

ISSUE

Under the circumstances described below, are the payments by a private foundation of premiums on a life insurance policy and the interest on a loan secured by the policy jeopardizing investments under section 4944 of the Internal Revenue Code?

FACTS

The organization is exempt from federal income tax under section 501(c)(3) of the Code and is a private foundation under section 509(a) of the Code. A whole-life insurance policy was donated to the foundation. At the time of the donation, the policy was subject to a policy loan that the insurer had made to the donor. The policy provided that, upon the death of the insured, the foundation would receive insurance proceeds in an amount equal to the face value of the policy reduced by the sum of the outstanding principal of the loan and any unpaid interest thereon.

At the time of the donation of the policy, the life expectancy of the insured-donor was 10 years. Instead of immediately surrendering the policy to the insurer for its cash surrender value, the foundation retained the policy as an investment and annually pays the premiums and interest due on the policy and the policy loan, respectively. The combined premium and interest payments are of such an amount that, by the end of eight years, the foundation will have invested a greater amount in premiums and interest than it could receive as a return on this investment, i.e., in the form of insurance proceeds upon the death of the insured.

LAW AND ANALYSIS

Section 4944 of the Code imposes a tax on private foundations and, under certain conditions, foundation managers for investing any amount in such a manner as to jeopardize the carrying out of any of the foundation's exempt purposes.

Section 53.4944-1(a)(2)(i) of the Foundation Excise Tax Regulations provides that an investment shall be considered to jeopardize the carrying out of the exempt purposes of a private foundation if it is determined that the foundation managers, in making such investment, have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment, in providing for the long-term and short-term financial needs of the foundation to carry out its exempt purposes. In the exercise of the requisite standard of care and prudence the foundation managers may take into account the expected return on an investment and the need for diversification within the investment portfolio. The determination whether the investment of a particular amount

jeopardizes the carrying out of the exempt purposes of a foundation shall be made on an investment by investment basis, in each case taking into account the foundation's portfolio as a whole.

The foundation managers in the present case invested in a life insurance policy of an insured who has a life expectancy of ten years. The foundation pays combined premium and interest payments that will produce a financial loss to the foundation at the end of eight years. The period of time the payments could reasonably be expected to last is ten years. Under the facts and circumstances, the foundation managers, by investing at the projected rate of return prevailing at the time of the investment failed to exercise ordinary business care and prudence in providing for the long-term and short-term financial needs of the foundation in carrying out its exempt purposes.

See Rev. Rul. 80-132, page 12, this Bulletin, for the application of section 4941 of the Code to a similar transaction where the donor is a disqualified person.

HOLDING

Under the circumstances described above, each payment made by the private foundation for a premium on the insurance policy and the interest on the policy loan is a jeopardizing investment under section 4944 of the Code.