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

200208039

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Date:

NOV 29 2001

Contact Person:

Identification Number:

Telephone Number:

T:EO:B2

Employer Identification Number:

LEGEND:

B =
X =

UIL No.
4941.04-00

Dear Sir or Madam:

We have considered your ruling request dated June 1, 2000 for a ruling that the proposed early termination of X will not constitute self-dealing under section 4941(d) of the Code.

X is a charitable remainder unitrust described in section 664(d)(3) of the Internal Revenue Code, and a split-interest trust described in section 4947(a)(2). As a unitrust, X pays out each year the lesser of (1) X's net income, as defined in section 643(b), or (2) 8% of the net fair market value of X's assets. X's donor has died. Only one of X's several income beneficiaries, B, is still alive. B is a child of the grantor, and thus a disqualified person under section 4946. The remainder beneficiary is a church described in section 501(c)(3). The trustee is an affiliate of the church.

In recent years, the payout from X to the income beneficiary has averaged less than 3% of the net fair market value. In accordance with modern portfolio investment theory, the trustee has invested the assets for total return (a combination of distributable income and nondistributable capital appreciation) rather than seeking to maximize the annual distributable income. The income beneficiary is dissatisfied with the relatively low payouts. The trustee is faced with the uncomfortable situation of balancing its fiduciary obligations to the income and remainder beneficiaries in a marketplace that currently favors capital appreciation over the production of distributable income.

To alleviate the difficulty, X proposes to terminate, and to distribute to the income and remainder beneficiaries lump sums equal to the present value of their respective interests effective on the date of termination. X represents that the values will be determined using the discount rate in effect under section 7520 of the Code on the date of termination, and using the methodology under section 1.664-4 of the regulations for valuing interests in charitable remainder trusts. The termination procedure will comply with State law, which permits early termination upon consent of all beneficiaries, provided that all income and remainder interests are vested (i.e., there are no contingent income beneficiaries and no individuals have retained the right to change the remainder beneficiaries), that all income beneficiaries are of full legal capacity, and that the trust does not, by its terms, prohibit early termination. All interested parties (the beneficiaries, the trustee, and the State Attorney General) will consent to the termination.

B's physician is a specialist in internal medicine and has been B's physician for over 20 years. The physician recently conducted a physical examination of B and has signed an affidavit, under penalties of perjury, that to the best of his knowledge and belief, B has no medical condition that is expected to result in a shorter longevity than that set forth in Table V of section 1.72-9 of the Income Tax Regulations for a person of B's age. B has also signed an affidavit, under penalties of perjury, that to the best of B's knowledge and belief, B has no medical condition that is expected to result in a shorter longevity than that set forth in Table V of section 1.72-9 of the regulations for a person of B's age.

Section 508(e)(1) of the Code provides that a private foundation shall not be exempt from taxation under section 501(a) unless its governing instrument includes certain provisions requiring action so as not to subject itself to taxes under sections 4941-4945 of the Code.

Section 4941(a) of the Code imposes an excise tax on disqualified persons for each act of self-dealing between a disqualified person and a private foundation.

Section 4941(d)(1) of the Code defines self-dealing as including any direct or indirect--

(A) sale or exchange, or leasing, of property between a private foundation and a disqualified person, or

(E) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation.

Section 4947(a)(2) of the Code provides, in pertinent part, that in the case of a trust which is not exempt from tax under section 501(a), not all of the unexpired interests of which are devoted to charitable purposes, and which has amounts in trust for which a charitable deduction was allowed, sections 507 and 4941 apply as if such trust were a private foundation.

Section 4947(a)(2)(A) of the Code provides that section 4947(a)(2) shall not apply with respect to any amounts payable under the terms of such trust to non-charitable income beneficiaries.

Section 1.508-3(d)(1) of the Income Tax Regulations provides generally that a private foundation's governing instrument shall be deemed to conform with the requirements of section 508(e)(1) of the Code if valid provisions of State law have been enacted which:

(i) Require action so as not to subject the foundation to taxes under sections 4941-4945 of the Code; or

(ii) Treat the required provisions as contained in the foundation's governing instrument.

Section 1.508-3(d)(2)(i) of the regulations provides generally that any provision of State law described in section 1.508-3(d)(1) shall be presumed valid as enacted, and in the absence of State provisions to the contrary, to apply with respect to any foundation that does not specifically disclaim coverage under State law (either by notification to the appropriate State official or by commencement of judicial proceedings).

Section 1.508-3(d)(3) of the regulations provides that in order for a private foundation or trust described in section 4947(a)(2) to receive the benefit of coverage under any State statute which makes applicable the requirements of section 508(e)(1), where the statute by its terms does not apply to a governing instrument which contains a mandatory direction conflicting with any of such requirements, such organization must indicate on its annual return required to be filed under section 6033 (or section 6012 in the case of a trust described in section 4947(a)) that its governing instrument contains no mandatory directions which conflict with the requirements of section 508(e)(1), as incorporated by the State statute. General language in a governing instrument empowering the trustee to make investments without being limited to those investments authorized by law will not be regarded as a mandatory conflicting direction.

Section 1.508-3(e)(2) of the regulations provides generally that a split-interest trust described in section 4947(a)(2) of the Code is subject to the provisions of section 508(e) to the extent that section 4947 applies sections 4941-4945 to such a trust.

Section 53.4941(d)-1(a) of the Foundations and Similar Excise Taxes Regulations provides that it is immaterial whether a transaction results in a benefit or a detriment to the private foundation in determining whether the transaction is an act of self-dealing.

Section 53.4941(d)-2(f)(2) of the Foundations and Similar Excise Taxes Regulations provides that the fact that a disqualified person receives an incidental or tenuous benefit from the use by a foundation of its income or assets will not, by itself, make such use an act of self-dealing.

Section 53.4947-1(e) of the regulations provides that the provisions of section 507(a) of the Code shall not apply to a trust described in section 4947(a)(1) or (2) by reason of any payment to a beneficiary that is directed by the terms of the governing instrument of the trust and is not discretionary with the trustee or, in the case of a discretionary payment, by reason of, or following, the expiration of the last remaining charitable interest in the trust.

Section 53.4947-1(e)(2) of the regulations sets forth the following examples:

Example (1). H creates a section 4947(a)(1) trust under which the income is to be paid for 15 years to R, a section 501(c)(3) organization. Upon the expiration of 15 years, the trust is to terminate and distribute all of its assets to S, another section 501(c)(3) organization. Distribution of the corpus of the trust to S will not be considered a termination of the trust's private foundation status within the meaning of section 507(a).

Example (2). H creates a trust under which X, a section 501(c)(3) organization, receives $20,000 per year for a period of 20 years, remainder to S, H's son. H is allowed a deduction under section 2522 for the present value of X's interest. When the final payment to X has been made at the end of the 20-year period in accordance with the terms of the trust, the provisions of section 4947(a)(2) will cease to apply to the trust because the trust no longer retains any amounts for which the deduction under section 2522 was allowed. However, the final payment to X will not be considered a termination of the trust's private foundation status within the meaning of section 507(a).

Example (3). J creates a charitable remainder annuity trust described in section 664(d)(1) under which S, J's son, receives $10,000 per year for life, remainder to be distributed outright to P, an organization described in section 501(c)(3). J is allowed a deduction under section 170 for the value of the remainder interest placed in trust for the benefit of P, and the provisions of section 4947(a)(2) apply to the trust. At the death of S, the trust will terminate and all assets will be distributed to P. However, such final distribution to P will not be considered a termination of the trust's private foundation status within the meaning of section 507(a).

The proposed distribution in early termination of X is an act of self-dealing under section 4941 of the Code as it is a transfer to the income beneficiary of some of the assets of X. The question is whether section 4941 applies to the proposed transaction.

Since X is described in Section 4947(a)(2) of the Code, section 4941 applies to X except with respect to "amounts payable under the terms of such trust to income beneficiaries" under section 4947(a)(2)(A). The terms within the four corners of the trust instrument do not provide for early termination of the trust (prior to the death of the last surviving income beneficiary). However, the State law provisions allowing for early termination under the prescribed circumstances may be considered as implied terms of the trust instrument. In the similar situation of section 508(e), State laws are regarded as fulfilling the governing instrument requirements for split-interest trusts absent a prevailing conflicting clause in the trust instrument. The State court does not consider the provisions of X's trust instrument to be conflicting.

Whether section 4941 of the Code applies depends on whether the proposed allocation of trust assets to the income beneficiary may properly be considered as "payable under the terms of such trust" and "directed by the terms of the governing instrument of the trust and not discretionary with the trustee" under section 53.4947-1(e) of the regulations. The critical question, in our view, is whether early termination may be expected to result in a greater allocation of the trust assets to the income beneficiary, to the detriment of the charitable beneficiary, than a non-early termination. The possibility of gamesmanship by the income beneficiary and whipsawing of the Service exists here.

X's proposed allocation method is reasonable if the income beneficiary has no knowledge of a medical condition or other circumstance likely to result in a shorter life expectancy than that predicted by the actuarial tables. Otherwise, an early termination would tend to deprive the charity of its benefit and would be inconsistent with the charitable deduction allowed to the donor of the trust. In the latter case, a charitable remainder trust could not terminate early without paying the termination tax under section 507(c).

We find in favor of the taxpayer here because all of the following circumstances exist: State law allows the early termination; all beneficiaries favor the early termination; the trustee will use the Income Tax Regulations' formula for determining the present values of the income and remainder interests in a charitable remainder trust; the income beneficiary's longstanding physician, who is experienced and well-qualified in his profession, has conducted a physical examination and stated under penalties of perjury that he finds no medical condition expected to result in a shorter-than-average longevity (under section 1.72-9 of the regulations); and the income beneficiary has signed a similar statement.

Accordingly, we rule as follows: the proposed early termination of X will not constitute self-dealing under section 4941(d) of the Code.

Upon termination, X should file final tax and information returns in accordance with sections 6012 and 6034 of the Code.

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

Because this letter could help resolve any future tax questions, you should keep a copy of this ruling in your permanent records.

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 yours,

(signed) Terrell M. Berkovsky
Terrell M. Berkovsky
Manager, Exempt Organizations
Technical Group 2