



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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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Release Date: 6/21/2013
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Contact Person:
XXXXXX
Identification Number:
XXXXXX
Telephone Number:
XXXXXX

Uniform Issue List:

507.06-00
664.04-00
4941.00-00

Legend:

Trust = XXXXXX
Husband = XXXXXX
Wife = XXXXXX
D = XXXXXX
§ = XXXXXX
Charity = XXXXXX
F1 = XXXXXX
F2 = XXXXXX
F3 = XXXXXX
X = XXXXXX

Dear :

We have considered your ruling request as to the consequences of Trust's termination in general, and specifically whether such termination constitutes an act of self-dealing to you under § 4941 of the Internal Revenue Code.

Normally, we do not issue letter rulings under § 4941 or § 4945 pertaining to the tax consequences of the termination of a charitable remainder trust (as defined in § 664) before the end of the trust term as defined in the trust's governing instrument in a transaction in which the trust beneficiaries receive their actuarial shares of the value of the trust assets. However, this no-rule position was first published in 2008 in Rev. Proc. 2008-4, 2008-1 C.B. 121, § 6.17. Because your ruling request pre-dated the no-rule position, we are issuing this ruling.

Husband and Wife established Trust in F3 as a charitable remainder unitrust described in § 664(d)(3), and a split interest trust under § 4947(a)(2). You are the Trust.

The trust agreement provides that the quarterly "unitrust payments" that Husband and Wife receive shall equal the smaller of: (a) the trust income for the taxable year as defined in § 643(b)

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and its implementing regulations; and (b) a fixed percentage of X percent of the net fair market value of the trust assets, valued on the first business day of the taxable year. In addition, the agreement contains a "make-up" provision augmenting the unitrust payments in excess of the amount required to be distributed, to the extent that prior year distributions were less than X percent of the net fair market value of the trust's assets on the valuation date. As of D, the aggregate make-up amount was \$.

The trust agreement specifies that upon the death of the first settlor, the entire unitrust amount is to be paid to the survivor. When the survivor dies, the trust agreement requires you to distribute the remaining trust assets to Charity, the charitable remainder beneficiary. Charity is an organization recognized as tax-exempt under § 501(c)(3) and as a public charity under § 509(a)(1) and § 170(b)(1)(A)(vi).

In the years since creating Trust, Husband and Wife have become disappointed with the investment returns. In addition, their investment priorities have changed and are no longer compatible with a charitable remainder unitrust structure. Husband, Wife, and Charity have determined that it is in their best interests to avoid the continuing costs of administering Trust. Husband, Wife, Charity and you have agreed that it is in the best interests of all parties to terminate Trust and distribute the assets. Each has signed statements, under penalties of perjury, agreeing to the termination.

You represent that the law of your state permits early termination of Trust, provided there is agreement among the trustees and beneficiaries. There is no requirement that the state attorney general be involved in a trust termination in which all beneficiaries consent. In addition, the Restatement of the Law of Trusts 3d (2001) says at § 651(1) that "...if all of the beneficiaries of an irrevocable trust consent, they can compel the termination or modification of the trust."

You represent that upon termination of Trust, you will distribute to Husband and Wife the actuarial value of their income interests, to be determined by using (1) the discount rate in effect under § 7520 on the date of termination; (2) the life expectancies of Husband and Wife on the date of termination; and (3) the methodology under § 1.664-4 for valuing interests in a charitable remainder unitrust. You state that the balance of Trust's assets will be distributed to Charity as the charitable remainder beneficiary.

Husband's date of birth is F1; Wife's date of birth is F2. Husband and Wife have signed statements under penalties of perjury that to the best of their knowledge and belief, they have no medical conditions that are expected to result in a shorter longevity than expected of persons of their respective ages. Their personal physicians also have submitted statements, under penalties of perjury, attesting that they have examined Husband and Wife, respectively, and to the best of their knowledge and belief, they have no medical conditions that are expected to result in a shorter longevity than expected of persons of their respective ages.

RULING REQUESTED

You have requested the following rulings:

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- (1) Early termination of the trust will not constitute an act of self-dealing by either Husband or Wife under § 4941(d)(1) with respect to the trust.
- (2) Early termination of the trust will not constitute an act of self-dealing by Trustee under § 4941(d)(1) with respect to the trust.
- (3) The early termination of the trust will not result in imposition of termination tax under § 507(c).
- (4) Any gain to be recognized by Husband and Wife upon termination of the trust will be a long-term capital gain.
- (5) The calculation prescribed by § 1.664-4 is the proper method for valuing the respective interests of Husband, Wife and Charity upon termination of the trust.

LAW

Section 507(b)(1)(A) provides that the status as a private foundation of any organization with respect to which there have not been either willful repeated acts (or failures to act) or a willful and flagrant act (or failure to act) giving rise to liability for tax under chapter 42, shall be terminated if such organization distributes all of its net assets to one or more organizations described in § 170(b)(1)(A) (other than in clauses vii or viii), each of which has been in existence and so described for a continuous period of at least 60 calendar months immediately preceding such distribution.

Section 507(c) imposes a tax on a private foundation under certain circumstances.

Section 664 exempts from income tax charitable remainder unitrusts, which it defines as those from which a fixed percentage of the net fair market value of its assets is paid to at least one person not an organization described in § 170(c) for a term of years, after which the remainder interest is transferred to an organization described in § 170(c).

Section 664(b) provides that amounts distributed by a charitable remainder unitrust to the beneficiary of an annuity or unitrust payment are characterized in the hands of the recipient first as ordinary income, second as capital gain, third as other income, and fourth as trust corpus. Both current and prior undistributed amounts from a tier must be exhausted before distributions will be deemed to be made from the next tier.

Section 4941(a)(1) imposes an excise tax on disqualified persons for each act of self-dealing between a disqualified person and a private foundation.

Section 4941(d)(1) defines self-dealing as including any direct or indirect:

- (A) sale or exchange, or leasing of property between a private foundation and a disqualified person, or

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(E) 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) provides that for purposes of this subchapter, the term "disqualified person" includes, with respect to a private foundation, a person who is—

- (A) a substantial contributor to the foundation,
- (B) a foundation manager (within the meaning of section (b)(1)).

Section 4946(a)(2) provides that for purposes of paragraph (1), the term "substantial contributor" means a person who is described in § 507(d)(2).

Section 4946(b) provides that for purposes of this subchapter, the term "foundation manager" means, with respect to any private foundation:

- (1) 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), and
- (2) with respect to any act (or failure to act), the employees of the foundation having authority or responsibility with respect to such act (or failure to act).

Section 4947(a)(2) provides, in pertinent part, that in the case of a trust which is not exempt from tax under § 501(a), not all of the unexpired interests of which are devoted to charitable purposes, and which has amounts in trust for which a charitable deduction was allowed, §§ 507 and 4941 apply as if such trust were a private foundation.

Section 4947(a)(2)(A) provides that § 4947(a)(2) shall not apply with respect to any amounts payable under the terms of such trust to non-charitable income beneficiaries.

Section 7520(a) provides that valuations of annuities, life estates, and remainder interests are to be determined as actuarial valuations using a mortality table established by the Secretary and using 120 percent of the federal annual mid-term rate for the month of transfer.

Section 53.4947-1(c)(2)(ii) of the Foundation and Similar Excise Taxes Regulations provides, in essence, that payments of income by a charitable remainder unitrust to its individual income beneficiaries do not result in any tax on self-dealing under § 4947.

Section 1.170A-1(e) of the Federal Income Tax Regulations provides that if, as of the date of a gift, a transfer for charitable purposes is dependent upon the performance of some act or the happening of a precedent event in order that it might become effective, no deduction is allowable unless the possibility that the charitable transfer will not become effective is so remote as to be negligible.

Section 1.664-3(a)(1)(i) describes a unitrust which pays out a stated percentage of the trust value each year, without reference to the trust income.

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Section 1.664-4 provides in general for the calculation of the fair market value of the remainder interest in a charitable remainder unitrust.

Section 1.664-4(a)(2) provides that the fair market value of a remainder interest in a charitable remainder unitrust is its present value determined under paragraph (d) of this section. The present value shall be computed in part on the basis of interest at the § 7520 rate in cases where the valuation date is after April 30, 1989.

Section 1.664-4(a)(3) provides that a qualified unitrust remainder interest shall be computed in part with an assumption that the amount described in § 1.664-3(a)(1)(i) shall be distributed.

Section 1.7520-3(b)(1)(ii) provides that the standard § 7520 annuity, life estate, or remainder factor may not be used to value a restricted beneficial interest. However, a special factor may be used to value a restricted beneficial interest in some circumstances.

Section 1.7520-3(b)(1)(i)(C) provides that the standard factor for an ordinary remainder interest represents the present worth of the right to receive \$1.00 at the end of a defined period.

Section 1.7520-3(b)(1)(i)(B) provides that the standard factor for an ordinary life estate interest represents the right to receive the use of \$1.00 for a defined period.

Section 20.2031-7(d)(7) provides information to calculate the present value of certain interests that are dependent on a term of years.

McAllister v. Commissioner, 157 F.2d 235 (2nd Cir.), cert. den. 330 U.S. 826 (1946), holds that a life tenant's sale of her entire interest in a testamentary trust to a remainderman is the sale of a capital asset under § 1222.

Rev. Rul. 72-243, 1972-1 C.B. 233, states that the Service will follow the holding in McAllister.

Rev. Rul. 2013-7, 2013 IRB LEXIS 122, provides various prescribed rates for federal income tax purposes for March 2013.

ANALYSIS

Self-Dealing

As a charitable remainder unitrust under § 664(d)(2), Trust is a split-interest trust described in § 4947(a)(2), and thus is treated as a private foundation subject to § 507 and § 4941.

Husband and Wife, as settlors of the trust, are disqualified persons within the meaning of § 4946(a)(1)(A). The tax on self-dealing applies to transfers to a disqualified person of the assets of a split-interest trust, except for amounts payable under the terms of such trust to income beneficiaries. Section 4947(a)(2)(A). Moreover, the terminating payments to Husband and Wife are not direct or indirect acts of self-dealing under § 4941, where the proposed

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allocation method is reasonable and does not result in greater allocation of trust assets to Husband and Wife than appropriate, to the detriment of the charitable remainderman.

The actuarial relationship between a life estate and a remainder interest is complementary, according to the regulations noted above. The life estate represents the right to receive income from an asset during a time period, while the remainder interest reflects the right to the asset itself after the period. By comparison, the payout interest in a flat rate unitrust is the right to receive a specified percentage each year regardless of the income.

While the unitrust remainder interest may not be a standard remainder interest, it nevertheless is quantifiable in actuarial terms. It is readily possible to compute actuarial factors for the remainder interest in a flat-rate unitrust. The Service has published tables to be used in computing unitrust interests, and these factors can be understood as ordinary unitrust factors.

A NIMCRUT (charitable remainder unitrust with a net make-up feature) does not necessarily pay a stated percentage of the trust value each year. Rather, it pays the lesser of the stated percentage of trust income plus any excess income over the stated percentage, to the extent that the aggregate of amounts paid in prior years was less than the stated percentage.

Thus, the income beneficiaries have a potential right to amounts in excess of the rates specified in § 7520, a right that is dependent on the happening of events which are not so remote as to be negligible. The computed charitable remainder interest must be minimized to reflect amounts that reasonably may be paid to the beneficiaries for a charitable deduction to be available.

We note that the maximum beneficiary payments would be payments up to the amount of the stated percentage. Thus, the available deduction for the remainder interest is reflected in a remainder factor which assumes that the trust pays the stated percentage each year. This assumption is required under § 1.664-4(a)(3). Accordingly, the remainder factor provided in the regulations for a NIMCRUT represents a special factor, which accounts for the non-standard charitable remainder interest, and which reflects the non-negligible potential for the payout to exceed the § 7520 rate.

One reasonable method not resulting in a greater allocation of assets to Husband and Wife than appropriate is the following:

The computation of the remainder interest is found using a special factor as indicated in § 1.7520-3(b)(1)(ii). The special remainder factor is found by using the methodology stated in § 1.664-4 for computing the factor for a remainder interest in a unitrust, with the following modification: where § 1.664-4(a)(3) of the regulations provides an assumption that the trust's stated payout percentage is to be paid out each year, instead the assumed payout shall be that of a fixed percentage which is equal to the lesser of the trust's stated payout percentage or the § 7520 rate for the month of termination. The special factor for the non-charitable payout interest is 1 minus the special remainder factor.

Based on this methodology, the calculation of Husband and Wife's income interest is made in

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the following manner:

The § 7520 rate for March 2013 and April 2013 is 1.4 percent under Rev. Rul. 2013-7. Assuming the termination occurs in either of these months, the lesser of this rate and the trust's stated percentage is 1.4 percent. Throughout these months the donor is age 72 and the spouse is age 70 (age nearest birthday).

Based on Table 2000CM in § 20.2031-7(d)(7), interest at 1.4 percent, an unadjusted payout rate of 1.4 percent, and annual payments made at the beginning of each year, the present value of the remainder interest in a unitrust which falls in at the death of the last to die of 2 persons aged 70 and 72 is \$0.77971 for each \$1.00 of the trust estate. The present value of the payout interest in the same unitrust until such death is \$1.00 minus \$0.77971 or \$0.22029 for each \$1.00 of the trust estate.

In this case, the income beneficiaries are not expected to receive more than they would during the full term of Trust under the above-described methodology for valuing their interests in a charitable remainder trust with a net income make-up feature. Further, you represent that state law provides for early termination under the facts presented.

In addition, Husband and Wife's personal physicians have conducted physical examinations and have stated under penalties of perjury that they find no medical condition expected to result in a shorter-than-average longevity; and Husband and Wife have signed similar statements.

Furthermore, because the effect of the transactions is to vest the income interests with the income beneficiaries and the remainder interest in the remainder beneficiary, the trust no longer will be a split-interest trust and § 4947(a)(2) will no longer apply and § 507 will not apply.

Capital Gains

Proceeds received by the life tenant of a trust, in consideration for the transfer of the life tenant's entire interest in the trust to the holder of the remainder interest, are treated as an amount realized from the sale or exchange of a capital asset under § 1222. See Rev Rul. 72-243, 1972-1 C.B. 233; McAllister v. Commissioner, 157 F.2d 235 (2nd Cir.), cert. den. 330 U.S. 826 (1946).

Husband and Wife have held income interests in Trust since F3. Accordingly, any gain to be recognized by Husband and Wife upon termination of the trust will be a long-term capital gain.

CONCLUSION

Therefore, we rule that:

- (1) Early termination of the trust will not constitute an act of self-dealing by either Husband or Wife under § 4941(d)(1) with respect to the trust.
- (2) Early termination of the trust will not constitute an act of self-dealing by Trustee under

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§ 4941(d)(1) with respect to the trust.

- (3) The early termination of the trust will not result in imposition of termination tax under § 507(c).
- (4) Any gain to be recognized by Husband and Wife upon termination of the trust will be a long-term capital gain.
- (5) The calculation prescribed by § 1.664-4 is the proper method for valuing the respective interests of Husband, Wife and Charity upon termination of the trust.

This ruling will be made available for public inspection under § 6110 after certain deletions of identifying information are made. For details, see enclosed Notice 437, *Notice of Intention to Disclose*. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

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

This ruling is based on the facts as they were presented and on the understanding that there will be no material changes in these facts. Also, we express no opinion as to the tax consequences of the transactions under other provisions of the Code.

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. You should keep a copy in your permanent records.

Sincerely,

Mary J. Salins
Manager, Exempt Organizations
Technical Group 4

Enclosure
Notice 437