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Department of the Treasury

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Person to Contact:

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Legend

Trust -
Foundation -
Taxpayer A -
Taxpayer B -
$x dollars -
$y dollars -

Dear :

This is in response to the letter from your authorized representative in which he requested rulings concerning the income, gift, and private foundation tax treatment of a proposed reformation of a charitable remainder trust.

In 1988, Taxpayer A and Taxpayer B established and funded Foundation, a charitable organization described in §§ 170(c), 2055(a) and 2522(a) of the Internal Revenue Code, and that is recognized as exempt from income taxes under § 501(c)(3) as a private foundation described in § 509(a). In 1994, Taxpayer A and Taxpayer B created and funded Trust, an irrevocable charitable remainder annuity trust described in § 664(d)(1). Taxpayer A and Taxpayer B are the co-trustees of Trust.

Under the terms of Trust, the trustees are directed to annually pay Taxpayer A and Taxpayer B, in equal shares, an annuity equal to seven percent of the initial net fair market value of the assets transferred to Trust. On the death of the first to die of Taxpayer A and Taxpayer B, the entire annuity is to be paid to the survivor. On the death of the survivor of Taxpayer A and Taxpayer B, the corpus of Trust will be paid to Foundation, providing that it is an organization described in §§ 170(c), 2055(a) and 2522(a). Any income in excess of the annuity amount is to be added to trust corpus. The terms of Trust also provide that no amount other than the annuity amount may be paid to or for the use of any person other than any organization described in §§ 170(c), 2055(a) and 2522(a). The initial net fair market value of the assets transferred to Trust was $x dollars, resulting in an annual annuity payable to Taxpayer A and Taxpayer B of $y dollars.

You represent that the assets held by Trust have nearly doubled in value since it was created. You also represent that the cost of the charitable activities of the Foundation has increased to the point that the Foundation no longer has the revenue from investments and donations to conduct its charitable activities.

In order to improve the financial condition of the Foundation so that it may conduct its charitable activities, you propose to petition the appropriate local court for approval to reform the dispositive provisions in Paragraph FIRST (A) of Trust. The trust, as reformed, will continue to provide for the same annual annuity payments to Taxpayer A and Taxpayer B and for the distribution of the corpus to Foundation upon the death of the survivor of Taxpayer A and Taxpayer B. Under the instrument as modified, the annuity amount is to be paid first from Trust income, and if the income is insufficient then from trust principal. Further, Trust will be modified to provide that any trust income not distributed in satisfaction of the annuity payable to Taxpayer A and Taxpayer B will be distributed to the charitable remainder beneficiary (Foundation) providing that it is an organization described in §§ 170(c), 2055(a) and 2522(a). In addition, the trustees will have the discretion to distribute the principal of Trust to Foundation to "improve its financial situation," provided the aggregate fair market value of the Trust assets remaining after the distribution will not be less than $x dollars and provided that Foundation is an organization described in §§ 170(c), 2055(a) and 2522(a). In addition, Trust, as reformed, will provide that, in the case of distributions in kind, the adjusted basis of the property distributed will be fairly representative of the adjusted basis of the property available for payment on the date of payment. The reformed Trust will continue to provide that no amount other than the annuity amount can be paid to or for the use of any person other than a qualified charitable organization.

You represent that the charitable and non-charitable beneficiaries have agreed to the proposed reformation and will execute written consents prior to the filing of the petition in the appropriate local court.

You have requested the following rulings:

1. Status of the Trust as a charitable remainder annuity trust.

You have requested a ruling that the Trust, as reformed, will satisfy the requirements of § 664(d)(1) and will continue to qualify as a charitable remainder annuity trust under § 664, or, in the alternative, that the proposed reformation will not disqualify the Trust as a charitable remainder annuity trust under § 664.

Under § 664(d)(1)(A), a charitable remainder annuity trust is a trust from which a sum certain (which is not less than 5 percent nor more than 50 percent of the initial net fair market value of all property placed in trust) is to be paid, not less often than annually, to one or more persons (at least one of which is not an organization described

in § 170(c) and, in the case of individuals, only to an individual who is living at the time of the creation of the trust) for a term of years (not in excess of 20 years) or for the life or lives of such individuals.

Section 664(d)(1)(B) states, generally, that no amount other than the annuity amount may be paid to or for the use of any person other than an organization described in § 170(c). Under § 664(d)(1)(D), the value (determined under § 7520) of the remainder interest must be at least 10 percent of the initial net fair market value of all property placed in trust.

Section 1.664-2(a)(4) of the Income Tax Regulations states that the governing instrument of the charitable remainder annuity trust may provide that any amount other than the amount payable to or for the use of a person or persons at least one of which is not an organization described in § 170(c), shall be paid (or may be paid at the discretion of the trustee) to an organization described in § 170(c) provided that, in the case of distributions in kind, the adjusted basis of the property distributed is fairly representative of the adjusted basis of the property available for payment on the date of payment. For example, the governing instrument may provide that a portion of the trust assets may be distributed currently, or upon the death of one or more recipients, to an organization described in § 170(c).

The proposed reformation will authorize the trustee to make distributions of income and principal to qualified charitable organizations. This grant of authority is permitted under the regulations discussed above, and as discussed below (Item 4), the reformation will have no effect on the present values of the beneficiaries' respective interests in Trust.

Accordingly, assuming Trust satisfies all the other requirements for qualification as a charitable remainder annuity trust under § 664(d)(1), the reformation as proposed will not adversely effect qualification of Trust as a charitable remainder annuity trust under § 664.

2. Tax-exempt status of the Trust and the Foundation

Your request a ruling that if Trust, as reformed, qualifies as a charitable remainder annuity trust under § 664(d)(1), then it will be exempt from income tax pursuant to § 664(c).

Section 664(c) provides, in part, that a charitable remainder annuity trust shall, for any taxable year, not be subject to any tax imposed by this subtitle, unless such trust, for such year, has unrelated business taxable income.

Section 1.664-1(a) provides that a trust created after July 31, 1969, which is a charitable remainder trust is exempt from all the taxes imposed by subtitle A of the

Code for any taxable year of the trust except a taxable year in which it has unrelated business taxable income.

Accordingly, assuming Trust satisfies all the other requirements for qualification as a charitable remainder annuity trust under § 664(d)(1) and since the reformation as proposed will not adversely effect its qualification as a charitable remainder annuity trust, the Trust will be exempt from income tax pursuant to § 664(c).

In addition, you request a ruling that, if the Foundation now qualifies as a tax-exempt organization under § 501(c)(3), neither the proposed reformation, the proposed distribution of principal, nor any subsequent distributions of principal or income from the Trust to the Foundation in accordance with the reformation, will disqualify the Foundation as a tax-exempt organization under § 501(c)(3).

Section 501(c)(3) provides, in part, for an exemption from federal income tax for corporations organized and operated exclusively for charitable, scientific, or educational purposes provided no part of the corporations' net earnings inures to the benefit of any private shareholder or individual.

After the reformation, the Foundation will continue to expand and operate its charitable programs pursuant to § 501(c)(3). The Trust will also continue to hold assets and make distributions on behalf of the income beneficiaries and the Foundation.

If it is assumed that the Foundation now so qualifies, neither the proposed reformation of the Trust, the proposed distribution of principal, nor any subsequent distributions of principal or income from the Trust to the Foundation in accordance with the reformation will disqualify the Foundation as a tax-exempt organization under § 501(c)(3).

3. Recognition of taxable income or gain

You request a ruling that neither the proposed reformation, the proposed distribution of principal, nor any subsequent distributions of principal or income from the Trust to the Foundation in accordance with the trust instrument as reformed will result in recognition of taxable income or gain by the Trust, the Foundation, or Taxpayer A and Taxpayer B, under §§ 61or 1001.

Section 61(a)(3) provides that gross income includes gains derived from dealings in property.

Section 1001 provides that the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in § 1011 for determining gain, and the loss shall be the excess of the adjusted basis over the amount realized.

For purposes of § 1001, in an exchange of property, each party to the exchange gives up a property interest in return for a new or additional property interest. Such an exchange is a disposition under § 1001(a). See § 1.1001-1 of the Income Tax Regulations.

Under the proposal here, the trust provisions will be reformed to provide that any income not distributed in satisfaction of the annuity payable to Taxpayers A and B, will be distributed to the charitable remainder beneficiary, Foundation. In addition, the trustees will have the discretion to distribute the principal of Trust to Foundation to "improve its financial situation," provided the aggregate fair market value of the Trust assets remaining after the distribution will not be less than $x dollars.

Under the proposal, the corpus will be maintained at a level that will support the annuity payment to Taxpayers A and B. Any distributions to Foundation under the proposed changes, however, would reduce the trust corpus from what it would be without the distributions, i.e., income in excess of the annuity amount distributed to Foundation under the proposal would otherwise have been added to trust corpus.

The proposed changes would accelerate the payment of part of the remainder to Foundation. The changes are not intended to have any effect on the life beneficiaries. It appears there is only a remote possibility that there would be any effect, because trust corpus is to be maintained at a level that appears to be more than sufficient to provide for the continued payment of the annual annuity amounts.

As described by the taxpayers, the trust reformation will not constitute an exchange for purposes of § 1001. Taxpayers A and B do not intend to give up any of their life annuity interests, nor are they receiving any new or additional property interest in return. Foundation, the charitable remainder beneficiary, may benefit from the possibility of the accelerated payment of the remainder interest, but it, too, is not giving up a property interest. Thus, there is no exchange.

However, to the extent that Taxpayers A and B are consenting to an acceleration to Foundation of a portion of the trust remainder (either trust income that would otherwise be added to corpus, or corpus itself), they will not be allowed a deduction for a charitable contribution under § 170 of the Code.

Section 170(a)(1) provides a deduction for charitable contributions (as defined in § 170(c)), payment of which is made within the taxable year.

Section 170(f)(2)(B) provides in part that no charitable contribution deduction is allowed for the value of any interest in property (other than a remainder interest) transferred in trust unless the interest is in the form of a guaranteed annuity and the grantor is treated as the owner of the interest for purposes of applying § 671.

Taxpayers A and B have previously transferred their interest (except for their annuity interests) in the property transferred to Trust. In addition, they received a charitable contribution income tax deduction for the value of the remainder interest when they created and funded Trust as an irrevocable charitable remainder annuity trust under the provisions of § 664(d)(1). As discussed below, inasmuch as Taxpayers A and B are not intending reducing the present value of their annuity interests, they are not making a further gift to charity. This is different from the facts described in Rev. Rul. 86-60, 1986-1 C.B. 302, where the donor beneficiaries transferred their retained annuity interests to the charitable remainderman and were found to have qualified for an income tax charitable contribution tax deduction.

4. Gift Tax

You request a ruling that neither the proposed reformation, the proposed distribution of principal, nor any subsequent distribution of principal or income from the Trust to the Foundation in accordance with the trust instrument as reformed will be subject to gift tax under § 2501.

Section 2501 imposes a tax for each calendar year on the transfer of property by gift during the calendar year by any individual, resident or nonresident.

Section 2511 states that the gift tax applies whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 25.2511-1(g)(1) the Gift Tax Regulations states that donative intent on the part of the transferor is not an essential element of the application of the gift tax to the transfer. The application of the tax is based on the objective facts of the transfer and the circumstances under which it is made, rather than on the subjective motives of the donor. A transfer by a trustee of trust property in which he has no beneficial interest does not constitute a gift by the trustee (but such a transfer may constitute a gift by the creator of the trust, if until the transfer he had the power to change the beneficiaries by amending or revoking the trust).

Section 25.2511-2(b) provides that a gift is complete where the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another. Section 25.2511-2(d) provides that a gift is not considered incomplete merely because the donor reserves the power to change the manner or time of enjoyment. Thus, the creation of a trust the income of which is to be paid annually to the donee for a period of years, the corpus being distributable to him at the end of the period, and the power reserved by the donor being limited to a right to require that, instead of the income being so payable, it should be accumulated and distributed with the corpus to the donee at the termination of the period, constitutes a completed gift.

Section 25.2511-2(g) provides that the application of the tax is based on the objective facts of the transfer and the circumstances under which it is made, rather than on the subjective motives of the donor. For instance, if a donor transfers property to himself as trustee and retains no beneficial interest in the trust property and no power over the property except fiduciary powers, the exercise or nonexercise of which is limited by a fixed or ascertainable standard, to change the beneficiaries of the transferred property, the donor has made a completed gift and the entire value of the transferred property is subject to the gift tax. However, the gift tax is not applicable to a transfer for full and adequate consideration in money or money's worth, or to ordinary business transactions.

As stated above, under the proposal, the trust provisions will be reformed to provide that any income not distributed in satisfaction of the annuity payable to Taxpayers A and B will be distributed to the charitable remainder beneficiary, Foundation. In addition, the trustees will have the discretion to distribute the principal of Trust to Foundation to "improve its financial situation," provided the aggregate fair market value of the Trust assets remaining after the distribution will not be less than $x dollars, the amount originally transferred to the trust by Taxpayer A and Taxpayer B.

These proposed changes authorize acceleration of the payment of part of the remainder to Foundation. However, Taxpayers A and B are not transferring or relinquishing any interest in their life-time annuities and the present value of the annuities payable to Taxpayer A and Taxpayer B (determined under § 7520, assuming the December § 7520 rate of 7.4 percent) will be the same before and after the reformation.

Accordingly, (assuming a § 7520 rate that is 7 percent or greater for the month of the reformation) the proposed reformation, the proposed distribution of principal, and any subsequent distribution of principal or income from the Trust to the Foundation in accordance with the trust as reformed will not constitute transfers by Taxpayer A and Taxpayer B that will be subject to gift tax under § 2501.

5. Self-dealing

You request a ruling that neither the proposed reformation, the proposed distribution of principal, nor a subsequent distribution of principal or income from the Trust to the Foundation in accordance with the trust instrument as reformed will constitute an act of self-dealing under § 4941 by the Trust, the Foundation, or Taxpayer A and Taxpayer B that would subject them to tax under § 4941(a)(2) for self-dealing.

Section 4941(a) provides for the imposition of tax on each act of self-dealing between a disqualified person and a private foundation.

Section 4941(d)(1)(E) provides that the term "self-dealing" means any direct or

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

Section 4946(a)(1)(A) provides that the term "disqualified person" means with respect to a private foundation a person who is a substantial contributor to the foundation.

Section 4946(a)(1)(B) provides that the term "disqualified person" means with respect to a private foundation a person who is a foundation manager within the meaning of § 4946(b)(1).

Section 4946(b)(1) provides, in part, that the term "foundation manager" means with respect to any private foundation an officer, director, or trustee of a foundation (or an individual having powers or responsibilities similar to those of officers, directors, or trustees of the foundation).

Section 53.4941(d)-1(b)(3)(ii) of the Foundation and Excise Taxes Regulations 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 paragraph (a) of § 1.641(b)-3 of this chapter (or in the case of a revocable trust, before it is considered subject to § 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).

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

Section 53.4947-1(c)(1)(ii) provides that a split-interest trust is subject to the provisions of §§ 507 (except as provided in paragraph (e) of this section), 508(e) (to the extent applicable to a split-interest trust), 4941, 4943 (except as provided in §§ 4947(b)(3)), 4944 (except as provided in section 4947(b)(3)), and 4945 in the same manner as if such trust were a private foundation.

Since Taxpayer A and Taxpayer B are the Foundation's managers and substantial contributors to the Foundation, they are disqualified persons within the meaning of §§ 4941(a)(1)(A) and (B). Taxpayer A and Taxpayer B, as trustees of the Trust as well as income beneficiaries, will seek to have the Trust reformed to ensure that the Foundation will have the assets necessary to continue as well as expand its charitable programs pursuant to § 501(c)(3). The reformation will not be an attempt to change the interest of the income beneficiaries or otherwise reduce the interest of the Foundation as charitable beneficiary. The trustees of the Trust will obtain the approval of a court having jurisdiction over the Trust before completing the proposed transaction pursuant to § 53.4941(d)-1(b)(3)(ii).

Accordingly, neither the proposed reformation, the proposed distribution of principal, nor a subsequent distribution of principal or income from the Trust to the Foundation in accordance with reformation would constitute an act of self-dealing under § 4941 by the Trust, the Foundation, or the Foundation's managers (Taxpayer A and Taxpayer B) such as would subject any of the them to taxation under § 4941(a)(2) for

self-dealing with a private foundation.

6. Termination Tax

Section 507(a) provides that, except as provided in § 507(b), the status of any private foundation shall be terminated only if such organization notifies the Secretary of its intent to accomplish such termination or, with respect to such organization, there have been either willful or repeated acts or a willful and flagrant act, giving rise to liability for tax under Chapter 42, and the Secretary notifies the organization that because of such act the organization is liable for the tax imposed by § 507(c), and either the organization pays the tax or the entire amount of the tax is abated under § 507(g).

Section 507(c) imposes an excise tax on each terminating private foundation equal to the lower of the aggregate tax benefit resulting from such termination or the value of its net assets.

After the reformation, the Foundation will continue to expand and operate its charitable programs pursuant to § 501(c)(3). The Trust will also continue to hold assets and make distributions on behalf of the income beneficiaries and the Foundation. Neither the Trust nor the Foundation will notify the Secretary of its intention to terminate pursuant to § 507(a). Therefore, the termination tax imposed by § 507(c) does not apply.

Accordingly, neither the Trust nor the Foundation would be subject to the tax under § 507(c) as a result of the proposed reformation, the proposed distribution of principal, or a subsequent distribution of principal or income from the Trust to the Foundation in accordance with the reformation.

The conclusions are based on the assumption that the Trust meets the requirements of section 664(d).

This ruling is contingent upon the trustees obtaining approval of the amendment, as proposed, from the appropriate court.

A copy of this letter should be attached to any income, gift, estate, or generation-skipping transfer tax returns that you may file relating to these matters.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by the appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Except as specifically set forth above, no opinion is expressed concerning the Federal tax consequences of the facts described above under the cited provisions or any other provision of the Code.

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

Sincerely,

Assistant Chief Counsel
(Passthroughs and Special Industries)
By: George Masnik
Chief, Branch 4

Enclosure
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