional charge for tenants and guests only, an on-site leasing office, clubhouse, fitness room, swimming pool, picnic area, and spa. There is mortgage indebtedness against the LLC3 real property. The personnel involved in the operation of the property, provided by Corp3, consist of a property manager who oversees the leasing and maintenance functions, a leasing agent responsible for leasing the apartments, and a maintenance manager and maintenance technician who provide maintenance as needed to tenants with plumbing, electrical, appliance, or other problems with the property. The services provided to tenants of the apartment units by LLC3 are limited to necessary and customary maintenance and utility services. The maintenance staff provides janitorial and related services for common areas only, such as the clubhouse, fitness room, swimming pool, picnic area, and spa, which are made available to all tenants as an amenity with no additional charge. Tenants are responsible for paying for their own gas and electric services, and for their share of water, sewer, and garbage services. A contract landscaping company maintains the common-area grounds. LLC3 also contracts with an independent security company for property security. No pool lifeguard or other services in connection with property common areas are provided. No housekeeping, cleaning, or other services are provided for occupied apartment units other than the general maintenance services described above and necessary preventative maintenance, including checking fire extinguishers and examining smoke alarms. LLC3 provides "turnkey" cleaning when an apartment is vacated, and tenants are responsible for any damage to apartment units beyond ordinary wear and tear. Repainting and other unit upgrades are done only when apartments are vacated or when required to retain the property in rentable condition. All of the services described above are rendered only in connection with the rental of apartment units for personal occupancy.

Tenants pay rent only for their respective private apartment dwelling units. Apartment units are unfurnished and contain only the usual kitchen and laundry appliances, for which there is no separate rent charged. The portion of rents attributable to these appliances, if any, is minimal, and in any case well below 5% of overall rents. No rents are based in whole or in part on the income or profits derived by any person from the property leased.

During the lifetime of Spouse (i.e., before termination of Trust), LLC2 or Corp2 may have an opportunity to exercise its option to purchase from a member, or a member of LLC2 may elect to require LLC2 or Corp2 to purchase, the member's interest in LLC3 for fair market value, as determined by appraisal, either for cash at closing or in installments pursuant to a promissory note.

During the lifetime of Spouse, LLC3 or Corp2 may have an opportunity to exercise its option to purchase from a member, or a member of LLC3 may elect to require LLC3 or Corp2 to purchase, the member's interest in LLC3 for fair market value, as determined by appraisal, either for cash at closing or in installments pursuant to a promissory note.

After the death of Spouse, the assets of Trust will become distributable to Foundation. Currently those assets would include Trust's interest in Corp3, LLC2, and LLC3. During the administration of Trust pending distribution to Foundation, LLC2 or Corp2 may have an opportunity to exercise its option to purchase from a member, or a member of LLC2 may elect to require LLC2 or Corp2 to purchase, the member's interest in LLC2 for fair market value, either for cash at closing or in installments pursuant to a promissory note. During administration of Trust pending distribution to Foundation, LLC3 or Corp2 may have an opportunity to exercise its option to purchase from a member, or a member of LLC3 may elect to require LLC3 or Corp2 to purchase, the member's interest in LLC3 for fair market value, either for cash at closing or in installments pursuant to a promissory note.

Rulings Requested

Foundation requests the following rulings:

1. After the death of Spouse, the estate administration exception to indirect self-dealing under Treas. Reg. § 53.4941(d)-1(b)(3) will be available with respect to transactions between Trust and disqualified persons during a reasonable period of settlement within the meaning of Treas. Reg. § 53.4947-1(b)(2)(v).

2. Trust's stock in Corp3 will constitute an excess business holding under section 4943(c) upon distribution to Foundation.

3. Foundation will have a period of five years within which to dispose of Corp3 stock or other excess business holdings (within the meaning of section 4943(c)) distributed from Trust to Foundation after the death of Spouse, commencing on the date of distribution to Foundation, provided that (a) the Corp3 stock or other excess business holding was held by Trust at Spouse's death and (b) the Corp3 stock or other excess business holding is distributed to Foundation within a reasonable period of settlement of Trust under Treas. Reg. § 53.4947-1(b)(2)(v).

4. Foundation's share (or that of Trust at any time when Trust is subject to section 4947) of rental income received by LLC3 will constitute "rents from real property" under section 512(b)(3)(A)(i), excludible from unrelated business taxable income under section 512(a)(1), except to the extent attributable to debt-financed property under sections 512(b)(4) and 514.

5. For purposes of determining unrelated business taxable income under section 512, and pursuant to section 514(c)(2)(B), any indebtedness secured by mortgages against real property owned by LLC3 will not be treated as acquisition indebtedness for purposes of section 514(a) during a period of ten years following the date of acquisition by Foundation of any interest in LLC3, provided that (a) Foundation does not assume and agree to pay the indebtedness secured by the mortgages and (b) Foundation does not make any payment for the equity in the property.

Law

Section 501(a) exempts from federal income taxation organizations described in section 501(c).

Section 501(c)(3) describes organizations organized and operated exclusively for charitable purposes.

Section 509(a) provides that, unless specifically excepted, any organization described in section 501(c)(3) is a private foundation.

Section 511(a)(1) imposes a tax for each taxable year on the unrelated business taxable income of every organization described in section 501(a).

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 this chapter which are directly connected with the carrying on of such trade or business.

Section 512(b)(3)(A)(i) excludes from unrelated business taxable income rents from real property.

Section 512(b)(4) provides, in part, that notwithstanding section 512(b)(3), unrelated business taxable income includes the amount ascertained under section 514(a)(1).

Section 513(a) provides that the term "unrelated trade or business" means, in the case of an organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance of such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501.

Section 514(a)(1) provides that in computing under section 512 the unrelated business taxable income for any taxable year, there shall be included with respect to each debt-financed property as an item of gross income derived from an unrelated trade or business an amount which is the same percentage (but not in excess of 100 percent) of the total gross income derived during the taxable year from or on account of such property as the average acquisition indebtedness (as defined in section 514(c)(7)) for the taxable year with respect to the property is of the average amount (determined under regulations prescribed by the Secretary) of the adjusted basis of such property during the period it is held by the organization during such taxable year.

Section 514(b)(1) defines "debt-financed property" as any property which is held to produce income and with respect to which there is an acquisition indebtedness at any time during the taxable year (or, if the property was disposed of during the taxable year, with respect to which there was an acquisition indebtedness at any time during the 12-month period ending with the date of such disposition).

Section 514(c)(1) defines "acquisition indebtedness," with respect to any debt-financed property, as the outstanding amount of the indebtedness incurred in acquiring or improving the property, the indebtedness incurred before the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement, and the indebtedness after the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement and the incurrence of such indebtedness was reasonably foreseeable at the time of such acquisition or improvement.

Section 514(c)(2)(A) provides that where property is acquired subject to a mortgage or other similar lien, the amount of indebtedness secured by such lien or mortgage shall be considered as an indebtedness of the property acquired even if the organization did not assume or agree to pay the indebtedness.

Section 514(c)(2)(B) provides that where an organization acquires property by bequest or devise, the indebtedness secured by the mortgage shall not be treated as acquisition indebtedness during a period of 10 years following the date of acquisition. If the organization acquires property by gift subject to a mortgage which was placed on the property more than 5 years before the gift, which property was held by the donor more than 5 years before the gift, the indebtedness secured by such mortgage shall not be treated as acquisition indebtedness during a period of 10 years following the date of such gift. This exception does not apply if the organization, in order to acquire the equity in the property by bequest, devise, or gift, assumes and agrees to pay the indebtedness secured by the mortgage, or if the organization makes any payment for the equity in the property owned by the decedent or the donor.

Section 4941(a) imposes an excise tax on disqualified persons (as defined in section 4946) for each act of self-dealing between a disqualified person and a private foundation.

Section 4941(d)(1) defines "self-dealing" as any direct or indirect (1) sale or exchange, or leasing, of property between a private foundation and a disqualified person, (2) lending of money or other extension of credit between a private foundation and a disqualified person, (3) furnishing of goods, services, or facilities between a private foundation and a disqualified person, (4) payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person, or (5) 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)(A) provides, in pertinent part, that the transfer of real or personal property by a disqualified person to a private foundation shall be treated as a sale or exchange if the property is subject to a mortgage or similar lien which a disqualified person placed on the property within a 10-year period.

Section 4943(a)(1) imposes an excise tax on a private foundation's excess business holdings in a business enterprise during any tax year.

Section 4943(c)(1) defines "excess business holdings" as the amount of stock or other interest in any business enterprise which a private 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) provides, in part, that the permitted holdings of any private foundation in an incorporated business enterprise are 20 percent of the voting stock, reduced by the percentage of the voting stock owned by all disqualified persons.

Section 4943(c)(6) provides, in pertinent part, 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 in the foundation) be treated as held by a disqualified person (rather than by the foundation) during the 5-year period beginning on the date of such change in holdings.

Section 4943(d)(1) provides that in computing the holdings of a private foundation, or a disqualified person (as defined in section 4946) with respect thereto, 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 4946(a)(1) provides that a "disqualified person," with respect to a private foundation, includes:

(A) a substantial contributor to the foundation,
(B) a foundation manager (within the meaning of subsection (b)(I)),
(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 (as defined in section 4946(d)) of any individual described in subparagraph (A), (B), or (C),

(E) a corporation of which persons described in subparagraph (A), (B), (C), or (D) own more than 35 percent of the total combined voting power,
(F) a partnership in which persons described in subparagraph (A), (B), (C), or (D) own more than 35 percent of the profits interest,
(G) a trust or estate in which persons described in subparagraph (A), (B), (C), or (D) hold more than 35 percent of the beneficial interest.

Section 4946(a)(2) provides that the term "substantial contributor" means a person who is described in section 507(d)(2) (i.e., a person who contributed or bequeathed an aggregate amount of more than $5,000 to the private foundation if such amount is more than 2 percent of the total contributions and bequests received by the foundation before the close of the taxable year of the foundation in which the contribution of bequest is received by the foundation from such person).

Section 4946(a)(4) provides generally that the constructive ownership rules of section 267(c) apply in determining ownership of profits or beneficial interests.

Section 4947(a)(1) provides that, for purposes of chapter 42, a trust which is not exempt from tax under section 501(a), all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B), and for which a deduction was allowed under section 170, 545(b)(2), 652(c), 2055, 2106(a)(2), or 2522, shall be treated as an organization described in section 501(c)(3).

Section 4947(a)(2) provides in part that, in the case of a trust which is not exempt from tax under section 501(a), not all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(8), and which has amounts in trust for which a deduction was allowed under section 170, 545(b)(2), 652(c), 2055, 2106(a)(2), or 2522, certain Code provisions, including section 4941, shall apply as if such trust were a private foundation. This paragraph does not apply with respect to (1) any amounts payable under the terms of such trust to income beneficiaries, unless a deduction was allowed under section 170(f)(2)(8), 2055(e)(2)(8), or 2522(c)(2)(8), (2) any amounts in trust other than amounts for which a deduction was allowed under section 170, 545(b)(2), 652(c), 2055, 2106(a)(2), or 2522, if such amounts are segregated from amounts for which no deduction was allowable, or (3) any amounts transferred in trust before May 27, 1969.

Treas. Reg. § 1.512(b)-1(c)(5) provides that payments for the use or occupancy of rooms and other space where services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist camps or tourist homes, motor courts, or motels, or for the use of occupancy of space in parking lots, warehouses, or storage garages, do not constitute rents from real property. Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. The supplying of maid service, for example, constitutes such service; whereas the furnishing of heat and light, the cleaning of public entrances, exists, stairways, and lobbies, the collection of trash, etc., are not considered as services rendered to the occupant. Payments for the use or occupancy of entire private residences or living quarters in duplex or multiple housing units, of offices in any office building, etc., are generally treated as rents from real property.

Treas. Reg. § 1.514(c)-1(b)(3)(i) provides that where property subject to a mortgage is acquired by an organization by bequest or devise, the outstanding principal indebtedness secured by such mortgage is not to be treated as "acquisition indebtedness" during the 10-year period following the date of acquisition. For purposes of this exception, the date of the bequest or devise is the date the organization receives the property.

Treas. Reg. § 1.514(c)-1(b)(3)(ii) provides that if an organization acquires property by gift subject to a mortgage, the outstanding principal indebtedness secured by such mortgage shall not be treated as "acquisition indebtedness" during the 10-year period following the date of such gift, provided that (1) the mortgage was placed on the property more than 5 years before the date of the gift, and (2) the property was held by the donor for more than 5 years before the date of the gift. For purposes of the preceding sentence, the date of the gift is the date the organization receives the property.

Treas. Reg. § 1.514(c)-1(b)(3)(iii) provides that Treas. Reg. § 1.514(c)-1(b)(3)(i) and (ii) shall not apply if (1) the organization assumes and agrees to pay all or any part of the indebtedness secured by the mortgage, or (2) the organization makes any payment for the equity owned by the donor in the property. Whether an organization has assumed and agreed to pay all or any part of an indebtedness in order to acquire the property shall be determined by the facts and circumstances of each action.

Treas. Reg. § 1.641(b)-3(a) provides that the period of administration or settlement of an estate is the period actually required by the administrator or executor to perform the ordinary duties of administration, such as the collection of assets and the payment of debts, taxes, legacies, and bequests, whether the period requires is longer or shorter than the period specific under the applicable local law for the settlement of estates. An estate will be considered as terminated when all the assets have been distributed except for a reasonable amount which is set aside in good faith for the payment of unascertained or contingent liabilities and expenses (not including a claim by a beneficiary in the capacity of a beneficiary).

Treas. Reg. § 1.641(b)-3(b) provides that the determination of whether a trust has terminated depends on whether the property held in trust has been distributed to the persons entitled to succeed to the property upon termination of the trust rather than upon the technicality of whether or not the trustee has rendered its final accounting. A reasonable time is permitted after such event for the trustee to perform the duties necessary to complete the administration of the trust. Thus, if pursuant to the terms of the governing instrument, the trust is to terminate upon the death of the life beneficiary and the corpus is to be distributed to the remainder beneficiary, the trust continues after the death of the life beneficiary for a period reasonably necessary to a proper winding up of the affairs of the trust.

Treas. Reg. § 53.4941(d)-1(b)(3) provides that the term "indirect self-dealing" shall not include a transaction with respect to a private foundation's interest or expectancy in property (whether or not encumbered) held by an estate (or revocable trust, including a trust which has become irrevocable on a grantor's death), regardless of when title to the property vests under local law, if:

> (i) The administrator or executor of an estate or trustee of a revocable trust either:
>
> > (a) Possesses a power of sale with respect to the property,
> > (b) Has the power to reallocate the property to another beneficiary, or
> > (c) Is required to sell the property under the terms of any option subject to which the property was acquired by the estate (or revocable trust);
>
> (ii) Such transaction is approved by the probate court having jurisdiction over the estate (or by another court having jurisdiction over the estate (or trust) or over the private foundation);
> (iii) Such transaction occurs before the estate is considered terminated for Federal income tax purposes pursuant to Treas. Reg. § 1.641(b)-3(a) (or in the case of a revocable trust, before it is considered subject to section 4947);
> (iv) The estate (or trust) receives an amount which equals or exceeds the fair market value of the foundation's interest or expectancy in such property at the time of the transaction, taking into account the terms of any option subject to which the property was acquired by the estate (or trust); and
> (v) With respect to transactions occurring after April 16, 1973, the transaction either:
>
> > (a) Results in the foundation receiving an interest or expectancy at least as liquid as the one it gave up,
> > (b) Results in the foundation receiving an asset related to the active carrying out of its exempt purposes, or
> > (c) Is required under the terms of any option which is binding on the estate (or trust).

Treas. Reg. § 53.4943-5(b)(1) provides that the date of distribution shall be deemed to occur no later than the date on which the trust or estate is considered to be terminated pursuant to Treas. Reg. § 1.641(b)-3.

Treas. Reg. § 53.4943-6(b)(1) provides that in the case of an acquisition of holdings in a business enterprise by a private foundation pursuant to the terms of a will or trust, the five-year period described in section 4943(c)(6) shall not commence until the date on which the distribution of such holdings from the estate or trust to the foundation occurs, and refers to rules under Treas. Reg. § 53.4943-5(b)(1) relating to the determination of the date of distribution pursuant to the terms of a will or trust.

Treas. Reg. § 53.4943-6(b)(1) provides that holdings in a business enterprise will not be treated as acquired by a private foundation pursuant to the terms of a will where the holdings in the business enterprise were not held by the decedent. Thus, in the case of after-acquired property, the five-year period described in section 4943(c)(6) shall commence on the date of acquisition of such holdings by the estate, and such five-year period may expire prior to the date of distribution of such holdings from the estate. To the extent that an interest to which section 4943(c)(6) applies is constructively held by a private foundation under section 4943(d)(1) prior to the date of distribution, it shall be treated as held by a disqualified person prior to such date by reason of section 4943(c)(6).

Treas. Reg. § 53.4943-8(a) provides that for purposes of section 4943, in computing the holdings in a business enterprise of a private foundation, or a disqualified person, 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 except as otherwise provided in this section. Any interest in a business enterprise actually or constructively owned by a shareholder of a corporation, a partner of a partnership, or beneficiary of an estate or trust shall not be considered as constructively held by the corporation, partnership, trust, or estate. Further, if any corporation, partnership, estate, or trust has a warrant or other option to acquire an interest in a business enterprise, such interest is not deemed to be constructively owned by such entity until the option is exercised.

Treas. Reg. § 53.4943-10(a)(1) defines the term "business enterprise" to include the active conduct of a trade or business, including any activity which is regularly carried on for the production of income from the sale of goods or the performance of services and which constitutes an unrelated trade or business under section 513.

Treas. Reg. § 53.4943-10(c) provides generally that for purposes of section 4943(d)(4), 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 sections 512(b)(1) (relating to dividends, interest, and annuities), 512(b)(2) (relating to royalties), 512(b)(3) (relating to rent) and 512(b)(5) (relating to gains or losses from the disposition of certain property). Any income classified as passive does not lose its character merely because section 512(b)(4) or 514 (relating to unrelated debt-financed income) applies to such income.

Treas. Reg. § 53.4947-1(a) provides that the basic purpose of section 4947 is to prevent trusts which are not exempt from tax under section 501(a), all or part of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B), and which have amounts in trust for which a deduction was allowed under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522, from being used to avoid the requirements and restrictions applicable to private foundations. For purposes of this section, a trust shall be presumed (in the absence of proof to the contrary) to have amounts in trust for which a deduction was allowed under section 170, 545(b)(2), 556(b)(2), 652(c), 2055, 2106(a)(2), or 2522 if a deduction would have been allowable under one of these sections.

Treas. Reg. section 53.4947-1(b)(1)(i) provides that, for purposes of this section and Treas. Reg. § 53.4947-2, a "charitable trust," within the meaning of section 4947(a)(1), is a trust which is not exempt from taxation under section 501(a), all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B), and for which a deduction was allowed under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522. A charitable trust (as defined in this paragraph) shall be treated as an organization described in section 501(c)(3), and, if it is determined under section 509 that the trust is a private foundation, then Chapter 42, including section 4941, shall apply to the trust.

Treas. Reg. § 53.4947-1(b)(2)(i) provides that an estate from which the executor or administrator is required to distribute all of the net assets in trust to charitable beneficiaries will not be considered a charitable trust under section 4947(a)(1) during the period of estate administration or settlement, except as provided in paragraph (b)(2)(ii) of this section. A charitable trust created by will shall be considered a charitable trust under section 4947(a)(1) as of the date of death of the decedent-grantor, except as provided in paragraph (b)(2)(v) of this section (relating to trusts which wind up).

Treas. Reg. § 53.4947-1(b)(2)(ii)(A) provides that when an estate from which the executor or administrator is required to distribute all of the net assets in trust for charitable beneficiaries, or free of trust to such beneficiaries, is considered terminated for federal income tax purposes under Treas. Reg. § 1.641(b)-3(a), then the estate will be treated as a charitable trust under section 4947(a)(1) between the date on which the estate is considered terminated under Treas. Reg. § 1.641(b)-3(a) and the date final distribution of all the net assets is made to or for the benefit of the charitable beneficiaries.

Treas. Reg. § 53.4947-1(b)(2)(iv) provides in part that, for purposes of this paragraph, the term "reasonable period of settlement" means that period reasonably required (or, if shorter, actually required) by the trustee to perform the ordinary duties of administration necessary for the settlement of the trust. These duties include, for example, the collection of assets, the payment of debts, taxes, and distributions, and the determination of the rights of the subsequent beneficiaries.

Treas. Reg. § 53.4947-1(b)(2)(v) provides that a revocable trust that becomes irrevocable upon the death of the decedent-grantor, or a trust created by will, from which the trustee is required to distribute all of the net assets in trust for, or free of trust to, charitable beneficiaries is not considered a charitable trust under section 4947(a)(1) for a reasonable period of settlement (within the meaning of paragraph (b)(2)(iv)) after becoming irrevocable. After that period, the trust is considered a charitable trust under section 4947(a)(1).

Treas. Reg. § 53.4947-1(b)(2)(vi) provides that a revocable trust that becomes irrevocable upon the death of the decedent-grantor in which all of the unexpired interests are charitable and under the terms of the governing instrument of which the trustee is required to hold some or all of the net assets in trust after becoming irrevocable solely for charitable beneficiaries is not considered a trust under section 4947(a)(1) for a reasonable period of settlement (within the meaning of paragraph (b)(2)(iv) of this section) after becoming irrevocable except that section 4941 may apply if the requirements of Treas. Reg. § 53.4941(d)-1(b)(3) are not met. After that period, the trust is considered a charitable trust under section 4947(a)(1).

Treas. Reg. § 53.4947-1(c)(1)(i) provides that for purposes of this section and Treas. Reg. § 53.4947-2, a "split interest trust," within the meaning of section 4947(a)(2), is a trust which is not exempt from taxation under section 501(a), not all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B), and which has amounts in trust for which a deduction was allowed under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522. A trust is one which has amounts in trust for which a deduction was allowed under section 642(c) within the meaning of section 4947(a)(2) once a deduction is allowed under section 642(c) to the trust for any amount permanently set aside.

Treas. Reg. § 53.4947-1(c)(6)(ii)(A) provides that when an estate from which the executor or administrator is required to distribute all of the net assets in trust or free of trust to both charitable and non-charitable beneficiaries is considered terminated for federal income tax purposes under Treas. Reg. § 1.641(b)-3(a), then the estate will be treated as a split-interest trust under section 4947(a)(2) (or a charitable trust under section 4947(a)(1), if applicable) between the date on which the estate is considered terminated under Treas. Reg. § 1.641(b)-3(a) and the date on which the final distribution of the net assets to the last remaining charitable beneficiary is made.

Treas. Reg. § 53.4947-1(c)(6)(iii) provides that a revocable trust that becomes irrevocable upon the death of the decedent-grantor under the terms of the governing instrument of which the trustee is required to hold some or all of the net assets in trust after becoming irrevocable for both charitable and non-charitable beneficiaries is not considered a split-interest trust under section 4947(a)(2) for a reasonable period of settlement after becoming irrevocable, except that section 4941 may apply if the requirements of Treas. Reg. § 53.4941(d)-1(b)(3) are not met. After that period, the trust is considered a split-interest trust under section 4947(a)(2). The term "reasonable period of settlement" means that period reasonably required (or, if shorter, actually required) by the trustee to perform the ordinary duties of administration necessary for the settlement of the trust. These duties include, for example, the collection of assets, the payment of debts, taxes, and distributions, and the determination of rights of the subsequent beneficiaries.

Analysis

Ruling 1.
After the death of Spouse, the assets of Trust will become distributable to Foundation. Those assets currently include Trust's interests in Corp2, LLC2, and LLC3, each member of which will be treated as a disqualified person with respect to Foundation.

While Trust, whose sole remainder interest is charitable, generally has a reasonable period to settle or wind up before it is subject to section 4941, its dealings with respect to Foundation's interest or expectancy could result in indirect self-dealing if the "estate administration" exception to indirect self-dealing under Treas. Reg. § 53.4941(d)-1(b)(3) is not met. The exception by its terms applies to an estate or revocable trust that has become irrevocable on a grantor's death. Although Trust is already irrevocable, upon Spouse's death Trust will be similarly situated to an estate or revocable trust that has become irrevocable on a grantor's death. It is reasonable to construe the reference in the exception to an estate or revocable trust to include other trusts the assets of which are includable in the beneficiary's gross estate for estate tax purposes (as Foundation represents is the situation here). Thus, the estate administration exception will apply to Trust upon Spouse's death. We are not ruling, however, whether any particular transaction contemplated by Trust will meet the requirements of this exception.

Rulings 2 and 3.
Treas. Reg. § 53.4943-8(b(1) provides generally that an interest actually or constructively owned by a trust is deemed constructively owned by its remainder beneficiaries (which, in the case of Trust, is Foundation). Under Treas. Reg. § 53.4943-6(b)(1), however, in the case of an acquisition of holdings in a business enterprise by a private foundation pursuant to the terms of a trust, the five-year period under section 4943(c)(6) begins on the date of distribution of such holdings from the trust to the foundation. To the extent that an interest to which section 4943(c)(6) applies (as here where Foundation is receiving excess business holdings from Trust other than by purchase) is constructively held by a private foundation under section 4943(d)(1) and § 53.4943-8 prior to the date of distribution, the interest is treated as held by a disqualified person prior to such date by reason of section 4943(c)(6), and the foundation has five years to eliminate the excess business holdings.

Distribution is deemed to occur once the trust is deemed terminated for federal income tax purposes, as provided in Treas. Reg. § 1.641(b)-3. Different rules apply in the case of property acquired by an estate after the decedent's death—the five-year period begins on the date of acquisition. It is represented that all assets of Trust will be includable in Spouse's estate at death. Thus, for purposes of section 4943(c), Spouse should be treated as the decedent with respect to Trust's interest in Corp3, and to the extent Foundation acquires excess business holdings in Corp3 from Trust after Spouse's death, the five-year period set forth in section 4943(c)(6) will commence at the time of such distribution.

Corp3, a stock corporation engaged in the management of residential real estate properties, is a business enterprise for purposes of section 4943. If Trust distributed the stock in Corp3 directly to Foundation, the stock would be an excess business holding of Foundation. Thus, assuming that holdings in Corp3 or other entities distributed from Trust to Foundation constitute excess business holdings (or an increase in excess business holdings) directly or constructively held by Foundation, taking into account the rules for constructive ownership under Treas. Reg. § 53.4943-8, Foundation will have five years to eliminate the excess (or the increase in excess).

Ruling 4.
Foundation's primary charitable activity is to make distributions to other charities in furtherance of Foundation's charitable purposes. Income received by Foundation from LLC3 would be unrelated business taxable income unless excluded under section 512. Section 512(b)(3) and (4) exclude from the computation of unrelated business taxable income all rents from real property, except to the extent treated as unrelated debt-financed income under section 514.

LLC3 owns an apartment complex. Treas. Reg. § 1.512(b)-1(c)(5) provides, in pertinent part, that payments for the use or occupancy of rooms and other space where services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist camps or tourist homes, motor courts, or motels, do not constitute rent from real property. Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. The supplying of maid service, for example, constitutes such service; whereas the furnishing of heat and light, the cleaning of public entrances, exists, stairways, and lobbies, the collection of trash, etc., are not considered as services rendered to the occupant. Payments for the use or occupancy of entire private residences or living quarters in multiple housing units are generally treated as rent from real property.

Under the circumstances described, payments from tenants received by LLC3, and indirectly by Foundation, will appropriately be treated as rents from real property as described in section 512(b)(3)(A)(i), excludible from unrelated business income under section 512(a)(1), except to the extent attributable to debt-financed property under sections 512(b)(4) and 514.

Ruling 5.
Under section 512, rents from real property are included in unrelated business income to the extent they are attributable to debt-financed property, defined as property held to produce income and with respect to which there is acquisition indebtedness.

Under section 514(c)(2)(A), where an exempt organization acquires property subject to a mortgage, the amount of indebtedness secured by such mortgage will be considered acquisition indebtedness even if the organization did not assume or agree to pay the indebtedness. LLC3 owns real property subject to mortgage debt. Upon distribution of Trust's interest in LLC3 to Foundation after Spouse's death, under section 514(c)(2)(A) Foundation would have "acquisition indebtedness" equal to its share of any outstanding indebtedness encumbering real property owned by the companies, determined at the time the interest is transferred to Foundation (as provided in Treas. Reg. § 1.514(c)-1(b)(3)).

However, section 514(c)(2)(B) excepts from this rule any such mortgaged property that is acquired by an organization by devise or bequest. In such case, the indebtedness secured by the mortgage is not treated as acquisition indebtedness for a period of ten years following the date of the acquisition, provided the organization did not assume and agree to pay the indebtedness incurred by the mortgage, or make any payment for the equity in the property owned by the donor.

It is represented that all assets of Trust will be includable in Spouse's estate at death under section 2044. Accordingly, for purposes of the exception to acquisition indebtedness under section 514(c)(2)(B), the distribution of Trust's interest in LLC3 to Foundation after Spouse's death should be treated as a devise from Spouse rather than as a gift from Spouse during Spouse’s life. As a result, for purposes of determining unrelated business taxable income under section 512, and pursuant to section 514(c)(2)(B), any indebtedness secured by mortgages against real property owned by LLC3 will not be treated as acquisition indebtedness for purposes of section 514(a) during a period of ten years following the date of acquisition by Foundation of any interest in the company, provided that (1) Foundation does not assume and agree to pay the indebtedness secured by the mortgages and (2) Foundation does not make any payment for the equity in the property.

Rulings

Based solely on the facts and representations submitted by Foundation, we rule as follows:

1. After the death of Spouse, the estate administration exception to indirect self-dealing under Treas. Reg. § 53.4941(d)-1(b)(3) will be available with respect to transactions between Trust and disqualified persons during a reasonable period of settlement within the meaning of Treas. Reg. § 53.4947-1(b)(2)(v).

2. Trust's stock in Corp3 will constitute an excess business holding under section 4943(c) upon distribution to Foundation.

3. Foundation will have a period of five years within which to dispose of Corp3 stock or other excess business holdings (within the meaning of section 4943(c)) distributed from Trust to Foundation after the death of Spouse, commencing on the date of distribution to Foundation, provided that (a) the Corp3 stock or other excess business holding was held by Trust at Spouse's death and (b) the Corp3 stock or other excess business holding is distributed to Foundation within a reasonable period of settlement of Trust under Treas. Reg. § 53.4947-1(b)(2)(v).

4. Foundation's share of rental income received by LLC3 will constitute "rents from real property" under section 512(b)(3)(A)(i), excludible from unrelated business taxable income under section 512(a)(1), except to the extent attributable to debt-financed property under sections 512(b)(4) and 514.

5. For purposes of determining unrelated business taxable income under section 512, and pursuant to section 514(c)(2)(B), any indebtedness secured by mortgages against real property owned by LLC3 will not be treated as acquisition indebtedness for purposes of section 514(a) during a period of ten years following the date of acquisition by Foundation of any interest in LLC3, provided that (a) Foundation does not assume and agree to pay the indebtedness secured by the mortgages and (b) Foundation does not make any payment for the equity in the property.

The rulings contained in this letter are based upon information and representations submitted by or on behalf of Foundation and accompanied by a penalty of perjury statement executed by an appropriate party, as specified in Rev. Proc. 2018-1, 2018-1 I.R.B. 1, § 7.01(15)(b). This office has not verified any of the material submitted in support of the request for ruling, and such material is subject to verification on examination. The Associate Office will revoke or modify a letter ruling and apply the revocation retroactively if: (1) there has been a misstatement or omission of controlling facts; (2) the facts at the time of the transaction are materially different from the controlling facts on which the ruling is based; or (3) the transaction involves a continuing action or series of actions and the controlling facts change during the course of the transaction. See Rev. Proc. 2018-1, § 11.05.

No ruling is granted as to whether Foundation qualifies as an organization described in section 501(c) or section 509(a). Except as expressly provided above, no opinion is expressed or implied concerning the federal income or estate tax consequences of any aspects of any transaction or item of income described in this letter ruling, including the allowability of an estate tax charitable deduction under section 2055 upon Spouse's death.

This letter is directed only to Foundation. Section 6110(k)(3) provides that it may not be used or cited as precedent.

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.

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,

Mary Jo Salins
Chief
(Tax Exempt & Government Entities)

cc: