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

200020060

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.4941.04-00
.4945.04-00

NO THIRD PARTY CONTACTS

Contact Person:

ID Number:

Telephone Number:

OP:E:EO:T4

FEB 24 2000

Employer Identification Number:

Legend:
Foundation =
Dr. X =
x =
y =
z =

Dear Sir or Madam:

We have considered your ruling request dated July 30, 1999, as further amended on December 22, 1999, in which you request certain rulings concerning a proposed split-dollar life insurance arrangement involving Foundation and its President and Chief Executive Officer, Dr. X. The proposed arrangement is intended as part of a comprehensive compensation package for Dr. X. You have requested rulings that the proposed arrangement will not result in private inurement or adversely affect Foundation's exempt status under section 501(c)(3) of the Internal Revenue Code and will not involve an act of self-dealing or a taxable expenditure under section 4941 and 4945 respectively.

Foundation is exempt under section 501(c)(3) of the Code and is classified as a private foundation described in section 509(a). Its purposes are to receive and administer funds for educational and charitable purposes. Foundation's principal activity is making grants to support charitable programs in higher education and health care as well as other areas.

Foundation is governed by a Board of Trustees currently consisting of 12 members, including Dr. X, who as President and CEO serves as an ex-officio member of the Board. Foundation has 10 officers and more than y employees. Based on the amount of its total expenditures, Foundation is a large grant-making institution.

Dr. X became Foundation's President and CEO five years ago. The office of President and CEO is a full-time position involving a wide range of responsibilities. These include overseeing Foundation's operations, implementing grant-making policies, serving as Foundation spokesman, and recommending candidates for officers of, and other key positions within Foundation.

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Dr. X entered into an employment agreement with Foundation in 1995 to serve as President and CEO for a five-year period. This agreement was amended in certain respects in 1997 and in 1998 the parties further agreed to extend the agreement to 2004. The agreement provides for a base salary (which may be increased after annual Board review), participation in Foundation retirement and employee benefit plans, and other fringe benefits. In addition, pursuant to two supplemental agreements executed in 1995 and a third executed in 1999, Dr. X is entitled to receive, subject to certain conditions, additional retirement benefits and deferred compensation. Many of these benefits were negotiated to match the benefits package Dr. X had received under his previous employment.

As part of Dr. X's compensation and benefits, the employment agreement provides that during the employment period Foundation shall maintain, at its expense, term insurance coverage on the life of Dr. X providing a death benefit in an amount equal to two times his salary. The agreement further provides that Dr. X may designate as a beneficiary of such insurance the trustee of an irrevocable life insurance trust previously created by Dr. X and his wife.

To fulfill this obligation under the employment agreement, Foundation has proposed entering into a split-dollar life insurance arrangement. Under this arrangement, Foundation will purchase an insurance policy on Dr. X's life. Foundation and Dr. X will share responsibility for payment of policy premiums and each will receive a portion of the policy proceeds upon Dr. X's death while employed by the Foundation.

This proposed arrangement has certain benefits to the Foundation and to Dr. X. First, it provides guaranteed insurability of Dr. X during the employment period and thereafter, as long as the policy continues. Second, the arrangement simplifies the process of securing annual increases in the amount of insurance coverage that Foundation may be required to provide under the employment agreement. Third, the amount of term insurance coverage which Foundation is obligated to provide Dr. X during the period of his expected employment is likely to exceed the current limits of the Foundation's group term policy. Thus, Foundation would be required to increase the coverage limits under the group policy or to purchase additional individual term insurance coverage on Dr. X's life, a possibility eliminated by this arrangement. Fourth, the arrangement eliminates the necessity to purchase incremental coverage in each year that Dr. X's salary increases and thereby avoids the requirement of an annual physical exam. Lastly, the arrangement also reduces the amount of taxable income that is imputed to Dr. X compared to what would be imputed if a group term insurance policy were used to provide the coverage.

Under the proposed arrangement, premiums paid by Foundation will be lower than what Foundation would pay for a group term insurance policy. The decrease in premium payments will be approximately $z over the full period of Dr. X's expected employment.

In addition, the proposed arrangement entitles Foundation to a share of the policy proceeds upon Dr. X's death, if he dies while employed by Foundation. In light of the expected cost savings, sharing of policy proceeds upon Dr. X's death while employed by Foundation and the other advantages of the arrangement, Foundation believes that the proposed arrangement is to its advantage.

Foundation has retained a nationally recognized executive compensation consulting firm to assist in its review of the proposed compensation package provided Dr. X. That firm has advised that the compensation package is competitive in relation to the Foundation's peer group, including other large foundations and institutions of higher education. Using information provided by the consulting firm, Foundation has determined that the total compensation and other benefits to be provided Dr. X, including the split-dollar life insurance policy, will be reasonable in relation to his services to Foundation as President and CEO and as a trustee.

Foundation also contemplates entering into an additional agreement with Dr. X to govern the payment of premiums and to define the rights and interests of the parties with respect to the policy. Under the proposed arrangement, Foundation will be the purchaser and owner of the policy. As owner, Foundation will be entitled to exercise all policy rights except for designation of the beneficiary of a portion of the proceeds. The policy will provide for a $x benefit payable at Dr. X's death. (This amount will provide coverage to a level that is expected to be greater than the maximum amount of insurance that Foundation will be obligated to provide under the employment agreement over the expected term of Dr. X's employment.) The responsibility for payment of policy premiums will be divided between Foundation and Dr. X as follows:

(a) Foundation's portion of each premium will be an amount calculated as sufficient (i) to provide insurance coverage equal to the sum of (A) two times Dr. X's base salary at the time such premium payment is due and (B) the total of the premiums paid by the Foundation through the end of the policy period for which premiums have been paid, less (ii) the "economic benefit" (based on the lesser of the P.S. 58 costs and the insurance company's one-year term life insurance rates) attributable to this insurance coverage. Foundation's portion of the insurance coverage will increase in each year that Dr. X's base salary increases, although the dollar amount of Foundation's premium is expected to decrease over time.

(b) Dr. X's portion of each premium will be an amount equal to the sum of (i) the "economic benefit" attributable to the insurance coverage as noted above, and (ii) the cost of additional insurance (in excess of the coverage described in clause (i) above) to bring the policy death benefit to $x. The amount of the insurance coverage for which Dr. X will pay will decrease each year as the Foundation portion increases, but the economic benefit to Dr. X will increase each year, resulting in an expected increase in the total dollar amount payable by him over time.

Each party's portion of the premium payments will be paid directly to the insurance company. At no time will any premium payments attributable to Dr. X's portion be made to or through the Foundation or any other tax-exempt organization.

The proposed agreement will also provide that Dr. X has an "endorsement" right on the policy to name the beneficiary of a portion of the policy proceeds at his death. Dr. X will be permitted to assign this endorsement right and any other rights he has under the agreement (for example, to designate a transferee of the policy upon Dr. X's retirement as provided below) to another party such as Dr. X's irrevocable life insurance trust. (The assignee will also assume Dr. X's obligations under the agreement, including payment to the insurance company of Dr. X's portion of the insurance premiums.) Pursuant to the proposed arrangement, upon Dr. X's death while still employed by Foundation, Foundation will be entitled to policy proceeds in an amount equal to the

total amount of premiums paid by Foundation. The balance of the policy proceeds will be paid by the insurance company to the beneficiary named by Dr. X (or his assignee).

The proposed agreement further provides that upon Dr. X's retirement from Foundation, Foundation will transfer the policy to such transferee as Dr. X (or his assignee) has designated in writing. For example, the policy may be transferred to the irrevocable insurance trust or another party for the benefit of Dr. X's family. Under this approach, the policy will be transferred upon termination of Dr. X's employment unless Dr. X terminates his employment (other than through retirement, disability or death) or the Foundation terminates him for "cause" as defined in the employment agreement. As a result of this transfer, the transferee of the policy will become the owner of the policy and will have all rights with respect to the policy. Foundation will take the policy's value (as of the anticipated time of transfer) into account in determining other benefits that Dr. X will receive from Foundation to insure that his overall compensation package does not result in the payment of unreasonable compensation. In the event the policy is terminated prior to the retirement, disability or death of Dr. X, there would be no amount for Dr. X's beneficiaries.

Section 501(c)(3) of the Code provides for exemption from federal income tax for corporations organized and operated exclusively for charitable and other enumerated exempt purposes, provided that no part of the corporation's net earnings inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(c)(2) of the Income Tax Regulations provides that an organization will not be considered as operating exclusively for charitable purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals.

Section 1.501(a)-1(c) of the regulations defines "private shareholder or individual" as persons having a personal and private interest in the activities.

The IRS has consistently held that the prohibition against private inurement is not violated if the tax-exempt organization pays reasonable compensation for services provided to the organization. For example, in Rev. Rul. 73-126, 1973-1 C.B. 220, the IRS determined that a tax-exempt organization's payment of pensions to retired employees does not constitute inurement to private individuals as the payment of pensions, if reasonable in amount, is an accepted method of employee compensation and a proper expense in the operation of the organization's charitable activities. Courts have similarly held that the payment of compensation to a trustee, officer or other person for services to the tax-exempt organization does not result in inurement of net earnings to the benefit of a private shareholder or individual if the compensation is reasonable and in furtherance of the organization's exempt purposes. See, World Family Corporation v. Commissioner, 81 T.C. 958 (1983); Mabee Petroleum Corporation v. U.S., 203 F.2d 872 (5th Cir. 1953.

Your submission states that the services rendered by Dr. X, as President and CEO, and as trustee of Foundation, are necessary to carry out Foundation's exempt purposes. Accordingly, Foundation's payment of reasonable compensation to Dr. X for his services is a necessary expense incurred in furtherance of its exempt purposes. The payment of compensation in the form of payment of premiums on a split-dollar life insurance plan is an accepted method of employee

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compensation, and is not in itself an excessive or otherwise unreasonable compensation arrangement.

Notice 99-36, 1999-26 I.R.B. 1, warns taxpayers and exempt organizations that IRS will challenge certain charitable split-dollar insurance transactions that purport to give rise to charitable contribution deductions under section 170 or 2522 of the Code. In general, these transactions involve a transfer of funds by a taxpayer to a charity, with the understanding that the charity will use the transferred funds to pay premiums on a cash value life insurance policy that benefits both the charity and the taxpayer's family. Typically, as part of this transaction, the charity or an irrevocable life insurance trust formed by the taxpayer purchases the cash value life insurance policy. The designated beneficiaries of the policy include both the charity and the trust. Members of the taxpayer's family are beneficiaries of the trust.

The split-dollar arrangement described in the Notice also involves an agreement between the charity and the taxpayer specifying what portion of the insurance policy premiums is to be paid by the trust and what portion is to be paid by the charity; the extent to which each party can exercise standard policyholder rights; the manner in which the policy may be terminated and the consequences of such termination. A common feature of these arrangements is that, over the life of the split-dollar agreement, the trust has access to a disproportionately high percentage of the cash-surrender value and death benefit under the policy, compared to the percentage of premiums paid by the trust.

As part of the transaction, the taxpayer may also attempt to deduct from his income the amount of the funds transferred to charity and subsequently used to pay a portion of the insurance premium. Notice 99-36 warns the public that taxpayers participating in this type of split-dollar insurance transaction are not entitled to a charitable contribution deduction under section 170 or 2522 for the funds transferred to the charity because it violates the partial-interest rule in sections 170(f)(3)(B)(ii) and 1.170A-7(a)(2)(i) of the regulations.

Foundation has represented that each party's portion of the premium payments will be paid directly to the insurance company, and that neither Dr. X (nor his assignee) will transfer any funds to Foundation for payment of premiums attributable to Dr. X's portion of the premium. No premium payments attributable to Dr. X's portion will be made to or through Foundation or any other tax-exempt organization. In addition, Foundation has submitted evidence that its method of allocation for insurance premium payments is part of a compensation agreement that takes into consideration the financial benefit of the split-dollar insurance transaction to Dr. X and results in no more than reasonable compensation being paid to Dr. X.

Based on the representations that the provision of the split-dollar insurance policy is part of a reasonable compensation package for Dr. X's services, the proposed arrangement will not result in prohibited inurement of Foundation's earning to the benefit of Dr. X or any other private individual, and therefore will not adversely affect Foundation's tax exempt status under section 501(c)(3) of the Code. Notice 99-36 is not applicable to this transaction.

Section 4941(d)(1) of the Code enumerates a number of acts that are considered to be acts of self-dealing between a private foundation and a "disqualified person." These include:

(a) any direct or indirect sale or exchange , or leasing, of property between a private foundation and a disqualified person [4941(d)(1)(A)];

(b) any direct or indirect payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person [4941(d)(1)(D)]; and

(c) any transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation [4941(d)(1)(E)].

Section 4941(d)(2) of the Code enumerates certain exceptions to the foregoing rules. For example, section 4941(d)(2)(E) provides that, except in the case of a government official (as defined in section 4946(c)), the payment of compensation (and the payment or reimbursement of expenses) by a private foundation to a disqualified person for personal services which are reasonable and necessary to carrying out the exempt purpose of the private foundation shall not be an act of self-dealing if the compensation (or payment or reimbursement) is not excessive. See section 53.4941(d)-3(c)(1).

The term "disqualified person" is defined in section 4946 of the Code. Under section 4946(a)(1)(B), disqualified persons include a "foundation manager" as defined in section 4946(b)(1). This definition includes an officer, director, or trustee of a private foundation. Dr. X, therefore, is a disqualified person with respect to Foundation. Disqualified persons also include family members (as defined in section 4946(d)) of an officer or trustee, and trusts in which disqualified persons hold more than 35 percent of the beneficial interest. (See section 4946(a)(1)(D) and 4946(a)(1)(G). Accordingly, members of Dr. X's family such as his wife and children, and the Irrevocable Insurance Trust, are also disqualified persons with respect to Foundation.

In Rev. Rul. 74-591, 1974-2 C.B. 385, the IRS, citing the section 4941(d)(2)(E) self-dealing exception, held that payment of a pension by a private foundation to one of its directors, a disqualified person, for past services as a foundation employee, did not constitute an act of self-dealing under section 4941(d)(1). The services performed by the disqualified person were considered reasonable and necessary to fulfilling the foundation's exempt purposes, and the total compensation to the director, including the pension, was reasonable in relation to the services.

Similarly, in Rev. Rul. 74-405, 1974-2 C.B. 384, the IRS ruled that the payment of premiums by a private foundation for insurance indemnifying a disqualified person against liability for claims arising from the person's foundation responsibilities was not an act of self-dealing under section 4941, so long as the amount of premiums paid would not cause the total compensation of the disqualified person to be excessive. The IRS ruled in Rev. Rul. 82-223, 1982-2 C.B. 301, that the payment of premiums by a private foundation for an insurance policy providing liability insurance for its foundation manager for all liabilities arising under state mismanagement laws was not an act of self-dealing, as long as the premiums paid were treated as compensation paid to the manager and the total compensation was not excessive.

The self-dealing rules permit private foundations to pay reasonable compensation, including insurance benefits, to officers and trustees for their services in carrying out a foundation's exempt

purposes. You have indicated that the payments to be made under the proposed agreement are part of a reasonable compensation package for Dr. X's services to Foundation.

Foundation's proposed arrangement, as herein described, requires Dr. X and Foundation to share the responsibility for paying for the policy and reallocates premium payments every year. The premiums (as reallocated) will be paid by each of Dr. X (or his assignee) and Foundation directly to the insurance company and do not constitute a sale, exchange or other transaction of property between Foundation and Dr. X (or his assignee) within the meaning of section 4941(d)(1)(A). You have stated that the proposed arrangement is part of a compensation package Foundation plans to offer Dr. X. Foundation has secured the advice of a nationally recognized compensation consulting firm that has advised that the proposed insurance arrangement will not result in Dr. X receiving compensation in excess of similarly situated executives in other large foundations and institutions of higher learning. Based on the understanding that the premium payments will not cause Dr. X's overall compensation to be unreasonable, the premium payments will not be considered acts of self-dealing under sections 4941(d)(1)(D) or 4941(d)(1)(E), because they fall within the exception provided by section 4941(d)(2)(E).

Foundation's proposed arrangement also calls for the transfer of the split-dollar life insurance policy to Dr. X or his designated beneficiary upon termination of his position with Foundation other than by death unless he is terminated for cause. You have indicated that the value of the policy at the time of transfer will be taken into consideration when negotiating Dr. X's compensation package for that year so as assure that his overall compensation will not be excessive. Although the transfer of the policy will be to a disqualified person with respect to Foundation, the transfer will also fall within the exception for the payment of reasonable compensation as permitted under section 4941(d)(2)(E) so long as the overall compensation package is not unreasonable.

The proposed arrangement also permits Dr. X to assign his rights under the agreement to another party such as Dr. X's irrevocable life insurance trust. An assignment by Dr. X of his rights under the proposed arrangement, and the assignee's exercise of such rights and assumption of obligations under the agreement (including payment directly to the insurance company of Dr. X's portion of the insurance premiums) will not constitute acts of self-dealing under section 4941. None of these actions involves a sale, exchange or other transfer of property between Foundation and a disqualified person in violation of section 4941(d)(1)(D) or 4941(d)(1)(E).

Section 4945(d)(5) of the Code provides that the term "taxable expenditure" includes any amount paid or incurred by a private foundation for any purpose other than a charitable or other exempt purpose specified in section 170(c)(2)(B).

Section 53.4945-6(b)(2) of the Foundation and Similar Excise Taxes Regulations provides that expenditures for unreasonable administrative expenses, including compensation and other fees for services rendered, will ordinarily be taxable expenditures under section 4945(d)(5), unless the private foundation can demonstrate that such expenses were paid or incurred in the good faith belief that they were reasonable and that the payment or incurring of such expenses in such amounts was consistent with ordinary business care and prudence. The determination of whether an expenditure is unreasonable depends upon the facts and circumstances of the particular case.

In Rev. Rul. 82-223, supra, the IRS held that the payment of premiums by a private foundation for an insurance policy providing liability insurance did not constitute a taxable expenditure under section 4945, so long as the premiums paid by the foundation were treated as compensation paid to the manager and the total compensation paid to the manager was not excessive.

The proposed arrangement is part of a compensation package for Dr. X's services to the Foundation. Foundation has taken steps, including consulting a nationally recognized firm specializing in the area of executive compensation, to structure the total compensation package so as to provide reasonable compensation to Dr. X. Based on the representation that the total compensation paid is reasonable, the proposed arrangement will not result in a taxable expenditure under section 4945 of the Code.

This ruling is based on the understanding that there will be no material changes in the facts upon which it is based. The ruling is further conditioned on the total compensation paid to Dr. X in any year not being determined to be excessive or otherwise unreasonable.

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

We are informing your Area Manager of this ruling. Please keep a copy of it 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,

Gerald V. Sack

Gerald V. Sack
Manager, Exempt Organizations
Technical Group 4