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## **Trusts: Common Law and IRC 501(c)(3) and 4947**

By Ward L. Thomas and Leonard J. Henzke, Jr.



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### Overview

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#### Purpose

The Service published a lengthy and sophisticated discussion of trusts, with particular detail on split-interest trusts, in "Trust Primer," 2001 EO CPE 79. This office, however, continues to receive requests from EO examination and determination specialists for basic legal information on trusts. This article will discuss common-law and federal tax definitions, distinctions, and rules regarding trusts, with a focus on charitable trusts and IRC 501(c)(3), and some discussion of IRC 4947.

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#### In this article

This article contains the following topics:

Topic	See Page
Overview	1
Basic Legal Rules Regarding Trusts and IRC 501(c)(3)	3
What is a trust?	4
Who are the parties to a trust?	5
Can a trust exist without assets?	7
Can a trust exist without a trustee?	8
How many trustees are required?	9
Does a trust have to be registered with the State?	10
When does a trust begin to exist for IRC 508(a) purposes?	11
How are courts involved in the regulation of trusts?	12
Can a trust exist without beneficiaries? (cy pres)	14
Can a trust exist without a written document?	16
Can a trust carry on business?	17
Are there special tax rules for trusts?	18
How do private trusts differ from charitable trusts?	19
How does trust income differ from trust principal?	21
How does a beneficiary's income interest differ from a remainder interest?	22
Can a revocable trust qualify under IRC 501(c)(3)?	23
How does an inter vivos trust differ from a testamentary trust?	24
What is a community trust?	25

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*Continued on next page*

## Overview, Continued

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**In this article,  
continued**

<b>Topic</b>	<b>See Page</b>
What is a non-exempt charitable trust?	26
What is a split-interest trust?	27
Can a split-interest trust qualify under IRC 501(c)(3)?	28
Why are 4947 trusts treated like private foundations?	29
Can a non-exempt charitable trust apply for 501(c)(4) status and avoid the 4947 rules?	30
When does the application of IRC 4947(a)(1) to a non-exempt charitable trust begin?	31
When does the application of IRC 4947(a)(2) to a split-interest trust begin and end?	33
Can charitable trust assets be used to pay estate settlement expenses?	34

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## **Basic Legal Rules Regarding Trusts and IRC 501(c)(3)**

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### **Introduction**

The following Q&As discuss basic definitions, distinctions, and rules regarding trusts and IRC 501(c)(3). Much of the discussion focuses on State common law concepts regarding trusts.

- State law creates legal interests and rights; federal tax law designates what interests or rights, so created, shall be taxed. Morgan v. Commissioner, 309 U.S. 78, 80 (1940).
  - The law in any particular State may differ from a general rule discussed below, so it may sometimes be necessary to refer to the law in the particular State involved. There is no uniform or model law of trusts adopted by most States, although a few uniform laws relating to certain aspects of trusts have been widely adopted.
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## What is a trust?

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**Kind of organization**

Trusts are one of the major forms of organization for federal tax purposes, along with corporations, partnerships, and governmental units.

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**Restatement definition**

The Restatement (Second) of Trusts (1959) (hereafter "Restatement") § 2 defines a trust generally as

a fiduciary relationship with respect to property, subjecting the person by whom the title to the property is held to equitable duties to deal with the property for the benefit of another person, which arises as a result of a manifestation of an intention to create it.

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**Regs definition**

Reg. 301.7701-4(a) defines a trust as

an arrangement created either by will or inter vivos declaration whereby trustees take title to property for the purpose of protecting and conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts . . . . Generally speaking, an arrangement will be treated as a trust under the Internal Revenue Code if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.

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**Differences**

The regulations emphasize the non-business character of the activity; thus a trust for State law purposes may be treated as a corporation or partnership for federal tax purposes.

- However, both definitions emphasize a relationship among several parties.
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## Who are the parties to a trust?

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<b>Parties</b>	Trusts are defined in terms of parties (grantor, trustee, beneficiary) and relationships pertaining to the trust property.
<b>Grantor</b>	<p>Every express trust has one or more grantors who contribute the property to the trustee and state the terms of the trust. The grantor is deemed a substantial contributor/disqualified person with respect to the trust, under IRC 507(d)(2)(A). Other names for the grantor include:</p> <ul style="list-style-type: none"><li>• creator</li><li>• donor</li><li>• founder</li><li>• settlor</li><li>• Trustor</li></ul>
<b>Trustee</b>	<p>The trustee or trustees receive the property and hold it for the benefit of one or more beneficiaries.</p> <ul style="list-style-type: none"><li>• The trustee is the legal owner of the property but must use it for the benefit of the beneficiaries. As a fiduciary, he owes the beneficiaries duties of loyalty and care.</li><li>• The trustee may be an individual or organization. <u>Restatement</u> § 378. Trust companies and banks specialize in acting as trustees in addition to conducting banking and loan business.</li><li>• The grantor and trustee ordinarily may be the same person, and may create the trust by declaring that he holds certain property in trust. <u>Restatement</u> § 349(a). The sole trustee and sole beneficiary may not be identical, because the purpose of a trust is to separate the legal and equitable interests. <u>Restatement</u> § 115.</li></ul>
<b>Beneficiary</b>	The beneficiary, also known as the cestui que trust, is the beneficial or equitable owner of the property. The beneficiary is said to have the "use" of the property, and can appeal to the court for an accounting or replacement of the trustee to ensure proper use of the property. See <u>Black's Law Dictionary</u> (5 <sup>th</sup> Ed. 1979), "use."

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**Who are the parties to a trust?, Continued**

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**Property**

Alternative names for the property transferred to the trust are the:

- Capital
  - Corpus
  - Estate
  - Principal
  - Res
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## Can a trust exist without assets?

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**Assets required** By definition, a trust is a legal relationship with regard to property. Thus, the common-law rule is that a trust does not exist without a res. Am. Jur. 2d "Trusts" § 47. The res may be of nominal value (e.g., \$1).

- A charitable trust may be created by a transfer (inter vivos or by will) by the owner (or a person with a power of appointment) of property to another person to hold the property upon a charitable trust. Restatement § 349.
  - Alternatively, the owner may simply declare that he holds his property upon a charitable trust--no transfer of title is necessary. Id.
  - A promise to transfer property to the trustee does not create a trust unless the promise is enforceable as a contract. Id.
  - A trust that lists no assets in its Form 1023 balance sheet should be required to cite the proper State law that it nonetheless exists as a valid trust under State law.
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## Can a trust exist without a trustee?

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**Trust still exists** Trustees may die, resign, become incompetent, or be removed as trustee by the court for cause (e.g., mismanagement). See Am. Jur. 2d "Trusts" § 254. If a trust loses its trustees, the court will appoint others--a trust will not fail for lack of a trustee, unless the settlor manifests a contrary intent. Restatement § 388, 397. Similarly, if a transfer of property to trust is ineffective only because no trustee is named in the instrument of conveyance or the trustee is dead or incapable of taking title, a charitable trust is created. Restatement § 353(2).

- If a trust loses all of its trustees during the application process, the determination specialist should ordinarily wait until the new trustees are appointed before recognizing exemption, to ensure that the trust will in fact continue. Also, as discussed below, the number and identity of the trustees could be a material factor in determining whether the trust serves a private interest.
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## How many trustees are required?

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**Single trustee may be permissible,**

A single trustee is all that is required of trusts under State law, although a typical arrangement for a charitable trust is a governing board of several trustees that makes decisions by majority rule. Restatement § 383. Rev. Rul. 66-219, 1966-2 C.B. 208, held that a 501(c)(3) organization is not precluded from exemption merely because the creator of the organization (if a trust) is either the sole or controlling trustee or merely because the organization is controlled by one individual.

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**But not recommended**

In the case of a single-trustee organization claiming public charity status, however, the lack of oversight inherent in such situation is a very unfavorable fact (private foundations are subject to strict prohibitions against self-dealing under IRC 4941).

- Sole corporate trustees are less objectionable (e.g., in the context of testamentary trusts), except where the trustee plans to do business with itself or related entities with the trust's funds.
- Even three-member boards have been held to present a problem where there are other unfavorable facts. See, e.g., Church of Ethereal Joy v. Commissioner, 83 T.C. 20 (1984) (three-member, self-perpetuating board provides an obvious opportunity for abuse of the claimed tax-exempt status).
- A large, community-based board of trustees is a favorable fact in determining whether the trust is operated exclusively for charitable purposes and is (or may reasonably be expected to be) publicly supported. See, e.g., Rev. Rul. 69-545, 1969-2 C.B. 117; Regs. 1.170A-9(e)(3)(v) and (5)(ii) and 1.509(a)-3(d)(3)(i).

## **Does a trust have to be registered with the State?**

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- No State filing** Unlike corporations, LLCs, or limited partnerships, trusts generally do not file their governing instrument with the State to become legal. However, a will that includes a testamentary trust is filed with the court as part of the will probate process.
- A few States have adopted Article VII of the Uniform Probate Code, which requires the trustees of all trusts to register in the court of the principal place of administration of the trust. The Uniform Probate Code imposes penalties on the trustee for failure to register but does not invalidate the trust.
  - The trust instrument usually indicates the State law under which the trust is organized. If it doesn't, the determination specialist should ascertain the State law, and get a representation from the trust that it is properly organized under the State law, particularly if there is doubt as to the validity of the trust.
  - Like other nonprofit organizations, trusts must keep orderly financial books and records, and minutes of meetings and decisions/resolutions by their trustees. See IRC 6001; Rev. Rul. 59-95, 1959-1 C.B. 627
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## When does a trust begin to exist for IRC 508(a) purposes?

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### **Sometimes it matters**

To be exempt from the date of organization, an organization must file its Form 1023 Application within 15 months from the end of the month in which it was "organized." Reg. 1.508-1(a)(2).

- While there is liberalized late filing relief under Reg. 301.9100-2 and -3, it still sometimes matters when a trust was organized.
  - The regulations define an organization as organized when it becomes described in IRC 501(c)(3) but do not otherwise define when a trust is organized.
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### **Testamentary trust**

The Service wrestled with this issue in GCM 38529 (Oct. 6, 1980). The GCM recommended that for purposes of IRC 508(a), a testamentary trust be considered organized as of the earlier of:

1. The date of the first distribution of corpus to the trustee, or
2. The date the decedent's estate is considered terminated for tax purposes.

Counsel rejected the idea that the time of application of IRC 4947(a) should control for IRC 508(a) purposes, and reasoned in part that the tax imposed under subchapter J "shall apply to the income of estates or of any kind of property held in trust." Reg. 1.641(a)-1.

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### **Inter vivos trust**

The reasoning of GCM 38529 appears applicable to inter vivos trusts as well. They should be considered organized as of their initial funding e.g., the date of the first distribution of corpus to the trustee.

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## How are courts involved in the regulation of trusts?

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### Reformation of instrument

A trustee (particularly of a testamentary trust) may need to go to court to change the trust terms in order to comply with IRC 501(c)(3) or 508(e).

- Courts will permit a reformation if compliance with the original terms is impossible, illegal, or (owing to circumstances not anticipated by the settlor) would substantially impair the accomplishment of the purposes of the trust. Restatement § 381.
  - Examiners and determination specialists should be aware of this possible requirement when asking trustees to make changes in the trust document.
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### Other court proceedings

Courts are involved in the administration of trusts in many other ways.

- Trustees (particularly of testamentary trusts) may be required to account to the court for their administration of the trust, both periodically and upon termination.
  - Beneficiaries may sue for an accounting or to replace the trustee. Restatement §§ 387, 391.
  - The trustee may voluntarily account to the court for the court's approval and the trustee's own protection. Restatement § 260.
  - Trustees may bring legal proceedings to receive instructions from the court on the proper course of action. Restatement § 394.
- 

### Chancery

Legal proceedings involving the administration of trusts are usually proceedings in chancery. Am. Jur. 2d "Trusts" § 324.

- Trusts, with their separation of legal and equitable property interests, arose under English law. Historically, England had two court systems, courts of law and courts of equity or chancery. Law courts applied fixed rules, whereas the equity courts applied more flexible principles of justice based on considerations of equity or fairness. Law courts handled claims for money or property, whereas equity courts handled questions whether a person should be required to do certain acts, and under what conditions. Most States have abolished the separate courts of law and chancery, but many vestiges of the separate systems remain. Restatement § 2 Comment f.
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## **How are courts involved in the regulation of trusts?, Continued**

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**Chancery,  
continued**

- By statute, the State court of jurisdiction for trusts is often a special court known as Probate, Surrogate, or Orphan's Court. Black's Law Dictionary, "probate court." These courts have jurisdiction over probate of wills and administration of trusts and estates, as well as cases involving guardianships and minors.
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## Can a trust exist without beneficiaries? (cy pres)

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**Hypothetical** Suppose that a charitable trust is established to benefit X Hospital and has no contingency plan if X Hospital goes out of existence. Suppose X Hospital does go out of business. Was the trust charitable initially? Is the trustee now required to terminate the trust and return the property to the grantor?

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**Trustor's intent and cy pres** A primary rule of judicial interpretation of trusts is to determine and honor the trustor's intent at the time of creating the trust. Am. Jur. 2d "Trusts" § 35. In some cases, a particular charitable purpose stated in the trust instrument may become impossible, impracticable, illegal, or accomplished. If the court determines that the settlor had a more general charitable purpose, it may direct the application of the property to some charitable purpose which falls within the settlor's general charitable intention. Restatement § 399. This is the doctrine of cy pres ("as near as possible").

- In the case of X Hospital, the cy pres doctrine will be applied, and the court may direct the property to be applied to another hospital unless the trust terms provide otherwise. Restatement § 399 Comment o. However, the State laws are not uniform in the application of the cy pres doctrine.
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**Application of cy pres** The cy pres doctrine may apply in determining whether a trust's assets are dedicated by operation of law to an exempt purpose. Rev. Proc. 82-2, 1982-1 C.B. 367, as updated by Exempt Organizations Technical Guidelines Handbook IRM 7.8.2.3.3.6.4.1 (Feb. 23, 1999), sets forth guidelines for determining whether and under what circumstances States would apply the doctrine for this purpose.

- If the cy pres doctrine does not apply, then the trust instrument must expressly provide for dedication of the assets to charitable purposes upon dissolution. Reg. 1.501(c)(3)-1(a)(4).
  - In many cases, the IRS must determine whether the settlor had a general charitable intent, which may not be easy to determine. The case law of the particular State is highly relevant. One guideline is that courts are more likely to find a general charitable intention where the particular charitable purpose fails down the road than at the outset of the trust. Restatement § 399 Comment i. For an example of the application of cy pres, see GCM 39377 (Sept. 28, 1984).
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**Can a trust exist without beneficiaries? (cy pres), Continued**

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**Application of  
cy pres,  
continued**

- The taxpayer bears the burden of proof on this matter and should furnish a written legal opinion of counsel. EO agents may wish to seek guidance from EO Rulings & Agreements. In cases of doubt, the taxpayer should be required to amend the trust instrument to provide for the permanent dedication of assets for charitable purposes in the event that a beneficiary fails or the trust terminates.
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## Can a trust exist without a written document?

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**Express vs. implied trust**

Yes, but it will not pass the 501(c)(3) organizational test.

- An "express" trust, also known as a "direct," "technical," or "voluntary" trust, is declared in express terms (either oral or written) by the grantor.
- "Implied" trusts (including "constructive" or "involuntary" trusts and "resulting" trusts) are equitable remedies imposed by courts to prevent unjust enrichment. Am. Jur. 2d "Trusts" § 163.
- A court may impose a "constructive" trust upon the holder of property acquired through fraud, mistake, or undue influence. Am. Jur. 2d "Trusts" § 160.
- A "resulting" trust in favor of the grantor generally arises where a trust fails - the trustee must hold the property for the grantor or his estate. Restatement § 411.

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**501(c)(3) organizational test**

Since a written instrument with certain terms is required under the organizational test (Reg. 1.501(c)(3)-1(b)(2)), only an express written trust will pass muster under IRC 501(c)(3).

- The trust instrument ordinarily is signed by either the grantor or both the grantor and trustee. A copy of the signed document will satisfy the requirements of Rev. Proc. 90-27, 1990-1 C.B. 514, Section 5.05(6).

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**Document title**

The written document governing the trust typically is given one of the following titles, although no title is necessary:

- agreement
  - declaration
  - deed
  - indenture
  - instrument
  - will/testament (for testamentary trust)
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## Can a trust carry on business?

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**May conduct business**

Trusts are generally not precluded under State law from conducting business, if authorized to do so under the terms of the trust instrument. Am. Jur. 2d "Trusts" § 349.

- A trust may qualify under IRC 501(c)(3) even though it conducts business activity, whether related or unrelated.
  - However, corporations are the usually the preferred form for conducting business, for liability purposes. The trustee of a charitable trust is personally liable for torts committed in the course of administration of the trust if the trustee was personally at fault, and personally liable on contracts unless the contract provides otherwise. Restatement §§ 402, 403. The tort and contract creditors can also reach the trust property. Id. The trustee generally may receive indemnification from the trust. Am. Jur. 2d, "Trusts" §§ 397, 454.
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## **Are there special tax rules for trusts?**

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<b>EO matters</b>	<p>Yes. In the EO area, it is necessary in some cases to determine whether the entity in question is taxable as a trust.</p> <ul style="list-style-type: none"><li>• Exempt trusts are taxed on UBTI like taxable trusts, and the trustees are similarly responsible for payment. See IRC 511(b) and Reg. 1.511-3(a).</li><li>• There are special tax rules for nonexempt charitable trusts and split-interest trusts (as defined in IRC 4947).</li><li>• Some IRC 501 exemptions are not available to trusts (e.g., IRC 501(c)(2)). A few exemptions are limited to trusts (most notably, 401(a) trusts exempt under IRC 501(a)).</li></ul>
<b>Tax classification of entity</b>	<p>An organization is classified as a business entity (corporation or partnership) rather than a trust for tax purposes if it conducts business for the profit of its owners. Reg. 301.7701-4(a).</p> <ul style="list-style-type: none"><li>• The holding of stocks and bonds and the passive rental of real estate are not considered the conduct of business for this purpose.</li><li>• Trusts are subject to a special tax regime under subchapter J of the Code, different from corporations/associations and partnerships, so the distinction under IRC 7701 is important for taxable entities.</li></ul>

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## How do private trusts differ from charitable trusts?

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<b>Introduction</b>	IRC 501(c)(3) requires that an organization's purposes be exclusively charitable. The tax laws derive from common-law distinctions between charitable and private trusts.
<b>Private trust - definite beneficiaries</b>	A private trust requires a beneficiary that is definitely ascertained at the creation of the trust or definitely ascertainable within the period of the rule against perpetuities. <u>Restatement</u> § 112. The members of a definite class of persons can be the beneficiaries of a private trust, but the members of an indefinite class generally cannot be. <u>Restatement</u> §§ 120, 122.
<b>Charitable trust - indefinite beneficiaries</b>	<p>By contrast, a cardinal rule of a charitable trust is that the persons who are to benefit must be a sufficiently large or indefinite class that the community is interested in the enforcement of the trust. <u>Restatement</u> § 375. A charitable trust (sometimes referred to as a "public" trust or in some cases a "governmental" trust) holds its property for a charitable purpose. <u>Restatement</u> § 348; <u>Black's Law Dictionary</u>, "trust," "governmental trusts."</p> <ul style="list-style-type: none"><li>• The law defining a charitable purpose arose from the common law of trusts (and "uses", the historical antecedent of trusts), as trusts were the primary form of charitable organization in the past. Thus, legal treatises on trusts (e.g., by Scott and Bogert) are widely cited as to the definition of a charitable purpose. The 501(c)(3) prohibition against purposes contrary to law or public policy also derives from the common law of trusts. See Rev. Rul. 75-384, 1975-2 C.B. 204. Ordinarily the principles applicable to charitable trusts are applicable to charitable corporations. <u>Restatement</u> § 348 Comment f.</li></ul>
<b>Limited vs. unlimited term</b>	<p>Another distinction between private and charitable trusts is their term. Under the common law, private trusts have a limited term, whereas charitable trusts may exist forever. <u>Restatement</u> § 365.</p> <ul style="list-style-type: none"><li>• Private trusts are ordinarily subject to the common law rule against perpetuities, which prohibits the granting (at the time the trust becomes irrevocable) of an interest in property that will not necessarily vest within a time limited by a life or lives in being (including actual periods of gestation for the unborn) plus 21 years. <u>Revocable Inter Vivos Trusts</u>, 468-2<sup>nd</sup> Tax Management A-10. The rule has been modified or abolished by statute in some States. <u>Id.</u></li></ul>

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## How do private trusts differ from charitable trusts?, Continued

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**Government enforcement**

Another distinction is that the State (usually by the Attorney General) may enforce a charitable trust but not a private trust. Restatement, Charitable Trusts Introductory Note.

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**Split interests and reformation**

A trust may have both charitable and private interests. Although it would not qualify under IRC 501(c)(3) (see discussion below regarding split-interest trusts), a court might allow the trust to be reformed into one wholly charitable and one wholly private trust so as to allow for exemption for the charitable trust.

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**Single vs. multiple trusts**

In some cases, a single document (e.g., a will) may create several trusts, depending on the creator's purpose as determined by the words used in the document.

- Terms referring to several trusts, funds, or estates, and requiring segregation of funds, may indicate the intention to create several trusts. Am. Jur. 2d, "Trusts" § 27.
  - However, multiple trusts arising from a single document may be treated as one for tax purposes to prevent abuses. See, e.g., IRC 643(f); cf. TAM 200047048 (June 22, 2000).
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## How does trust income differ from trust principal?

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<b>Introduction</b>	<p>In some situations, federal tax law defines income. In others, federal tax law incorporates by reference the State trust law definition.</p>
<b>State law looks to definition in instrument</b>	<p>A trust's "income" must be distinguished from its principal. Allocation of trust assets between principal and income affects the rights of the beneficiaries, as discussed below. Principal and income are, to a large extent, defined by the trust instrument.</p> <ul style="list-style-type: none"><li>• As of January 2000, 41 States had adopted some version of the Uniform Principal and Income Act. The latest (1997) version of the Act defines "principal" as property held in trust for distribution to a remainder beneficiary when the trust terminates, and "income" as money or property that the trustee receives as current return from a principal asset. Act Section 102. In allocating receipts and disbursements to or between principal and income, Act Section 103 sets forth the following hierarchy of rules:<ol style="list-style-type: none"><li>(1) allocate according to the terms of the trust</li><li>(2) allocate according to the provisions of the Act</li><li>(3) allocate to principal</li></ol></li></ul>
<b>Federal tax definitions</b>	<p>Federal tax and State trust law concepts of income may differ substantially.</p> <ul style="list-style-type: none"><li>• The Internal Revenue Code sets forth its own definition of gross and taxable income (IRC 61 and 63).</li><li>• It taxes ordinary income differently from capital gains, and has its own definition of capital assets (and "adjusted basis" used to compute capital gain or loss). IRC 1001 and 1221.</li><li>• However, the State law definition of income sometimes comes into play in calculating the taxable income of trusts under subchapter J. See IRC 643(b). Depending on the context, references to "income" in other parts of the Code and regulations may refer to State law income, particularly where used in conjunction with the terms "principal" or "corpus."</li></ul>

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## How does a beneficiary's income interest differ from a remainder interest?

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### **Income vs. remainder interest**

A trust does not qualify under IRC 501(c)(3) if any of its "income" or "lead" beneficiaries or "remainder" beneficiaries ("remaindermen") are not charitable. However, if the income interests have expired and the remainder interests are wholly charitable, then the trust may qualify under IRC 501(c)(3). Thus, agents should understand the difference between income and remainder interests.

- The income beneficiary typically has a right to the trust income (or a fixed percentage of the assets) for the period of his interest. The trust may provide the trustee with discretion to transfer principal to the income beneficiary as well.
  - The interest of an income beneficiary runs for a stated period, typically the life of the beneficiary (such interest is known as a "life estate," and the beneficiary as a "life tenant"). The remainder beneficiary is entitled to the remaining property at the end of the income beneficiary's interest.
  - The income beneficiary is said to have a "present interest" in the trust during the period of his interest, and the remainder beneficiary a "future interest" during such period.
  - If the future interest is fixed, it is "vested"; if it depends on some preceding condition (other than the passage of time or death of the income beneficiary), it is "contingent." See Black's Law Dictionary, "beneficiary," "income beneficiary," "remainder," and "vested."
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## Can a revocable trust qualify under IRC 501(c)(3)?

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### **Inurement to private individual**

A revocable trust ordinarily cannot qualify for exemption under IRC 501(c)(3).

- Rev. Rul. 66-259, 1966-2 C.B. 214, held that a trust which provides for the reversion of principal upon termination to the creator or his estate does not qualify, because upon reversion, any gains derived from investing the principal would flow to the individual.
  - If, however, the grantor were itself a 501(c)(3) organization or a governmental unit, then the grantor's power to revoke and receive back the assets would be permissible, as such organizations are not regarded as private shareholders or individuals.
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### **Definition: "revocable"**

A "revocable" or "reversionary" trust is an inter vivos trust in which the grantor has reserved to himself or another person the right to revoke the trust and have the trust assets returned to the grantor or some third party. Revocable Inter Vivos Trusts, 468-2<sup>nd</sup> Tax Management A-1.

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### **Express vs. implied right**

The general rule is that a settlor cannot revoke a trust unless he reserved a power to revoke. Restatement § 330. Usually the power of revocation (or the irrevocability) is expressly stated.

- A power of revocation is implied where the phrase "until otherwise directed" immediately follows a grant of power, and where the trustor has the right to demand any or the whole of the money settled in trust, at any time, for any use that he might make of it. Am. Jur. 2d, "Trusts" § 31.
  - If there is no statement as to revocability but the trust instrument has an express dissolution clause dedicating the assets to charitable purposes in accordance with Reg. 1.501(c)(3)-1(b)(4), then the trust may be regarded as irrevocable, absent State law to the contrary.
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### **Lapse of power upon death**

A grantor's power to revoke a trust ordinarily lapses upon his death, unless the applicable law allows the grantor to revoke by his will and he did so. Thus, a revocable trust ordinarily becomes irrevocable upon the grantor's death. Am. Jur. 2d, "Trusts" § 98.

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## How does an inter vivos trust differ from a testamentary trust?

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**Introduction** EO agents may see both inter vivos and testamentary trusts in exemption applications and examinations. Different tax rules may apply depending on the kind of trust involved.

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**Matter of timing** The difference is when the trust takes effect.

- A testamentary trust does not become operative until the grantor's death. A testamentary trust is executed as part of a will and must meet the requirements of a will, including admission into probate court. Restatement § 357.
  - An inter vivos trust, also known as a "living" or "lifetime" trust, becomes operative while the grantor is alive. Black's Law Dictionary, "trust." An inter vivos trust is often used as a will substitute to avoid the probate process, which often entails publicity, expense, and delay.
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**Uniform Testamentary Additions to Trusts Act**

The distinction is blurred somewhat by the Uniform Testamentary Additions to Trusts Act (the 1991 version has been adopted in 15 States). Unless the testator's will provides otherwise, the Act treats as a non-testamentary trust (and thus like an inter vivos trust) a trust that is created concurrently with a will in a separate written instrument and that becomes established at the testator's death.

- The Act reverses the common-law rule (see Restatement § 360) that treated such a trust as testamentary.
  - The Act allows for "pour-over" trusts, which receive their property at the grantor's death under a will provision.
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## **What is a community trust?**

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**Kind of publicly supported organization**

Community trusts typically qualify for exemption under IRC 501(c)(3). A community trust is a term used in the regulations defining publicly supported organizations under IRC 170(b)(1)(A)(vi). See Regs. 1.170A-10 through 13.

- A community trust historically is a group of separate trusts or funds subject to some control by a governing body of community representatives, with a purpose to collect, invest, and distribute funds for the benefit of the community.
  - If the group of funds meets the applicable requirements, the group is treated as a single entity for tax purposes. See Regs. 1.170A-10 and 11(i).
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## What is a non-exempt charitable trust?

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- IRC 4947(a)(1)** IRC 4947(a)(1) treats a trust as described in IRC 501(c)(3) for purposes of chapter 42 and IRC 507, 508(d) and (e), and 509 if all of the following conditions are met:
1. the trust is not exempt under IRC 501(a) (i.e., it is not recognized as exempt, though it would be recognized under IRC 501(c)(3) if it applied)
  2. all the interests/beneficiaries are charitable
  3. a charitable deduction was allowed to donors to the trust (or to the trust itself under IRC 642(c) in distributing or setting aside amounts for charity--Reg. 53.4947-1(b)(1)(i))

A trust that meets these conditions is known as a non-exempt charitable trust or NECT.

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**Deduction  
allowed  
regardless of  
IRC 508(a)**

Assuming that the other requirements for an income, gift, or estate tax charitable deduction are met, a contribution to an NECT is not disallowed as a charitable deduction on the ground that the NECT has not met the IRC 508(a) notice requirement by filing a Form 1023 Application.

- The various charitable deduction provisions are all subject to IRC 508(d). IRC 508(d)(2)(B) generally denies a charitable deduction for a contribution to an organization in a period for which it is not exempt under IRC 501(c)(3) for failure to timely file an application.
  - However, NECTs are excepted from the 508(a) notice requirement. See IRC 4947(a)(1) and Reg. 1.508-2(b)(1)(i)(a) and (viii). Peek v. Commissioner, 73 T.C. 912 (T.C. 1980) held that IRC 508(a) barred a deduction to an NECT, but the parties (involving a pro se litigant) and court apparently overlooked the above-cited Code and regulation.
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**Private  
foundation  
status**

If the trust does not qualify as a public charity, then it is treated as a private foundation for the purposes set forth above. NECTs also must file an information return under IRC 6033(d)(1).

- IRC 509(a)(3) is usually the most viable public charity alternative. A non-exempt charitable trust may apply to the Service for a ruling on 509(a)(3) status under Rev. Proc. 72-50, 1972-2 C.B. 830.
  - If the trust must amend its instrument to qualify under IRC 509(a)(3), then it is considered a PF until it terminates under IRC 507. Rev. Rul. 76-92, 1976-1 C.B. 160.
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## What is a split-interest trust?

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<b>Introduction</b>	Split-interest trusts were treated at length in "Trust Primer," 2001 EO CPE at 84-94. A brief review of the rules is provided here.
<b>Definition</b>	A split-interest trust is essentially a trust with both charitable and non-charitable beneficiaries. The term is a term of art in the Code and regulations referring to certain trusts described in IRC 4947(a)(2) that have both (1) assets for which a charitable deduction was allowed for income, estate, or gift tax purposes and (2) unexpired noncharitable interests.
<b>Private foundation status</b>	<p>Split-interest trusts are treated as private foundations for many of the same purposes as NECTs are so treated.</p> <ul style="list-style-type: none"><li>• Unlike NECTs, split-interest trusts are conclusively deemed to be private foundations.</li><li>• However, IRC 4942, and in most cases IRC 4943 and 4944, do not apply.</li><li>• Also, the private foundation rules do not apply to amounts payable to any non-charitable income beneficiaries, segregated amounts for which a charitable deduction was not allowed, and amounts transferred in trust before May 27, 1969.</li></ul>
<b>Kinds of split-interest trusts</b>	<p>There are two kinds of split-interest trusts: charitable remainder trusts (the most common), and charitable lead trusts.</p> <ul style="list-style-type: none"><li>• A pooled income fund, which may be regarded as a kind of charitable remainder trust subject to its own special rules, is also subject to IRC 4947(a)(2).</li></ul>

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## Can a split-interest trust qualify under IRC 501(c)(3)?

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### Not exempt

No. A trust with any non-charitable interests or beneficiaries is not organized and operated exclusively for charitable purposes - it benefits private interests, and a part of its net earnings inure to private shareholders or individuals. See, e.g., Rev. Ruls. 66-259, 1966-2 C.B. 214 (trust providing for reversion of principal on termination to creator not exempt under IRC 501(c)(3)); Rev. Rul. 69-256, 1969-1 C.B. 151 (trust that makes annual payments to charities and pays fixed sum for perpetual care of testator's burial lot not exempt under IRC 501(c)(3)); and Rev. Rul. 69-279, 1969-1 C.B. 152 (trust that pays fixed percentage of income annually to settlor with balance to charity not exempt under IRC 501(c)(3)).

- A distinction is to be made between such a trust, where the non-exempt interest is specified under the terms of the trust or is a charge against its general assets, and a 501(c)(3) organization's acceptance of an income-producing asset either:
  1. subject to a reserved life estate in the transferor, or
  2. in exchange for an annuity payable only out of income and corpus of the asset transferred--acceptance of such an asset is permissible. Rev. Rul. 69-176, 1969-1 C.B. 150.

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### Matter of timing

However, for charitable remainder trusts, the issue is a matter of timing. When the noncharitable interests have expired, such a trust may qualify under IRC 501(c)(3), and typically will apply for 501(c)(3) exemption if it plans on continuing to hold its charitable interests in trust (rather than liquidating and distributing its remaining assets to other 501(c)(3) organizations). See Reg. 53.4947-1(b)(1)(ii), Example (2).

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## **Why are 4947 trusts treated like private foundations?**

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**Prevent tax avoidance**

If NECTs and split-interest trusts were not subject to many of the requirements and restrictions imposed on private foundations, it would be possible for taxpayers to avoid these restrictions by the use of nonexempt trusts instead of private foundations. To forestall this possibility, IRC 4947 generally imposes the same requirements and restrictions applicable to private foundations, with certain exceptions for split-interest trusts. S. Rep. No. 552, 91<sup>st</sup> Cong., 1<sup>st</sup> Sess. 93-94 (1969); Reg. 53.4947-1(a).

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## **Can a non-exempt charitable trust apply for 501(c)(4) status and avoid the 4947 rules?**

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### **Prevent tax avoidance**

No. An NECT may not be recognized as exempt under IRC 501(c)(4), particularly where such recognition would allow the trust to avoid treatment as a private foundation. Private foundations existing as of Oct. 9, 1969 also may not avoid private foundation status by claiming 501(c)(4) status. See Reg. 1.509(b)-1(a); GCM 37485 (March 30, 1978); TAM 9730002 (Jan. 7, 1997).

- Charitable trusts generally have the option of applying for exemption under either IRC 501(c)(3) or 501(c)(4), or applying for 501(c)(4) status for the period for which IRC 508(a) bars 501(c)(3) exemption. See Rev. Rul. 80-108, 1980-1 C.B. 119.
  - However, contributions to 501(c)(4) organizations are generally not deductible as charitable contributions (with exceptions for veterans' organizations and volunteer fire departments), and IRC 642(c) is not applicable to exempt organizations.
  - By definition, an NECT is a trust for which a charitable deduction has been allowed. Congressional intent underlying IRC 4947 would be frustrated if 501(c)(4) exemption were recognized, because the trust would no longer be non-exempt under IRC 501(a), and thus would enjoy the benefits of charitable deductions without the burdens.
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## When does the application of IRC 4947(a)(1) to a non-exempt charitable trust begin?

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<b>Introduction</b>	These rules are a bit complicated. They depend partly on whether the trust will continue on as a charitable trust, as opposed to winding up and distributing all of its assets.
<b>Inter vivos charitable trusts</b>	A trust created as an inter vivos charitable trust, for which a deduction is allowed, is subject to IRC 4947(a)(1) from the date of its creation. Reg. 53.4947-1(b)(1)(ii), Example (1).
<b>Testamentary trusts that do not wind up</b>	A testamentary trust that will continue on as a charitable trust and not distribute all of its assets is subject to IRC 4947(a)(1) as of the grantor's death. Reg. 53.4947-1(b)(2)(i).
<b>Charitable remainder and revocable trusts that do not wind up</b>	<p>If a charitable remainder trust or revocable trust that becomes irrevocable on the grantor's death will continue on as a charitable trust and not distribute all of its assets, it is subject to IRC 4947(a)(1) after a reasonable period for administration/settlement.</p> <ul style="list-style-type: none"><li>• Settlement duties may include collection of assets, payment of debts, taxes, and distributions, and determination of the rights of the subsequent beneficiaries. Reg. 53.4947-1(b)(2)(iv), (vi).</li><li>• For the revocable trust, IRC 4941 may apply if the requirements of Reg. 53.4941(d)-1(b)(3) are not met.</li><li>• As discussed above, in appropriate circumstances, which may include trust instrument changes, certain charitable trusts (with IRC 509(a)(1) and/or 509(a)(2) remaindermen and which continue to operate as charitable trusts) may qualify as public charities under IRC 509(a)(3). See Rev. Proc. 72-50, 1972-2 C.B. 830. IRC 509(a)(3) non-exempt trusts are not subject to the private foundation requirements imposed on non-exempt trusts that are described as private foundations under IRC 4947(a)(1).</li></ul>

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## **When does the application of IRC 4947(a)(1) to a non-exempt charitable trust begin?, Continued**

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**Estates and trusts that wind up**

If an estate is required to wind up and distribute all of its net assets to charitable beneficiaries (or to other trusts for them), then it is subject to IRC 4947(a)(1), if at all, only after a reasonable period for administration/settlement. It remains subject to IRC 4947(a)(1) until final distribution of the assets.

- The same rule applies to a revocable trust that becomes irrevocable on the grantor's death, a testamentary trust, and a charitable remainder trust, when such trusts are required to wind up and distribute all of their net assets to charity. Reg. 53.4947-1(b)(2)(ii), (iii), (v); Reg. 1.641(b)-3(a) and (b).
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## When does the application of IRC 4947(a)(2) to a split-interest trust begin and end?

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### Newly created split-interest trusts

A newly created split-interest trust is treated as having amounts for which a deduction was allowed, and is thus subject to IRC 4947(a)(2), even if the deduction was allowed only at a later date. Reg. 53.4947-1(c)(1)(ii).

- The date of creation is the later of (1) the time property is first transferred to the trust, or (2) the earliest time that the grantor trust rules under IRC 671 et seq. (which treat grantors or others as the owner of the trust) do not apply. Reg. 1.664-1(a)(4).

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### Testamentary trusts that do not wind up

A testamentary trust that will continue on as a split-interest trust and not distribute all of its assets is subject to IRC 4947(a)(2) as of the grantor's death. Reg. 53.4947-1(c)(6)(i).

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### Estates and trusts that wind up

As with NECTs, a reasonable period of administration or settlement is often allowed before IRC 4947(a)(2) takes effect.

- If an estate, a revocable trust that becomes irrevocable on the grantor's death, or a testamentary trust is required to wind up and distribute all of its net assets to both charitable and non-charitable beneficiaries (or to other trusts for them), then it is subject to IRC 4947(a)(2) only after a reasonable period for administration/settlement, until final distribution to the last remaining charitable beneficiary. Reg. 53.4947-1(c)(6)(ii) and (iv).
- If a revocable trust that becomes irrevocable on the grantor's death will continue on as a split-interest trust and not distribute all of its assets, it is similarly subject to IRC 4947(a)(2) after a reasonable period of settlement. IRC 4941 may apply if the requirements of Reg. 53.4941(d)-1(b)(3) are not met. Reg. 53.4947-1(c)(6)(iii).

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### Termination of 4947(a)(2) status

4947(a)(2) status ends for a charitable lead trust upon final payment to the charitable beneficiary, because the trust no longer retains amounts for which a charitable deduction was allowed. Reg. 53.4947-1(e)(2), Example (2).

- A similar rule would apply to charitable remainder trusts that wind up and distribute their assets within a reasonable period of settlement. For other charitable remainder trusts, 4947(a)(2) status would end, and 4947(a)(1) status begin, after the reasonable period of settlement.

## **Can trust assets be used to pay estate settlement expenses?**

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### **In general**

The use of charitable funds for the private purposes of the grantor generally results in inurement or private benefit. In addition, such use raises IRC 4941 self-dealing and IRC 4945 taxable expenditure issues. Thus, EO agents should insure that estate administration expenses are borne by the proper parties - copies of the trust instrument, probate accounting, or court order may be necessary in cases of doubt.

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### **Trustee's lien**

In some cases, however, a charitable trust may receive an advance distribution from an executor or trustee, subject to a lien imposed by State law for unknown or contingent expenses of the estate or trust.

- The Service has permitted the charitable trust's disbursement of such funds back to the executor or trustee in appropriate circumstances where the probate court has approved the transfer. See, e.g., PLR 9826040 (March 30, 1998); Restatement § 249(2).
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