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

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TAX EXEMPT AND GOVERNMENT ENTITIES DIVISION

Index Numbers: 501.03-02; 4941.04-00; 4942.04-00; 4944.00-00; 4945.04-00

Date: MAY 17 2002

Contact Person:

Identification Number:

Contact Number:

T:ED:B4

Employer Identification Number:

Legend:
R =
W =
M =
X =
T =

Ladies and Gentleman:

This is in response to your letter requesting a ruling regarding the proper treatment under sections 501, 4941, 4942, 4944, and 4945 of the Internal Revenue Code (the Code) for transactions involving a term-life insurance policy.

You are exempt from federal income tax under section 501(c)(3) of the Code and classified as a private foundation within the meaning of section 509(a) of the Code. Your purpose, as stated in your Articles of Incorporation, is to make contributions to organizations that are authorized to carry on charitable, religious, scientific, literary, or educational activities, and to conduct charitable activities. You represent that R, who is your founder, substantial contributor, and director for life, is a disqualified person with respect to you.

Action by your Board of Directors requires the vote of R and one of the two other directors. Under the Articles of Incorporation and the Bylaws, no matter can be approved, or expenditure made, without the affirmative vote of R. The other two directors are W and M. You represent that W is engaged in business with R and that M is an attorney. You also represent that M is not subject to the control of R and that M is a disqualified person because he is a foundation manager.

R has named you as the principal beneficiary of his residuary estate in his will. Thus, you will inherit property and an art collection currently worth approximately in excess of $ X.

T is an irrevocable trust established by R for the benefit of various persons and you. You maintain that T is not a disqualified person with respect to you. The current beneficiaries are R's brother and two stepchildren who are children of R's ex-wife. Thus, none of the current beneficiaries is a disqualified person with respect to you. In the event of the death of a current beneficiary before completing distribution, his or her share passes to you.

T is the owner of a term-life insurance policy on the life of R, which has a face value of $ and is subject to the payment of current annual premiums of $ The premiums will be fixed for 20 years. The policy is convertible into whole-life insurance, has no cash value, and is not subject to a policy loan. In fact, you represent that a policy loan will never be available to any owner of the term-life insurance policy or to anyone else. You maintain that you expect to receive sufficient contributions from R each year to enable you to pay the policy premiums as a condition of accepting and continuing the term policy. R's funding commitment lasts during the basic 20-year term of the policy during which premiums are fixed. However, you represent that you will not be obligated to apply contributions by R to the payment of life insurance premiums.

To address state law fiduciary concerns, R plans to transfer funds to T to reimburse it for the prepaid but as yet unused premium on the term policy. Upon receipt of the consideration, T proposes to use the "Assignment to Transfer Ownership" form to transfer ownership of the term policy to you. You will then name yourself as the beneficiary by using the "Change of Beneficiary" form. You are willing to accept the donation only under certain conditions. First, R simultaneously executes an agreement to contribute funds to you annually (and for so long as you elect to continue insurance coverage) that are equal to all premiums on the term policy and before the due date of such premiums. Second, R simultaneously executes an irrevocable voting proxy in favor of M (and his non-controlled successors) to allow M to cast R's Board of Director's vote with respect to all matters concerning the term policy including, without limitation, decisions regarding continuance or discontinuance of coverage and change of beneficiary. Third, R and your other directors agree in that same agreement that, if M ceases to be your director for any reason, a director not controlled by R or any other disqualified person will be elected to your Board of Directors and will hold and vote the proxy. Fourth, the Internal Revenue Service rules favorably with respect to all rulings requested herein.

In transferring the policy to you, T will relinquish all incidents of ownership. You maintain that you will be the only party with any power with respect to the policy after the transfers. You are the only party with any power to assign the policy or change its beneficiary. Because the policy has no cash value, no one can possibly borrow against it. Even if the policy were converted to whole life, only you would have borrowing power because, as you maintain, all powers with respect to the policy will then belong solely to you. You will be the only party who can cancel the policy or redeem it for the prepaid, unused premium. Furthermore, you represent that you have no intention of converting the term-life insurance into whole-life insurance.

Once your conditions are met, you will then be in a position to accept and hold the term policy until the death of R. At the death of R, you expect to receive the bequest of property and the art collection of R, convert the property into an art museum, display R's art collection to the public, and use the proceeds of the term policy for endowment of the museum. You maintain that you will have expended none of your current assets to accomplish this result.

Law & Analysis

Section 501(c)(3)

Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(a)-1(c) of the Income Tax Regulations (the regulations) provides that the words "private shareholder or individual" in section 501 refer to persons having a personal and private interest in the activities of the organization.

Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities that accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations provides that an organization is not organized or operated exclusively for one or more of the purposes specified in section 501(c)(3) of the Code unless it serves a public rather than a private interest. Thus, to qualify under section 501(c)(3), an organization must establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

Rev. Rul. 67-381, 1967-2 C.B. 189, provides that the payment of premiums on an insurance policy on the life of a disqualified person would not affect the organization's exempt status when all the incidents of ownership were surrendered by the donor except the right to select the method of payment.

Your payment of premiums on the term policy on the life of R is similar to the situation addressed in Rev. Rul. 67-381, *supra*. In that ruling, the Service found that the organization would not lose its exempt status when all the incidents of ownership were surrendered by the donor except the right to select the method of payment. Therefore, we find that each payment of premiums by you on the term policy will not result in inurement or benefit to private shareholders or individuals so as to jeopardize your exempt status under section 501(c)(3) of the Code. As represented, T will relinquish all incidents of ownership, thereby giving complete control of the policy to you. You have the power to assign the policy, change its beneficiary, cancel the policy, or redeem it.

Self-Dealing

Section 4941(a) of the Code imposes a five percent tax on each act of self-dealing between a disqualified person and a private foundation.

Section 4941(d)(1) of the Code provides that the term "self-dealing" means any direct or indirect:

(A) sale or exchange, or leasing of property between a private foundation and a disqualified person;
(B) lending of money or other extensions of credit between a private foundation and a disqualified person;
(C) furnishing of goods, services, or facilities between a private foundation and a disqualified person....

Section 53.4941(d)-2(a)(2) of the Foundation and Similar Excise Taxes Regulations (the regulations) provides 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 foundation assumes a mortgage or similar lien that was placed on the property before the transfer, or takes subject to a mortgage that a disqualified person placed on the property within the 10-year period ending on the date of transfer.

Section 53.4941(d)-2(c)(3) of the regulations provides that making a promise, pledge, or similar arrangement to a private foundation by a disqualified person, whether evidenced by an oral or written agreement, a promissory note, or other instrument of indebtedness, to the extent motivated by charitable intent and unsupported by consideration is not an extension of credit.

Section 53.4941(d)-2(d)(3) of the regulations provides that an act of self-dealing does not occur if a disqualified person provides goods to a private foundation without charge.

Rev. Rul. 80-132, 1980-1 C.B. 255, provides that the donation to a private foundation by a disqualified person of a life insurance policy subject to a policy loan will constitute an act of self dealing under section 4941(d)(1)(A) of the Code.

The transfer of an unencumbered life insurance policy by T to you is not among the transactions prohibited by section 4941 of the Code. Furthermore, because the life insurance policy is not subject to any policy loan or other encumbrances, the proposed transaction does not constitute an act of self-dealing of the type described in Rev. Rul. 80-132, *supra*.

Under the facts as represented, the contractual promise by R to contribute funds sufficient to pay future premiums will not constitute self-dealing according to section 53.4941(d)-2(c)(3) of the regulations. Furthermore, each annual transfer of funds by R to you for purposes of paying the premiums on the term policy will also not constitute an act of self-dealing under section 53.4941(d)-2(d)(3) of the regulations. These transfers would constitute unencumbered gifts from a disqualified person to a private foundation, and therefore, would not constitute acts of self-dealing.

Valuation

Section 4942(e)(1) of the Code provides that, for purposes of determining the "distributable amount," the minimum investment return for any private foundation for any taxable year is five percent of the excess of (A) the aggregate fair market value of all assets of the foundation other than those that are used directly in carrying out the foundation's exempt purpose, over (B) the acquisition indebtedness with respect to such assets.

Section 53.4942(a)-2(c)(4)(iv)(a) of the regulations provides that the fair market value of assets, other than certain securities, cash, and common trust funds, shall be determined annually.

Section 53.4942(a)-2(c)(4)(iv)(c) of the regulations provides that commonly accepted methods of valuation must be used in making an appraisal. Valuations made in accordance with the principles stated in the regulations under section 2031 constitute acceptable methods of valuation.

Section 53.4942(a)-2(c)(4)(vi) of the regulations provides that, in the case of assets that are required to be valued on an annual basis, such asset may be valued as of any day in the private foundation's taxable year to which such valuation applies.

For purposes of determining your minimum investment return under section 4942(e) of the Code, you may determine the value of the term policy in accordance with the principles provided for in the regulations under section 2031, as permitted by the regulations under section 4942 of the Code. Assets, other than certain marketable securities, cash, and common trust fund interests are valued according to section 53.4942(a)-2(c)(4)(iv) of the regulations.

Cash Balances

Section 53.4942(a)-2(c)(4)(ii) of the regulations provides that, to determine the amount of a foundation's cash balances, the foundation shall value its cash on a monthly basis by averaging the amount of cash on hand as of the first day of each month and as of the last day of each month.

The amount contributed to you and expended for payment of insurance premiums or otherwise is includible in the calculation of your monthly cash balance only if and to the extent that it is held on the first or the last day of the month.

Jeopardizing Investments

Section 4944 of the Code imposes an excise tax upon a private foundation that makes any investment that jeopardizes its exempt purpose.

Section 53.4944-1(a)(2)(i) of the regulations provides that an investment shall be considered to jeopardize the carrying out of the exempt purposes of a private foundation if it is determined that the foundation managers, in making such investment, have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of the investment, in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes.

The regulation further provides that no category of investments shall be treated as a per se violation of section 4944. The determination of whether the investment of any amount jeopardizes the carrying out of a foundation's exempt purposes is to be made as of the time that the foundation makes the investment and not subsequently on the basis of hindsight.

Section 53.4944-1(a)(2)(ii)(a) of the regulations provides that section 4944 shall not apply to an investment made by any person which is later gratuitously transferred to a private foundation. If the foundation furnishes any consideration to such person upon the transfer, the foundation will be treated as having made an investment (within the meaning of section 4944(a)(1)) in the amount of such consideration.

In Rev. Rul. 80-133, 1980-1 C.B. 258, the Service found that payments made by a private foundation for the premium on a life insurance policy and the interest on the policy loan is a jeopardizing investment under section 4944 of the Code. The foundation managers invested in a life insurance policy of an insured that has a life expectancy of ten years. The policy pays combined premium and interest payments that will produce a financial loss to the foundation at the end of eight years. The period of time the payments could reasonably be expected to last is ten years. Thus, the foundation managers, by investing at the projected rate of return prevailing at the time of the investment, failed to exercise ordinary business care and prudence in providing for the long-term and short-term financial needs of the foundation in carrying out its exempt purpose.

The contribution by T to you of the term policy insuring the life of R will not constitute a jeopardy investment by you under section 4944 of the Code. Because you do not furnish consideration to T, the transfer is considered gratuitous for purposes of section 53.4944-1(a)(2)(ii)(a) of the regulations and outside the scope of section 4944.

Furthermore, each annual contribution of funds by R to you will not constitute a jeopardy investment under section 4944 of the Code. There are no representations that you will furnish any consideration to R upon the transfer. Thus, according to section 53.4944-1(a)(2)(ii)(a) of the regulations, this is also a gratuitous transfer and outside the scope of section 4944 of the Code.

Your payment of premiums on the term policy will also not constitute a jeopardy investment under section 4944 of the Code and Rev. Rul. 80-133, *supra*. Based on your representations, the term policy is not subject to a policy loan. Although you represent that the total premiums paid on the term policy could exceed the face amount of the policy, R must contribute funds annually that are equal to all premiums on the policy and before the due date of such premiums as a condition of your accepting the policy. This agreement gives you the equivalent of the contribution of a fully paid-up insurance policy. Furthermore, as represented, R will execute an irrevocable voting proxy in favor of M (and his non-controlled successors) to allow M to cast R's Board of Director's vote on all matters concerning the term policy. Directors, other than R, have a majority of votes on your Board of Directors with respect to all matters involving the policy. Therefore, if the premiums are not contributed, your board, including M who will hold the voting proxy of R, can permit the policy to lapse so that you will not jeopardize your existing assets.

Accordingly, you will have no jeopardizing investment under section 4944 of the Code as a result of: 1) your receipt of T's gift of the term policy; 2) each annual contribution of funds by R to you; and 3) your continued payment of term-life insurance premiums with amounts contributed for that purpose.

Taxable Expenditure

Section 4945(a) of the Code imposes a tax on private foundations and foundation managers who make taxable expenditures.

Section 4945(d) of the Code defines "taxable expenditures" as any amount paid or incurred by a private foundation:

5) for any purpose other than one specified in section 170(c)(2)(B).

Section 53.4945-6(b)(1) of the regulations provides that the following types of expenditures ordinarily will not be treated as taxable expenditures under section 4945(d)(5):

i) expenditures to acquire investments entered into for the purpose of obtaining income or funds to be used in furtherance of purposes described in section 170(c)(2)(B).

Each payment of insurance premiums on the term policy by you from contributions received from R will not constitute a taxable expenditure within the meaning of section 4945 of the Code. Although you made an expenditure, section 53.4945-6(b)(1)(i) of the regulations treats it as nontaxable under section 4945. The term policy is subject to the payment of annual premiums of $ fixed for years. By accepting the policy and paying the annual premiums on it, you will ultimately receive your proceeds at the death of R and will use the money for the endowment of the museum as you represented. The promotion of the arts and of culture is generally recognized as an educational activity under section 501(c)(3) of the Code, and thus, is described in section 170(c)(2)(B) of the Code.

Rulings

Based on the above facts, we rule as follows:

1. Each payment of premiums by you on the term policy will not result in inurement or benefit to private shareholders or individuals so as to jeopardize your exempt status under section 501(c)(3) of the Code.

2. The transfer of the term policy on the life of R by T to you will not constitute an act of self-dealing under section 4941 of the Code.

3. The contractual promise by R to contribute funds sufficient to pay future premiums will not constitute an act of self-dealing under section 4941 of the Code.

4. Each annual transfer of funds by R to you for purposes of paying the premiums on the term policy will not constitute an act of self-dealing under section 4941 of the Code.

5. For purposes of determining your minimum investment return under section 4942(e) of the Code, the value of an insurance policy is to be determined according to section 53.4942(a)-2(c)(4)(iv) of the regulations.

6. For purposes of determining the amount of your cash balances, the income contributed to you and expended for payment of insurance premiums or otherwise is includible in the calculation of your monthly cash balance only if and to the extent that it is held on the first or the last day of the month.

7. The contribution by T to you of the term policy insuring the life of R will not constitute a jeopardy investment by you under section 4944 of the Code.

8. Each annual contribution of funds by R to you will not constitute a jeopardy investment under section 4944 of the Code.

9. Your payment of premiums on the term policy will not constitute a jeopardy investment under section 4944 of the Code.

10. Each payment of insurance premiums on the term policy by you from contributions received from R will not constitute a taxable expenditure within the meaning of section 4945 of the Code.

This ruling is limited to the applicability of sections 501(c)(3), 4941, 4942, 4944, and 4945 of the Code and does not purport to rule on any facts that were not represented in the ruling request as supplemented. This ruling is based on the understanding that there will be no material changes in the facts upon which they are based.

Except as specifically ruled upon above, no opinion is expressed concerning the federal income tax consequences of the transactions described above under any other provision of the Code.

Pursuant to a Power of Attorney on file in this office, a copy of this letter is being sent to your authorized representatives. A copy of this letter should also be kept in your permanent records.

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

If there are any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Gerald V. Sack

Gerald V. Sack
Manager, Exempt Organizations
Technical Group 4