Internal Revenue Service

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Date:
December 21, 2016

LEGEND

Trust =

A =

B =

C =

D =

E =

X =

State =

Court =

Year1 =

Year2 =

Year3 =

Year4 =

Year5 =

Year6 =

Date1 =

Date2 =

Date3 =

Date4 =

Date5 =

Date6 =

Date7 =

N1 =

N2 =

N3 =

Dear :

This letter responds to a letter dated February 18, 2014, and subsequent correspondence, submitted on behalf of Trust by Trust's authorized representative, requesting a ruling under § 664 and other provisions of the Internal Revenue Code ("Code").

FACTS

The information submitted states that Trust was formed by A under an agreement dated Date1, with A and B serving as co-trustees of Trust. At the time Trust was established, A was a resident of State. The information submitted states that Trust was intended to qualify as a Charitable Remainder Unitrust ("CRUT") under § 664 of the Code. Trust was funded by A on Date2. X was the initial charitable remainder beneficiary of Trust. A was the initial unitrust recipient of Trust, until A's death on Date3.

In Year1, A had a net worth in excess of $N1. A's assets consisted primarily of low basis, non-dividend paying stocks. A and B engaged C to provide financial and estate planning advice. C recommended that A and B engage D, an attorney licensed to practice law in State, for legal advice on estate planning and charitable giving. C and D ultimately recommended that A create Trust as a charitable remainder trust, and to transfer certain low-basis capital assets to Trust in order to avoid the imposition of capital gain taxes on the subsequent sale of those assets by Trust. A and B were advised that this arrangement would allow Trust to sell the stock in the future without incurring capital gains taxes, and that Trust would serve both as an estate planning vehicle and a charitable giving vehicle. According to the submission, D represented to A and B that there would be no gift taxes due upon creation of Trust because there would be no completed gift to the successor recipients at that time. To achieve this result, A would retain the right to change the successor recipients. However, when D drafted the trust agreement for Trust, D failed to reserve A's right to change the successor recipients. As a result, the interests of the successor recipients vested at the time the trust agreement was executed, and the gift to the successor recipients became complete causing gift tax to be due and owing. However, when gift tax returns were prepared by A's accountant for Year1, the accountant relied on the advice given by D that no gift tax was owed as a result of the property transfers to the Trust.

Under the trust agreement for Trust, Trust was required to make quarterly payments to A for the remainder of A's life or for a term of twenty years, whichever was shorter. If A died prior to the expiration of the twenty-year term, the payments would be made for the balance of the twenty-year term to the successor unitrust recipient, E, or to E's designated successor if E died prior to the expiration of the term. At the expiration of the twenty-year term, the remaining assets of Trust would be distributed to X or to a subsequently-named eligible entity.

According to the submission, C allegedly represented to A and B that Trust's assets would generate a N2% annual return if invested as C recommended. C allegedly further told A and B that A would receive a guaranteed N3% return on the fair market value of Trust assets during A's lifetime or during the 20-year term of Trust. Trust assets were invested in annuities and insurance products that C was licensed to sell. According to the submission, these types of investments made it difficult for Trust to generate an N3% annual return, and Trust never achieved an N3% return without including capital gains which, under the laws of State, were allocable to principal, not income.

At the time the trust agreement for Trust was drafted, C and D allegedly made a number of misleading and legally erroneous representations regarding the operation of Trust, including the promise that A would receive a guaranteed N3% annual return on the net fair market value of Trust assets. According to the submission, A and B executed the trust agreement, relying upon the advice and representations made to

them by C and D. In fact, the trust agreement of Trust, as drafted, provided for an N3% annual payout, except that the annual unitrust payment was limited to Trust's annual net income and included a "net income make-up" provision.

The trust agreement of Trust provided that the definition of income for this purpose is "as defined in § 643(b) of the Internal Revenue Code of 1986 and regulations thereunder." During the years that the unitrust amount was payable to A before A's death, Trust never generated sufficient income, without including capital gain, to meet the N3% payout. Nevertheless, based on the erroneous advice provided by C and D, the trustees of Trust included capital gain in trust income, and the trustees paid the N3% of the net fair market value of Trust assets to A for Year1 and Year3 (including a make-up amount in Year3 for a shortfall in Year2). Accordingly, the trustees erroneously determined the amount to be distributed to the unitrust beneficiary in Year1, Year2 and Year3 (and also in subsequent years) by improperly including capital gain in the calculation of trust income.

According to the submission, C and D also incorrectly advised A and B that the assets of Trust would not be includible in A's estate for estate tax purposes. This advice was incorrect since A retained an income interest in Trust as the unitrust recipient. However, based on this erroneous advice, A added additional assets to Trust in Year2 and Year3 in an attempt to further reduce the assets in A's taxable estate. According to the submission, A claimed charitable deductions on A's individual federal income tax returns for Year1, Year2 and Year3 for a portion of the fair market value of the property contributed to Trust by A in each such tax year, respectively, pursuant to § 170(a).

After A's death on Date3, E became the successor unitrust recipient of Trust. In addition, B and E became the co-trustees of Trust until B resigned as co-trustee on Date4. In Year4, E petitioned Court to reform the trust agreement of Trust. X, the named charitable beneficiary of Trust, along with the State Attorney General, objected to the reformation. E's petition was dismissed. In Year5, E petitioned Court a second time to reform Trust. Both X and State Attorney General again objected to the reformation. E's second petition was dismissed without prejudice. On Date5, E filed a third petition with Court to either reform or terminate Trust. In a letter dated Date6, the State Attorney General again objected to E's petition. X did not appear or make an objection to E's third petition.

On Date7, Court issued a declaration and order determining that Trust was void ab initio. Court's ruling in this regard is contingent on Trust receiving a favorable ruling from the Internal Revenue Service ("Service") that provides that such declaration would not result in additional federal income tax consequences. In the event that Trust does not receive a favorable ruling from the Service, the trustee shall file a statement to that effect with Court, and upon such filing Trust will be declared to be terminated and, after

payment of all amounts due and owing the Service and State Department of Revenue from the assets of Trust, Trust will be distributed to its unitrust income recipient.

Trust seeks the following rulings: 1) Trust should not be respected as a CRUT because it did not function exclusively as a charitable remainder trust throughout its existence; 2) Court's determination that Trust was void ab initio will not result in any additional federal tax; 3) Trust is described in § 4947(a)(2); and 4) a judicial termination of Trust will not result in any additional federal income tax, chapter 42 excise tax, or other federal tax owed by the Trust or any disqualified person or foundation manager with respect to the Trust.

LAW AND ANALYSIS

Section 664(c)(1) provides that a charitable remainder annuity trust and a charitable remainder unitrust shall, for any taxable year, not be subject to any tax imposed by this subtitle.

Section 664(d)(2)(A) provides that, for purposes of § 664, a charitable remainder unitrust is a trust from which a fixed percentage (which is not less than 5% nor more than 50%) of the net fair market value of its assets, valued annually, is to be paid, not less often than annually, to one or more persons (at least one of which is not an organization described in § 170 and, in the case of individuals, only to an individual who is living at the time of the creation of the trust) for a term of years (not in excess of 20 years) or for the life or lives of such individual or individuals.

Section 664(d)(2)(B) provides that, for purposes of § 664, a charitable remainder unitrust is a trust from which no amount other than the payments described in § 664(d)(2)(A) and other than gratuitous transfers described in § 664(d)(2)(C) may be paid to or for the use of any person other than an organization described in § 170(c).

Section 664(d)(3) provides that, notwithstanding the provisions of § 664(d)(2)(A) and (B), the trust instrument may provide that the trustee shall pay the income beneficiary for any year --

(A) the amount of trust income, if such amount is less than the amount required to be distributed under § 664(d)(2)(A), and

(B) any amount of the trust income which is in excess of the amount required to be distributed under § 664(d)(2)(A), to the extent that (by reason of § 664(d)(3)(A)) the aggregate of the amounts paid in prior years was less than the aggregate of such required amounts.

Section 1.664-1(a)(4) provides, in part, that in order for a trust to be a charitable remainder trust, it must meet the definition of and function exclusively as a charitable remainder trust from the creation of the trust.

In Estate of Atkinson v. Commissioner, 115 T.C. 26 (2000) aff'd 309 F.3d 1290 (11th Cir. 2002), the Tax Court determined that a charitable remainder annuity trust never qualified as a charitable remainder trust due to irregularities in the administration of the trust that violated the requirements of charitable remainder trusts, and that the operational failures of the trust could not be corrected by a reformation of the trust document. The trust agreement provided for a 5% annuity amount to be paid to the decedent during her life. At death, the annuity was to be distributed among various named individuals, but only if the beneficiaries paid their share of federal estate and state death taxes resulting from the inclusion of trust assets in decedent's estate. No annuity payments were actually made to the decedent during her lifetime. At trial, the trustee testified that he remitted checks to the decedent but that they were not cashed. There was, however, no record of canceled checks nor were copies of such checks presented in evidence to support the alleged payments. The Tax Court determined that the trust did not qualify as a valid charitable remainder trust because no payments were made to the lifetime beneficiary, so operationally the trust did not meet the express 5% requirement of § 664(d)(1)(A). In addition, one of the successor beneficiaries claimed that the decedent had told her that she would not be liable for her share of the estate taxes. The decedent's estate settled the claim and paid a significant sum to the beneficiary. As a result, there were insufficient funds in the estate to pay the estate tax, and it was necessary to invade the trust corpus to make up the shortfall. The Tax Court held that this was an additional reason to conclude that the trust failed to function exclusively as a charitable remainder trust from the date of its creation. Accordingly, the Tax Court found that the estate was not entitled to a charitable deduction in that case.

In Rev. Rul. 80-58, 1980-1 C.B. 181, which did not involve a trust, the Service stated that the legal concept of rescission refers to the abrogation, cancelling, or voiding of a contract that has the effect of releasing the contracting parties from further obligations to each other and restoring the parties to the relative positions that they would have occupied had no contract been made. However, the annual accounting concept requires that one must look at the transaction on an annual basis at the end of the tax year. That is, each taxable year is a separate unit for tax accounting purposes. Therefore, the annual accounting period principle requires the determination of income at the close of the taxable year without regard to subsequent events.

In § 3.02(8) of Rev. Proc. 2016-3, 2016-1 I.R.B. 126,133, the Service announced that the question of whether a completed transaction may be rescinded for Federal income tax purposes is an area in which rulings will not be issued. If the Court's declaration that Trust was void ab initio is given effect, we believe it would be equivalent to a rescission. Accordingly, after taking into account both Rev. Rul. 80-58 and § 3.02(8) of Rev. Proc. 2016-3, we conclude that we are unable to provide a favorable ruling that the Court's declaration that Trust was void ab initio would have no federal tax consequences. Without a favorable ruling on this issue, it appears that Court's order would default to Trust termination. In that event, the question becomes whether there are federal tax consequences for such termination.

Under the principles of § 1.664-1(a)(4) and Estate of Atkinson, Trust has failed to operate exclusively as a charitable remainder trust from its creation by failing to operate in accordance with its terms, namely, by making distributions in excess of the annual net trust income to the income beneficiary.

Section 4947(a)(2), relating to split-interest trusts, provides that in the case of a trust which is not exempt from tax under § 501(a), not all of the unexpired interests in which are devoted to one or more of the purposes described in § 170(c)(2)(B), and which has amounts in trusts for which a deduction was allowed under § 170 (or other charitable deduction provisions), §§ 507, 4941, and 4945, among others, shall apply as if such trust were a private foundation. This paragraph shall not apply with respect to—

(A) any amounts payable under the terms of such trust to income beneficiaries, unless a deduction was allowed under § 170(f)(2)(B), 2055(e)(2)(B), or 2522(c)(2)(B),

(B) any amounts in trust other than amounts for which a deduction was allowed under § 170, 545(b)(2), 642(c), 2055, 2106(a)(2), or 2522, if such other amounts are segregated from amounts for which no deduction was allowable, or

(C) any amounts transferred in trust before May 27, 1969.

Section 53.4947-1(a) provides that § 4947 subjects trusts which are not exempt from taxation under § 501(a), all or part of the unexpired interests in which are devoted to one or more of the purposes described in § 170(c)(2)(B), and which have amounts in trust for which a deduction was allowed under § 170 (or other charitable deduction provisions) to the same requirements and restrictions as are imposed on private foundations. The basic purpose of § 4947 is to prevent these trusts from being used to avoid the requirements and restrictions applicable to private foundations. For purposes of this section, a trust shall be presumed (in the absence of proof to the contrary) to have amounts under § 170 if a deduction would have been allowable under one of these sections.

In Virginian Hotel Corp. v. Helvering, 319 U.S. 523 (1943), the Supreme Court held that "allowed" meant that the taxpayer had taken the deduction and the Commissioner had not challenged it. Id. at 527. Noting that there was "no machinery for formal allowances of deductions from gross income," a deduction being claimed and going unchallenged is the only way in which a deduction could be "allowed."

While Trust failed to operate exclusively as a charitable remainder unitrust and thus maintain its tax exemption under § 664, it nevertheless is subject to the split-interest trust rules under § 4947(a)(2). Trust is not exempt from tax under § 501(a), not all of the unexpired interests in Trust are devoted to charitable purposes, and Trust has amounts in trust for which a deduction was allowed under § 170. On this latter point, because deductions were claimed by A under § 170 and were not challenged by the Service, these deductions were "allowed" for purposes of § 170, under the reasoning of

Virginian Hotel Corp. Thus, Trust is treated as a private foundation for purposes of certain chapter 42 excise taxes until it terminates its private foundation status under § 507.

Section 507(a) provides that, except as provided in § 507(b), the status of any organization as a private foundation shall be terminated only if

(1) such organization notifies the Secretary (at such time and in such manner as the Secretary may by regulations prescribe) of its intent to accomplish such termination, or

(2)(A) with respect to such organization, there have 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, and

(B) the Secretary notifies such organization that, by reason of § 507(a)(2)(A), such organization is liable for the tax imposed by § 507(c),

and either such organization pays the tax imposed by § 507(c) (or any portion not abated under § 507(g)) or the entire amount of such tax is abated under § 507(g).

Section 507(c) provides that there is hereby imposed on each organization which is referred to in § 507(a) a tax equal to the lower of (1) the amount in which the private foundation substantiates by adequate records or other corroborating evidence as the aggregate tax benefit resulting from § 501(c)(3) status of such foundation, or (2) the value of the net assets of such foundation.

Section 507(d)(1) provides that, for purposes of § 507(c), the aggregate tax benefit resulting from the § 501(c)(3) status of any private foundation is the sum of –

(A) the aggregate increases in tax under chapters 1, 11, and 12 (or the corresponding provisions of prior law) which would have been imposed with respect to all substantial contributors to the foundation if deductions for all contributions made by such contributors to the foundation after February 28, 1913, had been disallowed, and

(B) the aggregate increases in tax under chapter in tax under chapter 1 (or the corresponding provisions of prior law) which would have been imposed with respect to the income of the private foundation for taxable years beginning after December 31, 1912, if (i) it had not been exempt from tax under § 501(a) (or the corresponding provisions of prior law), and (ii) in the case of a trust, deductions under § 642(c) (or the corresponding provisions of prior law) had been limited to 20 percent of the taxable income of the trust (computed without the benefit of § 642(c) but with the benefit of § 170(b)(1)(A), and

(C) interest on the increases in tax determined under §§ 507(d)(1)(A) and (B) from the first date on which each such increase would have been due and payable to the date on which the organization ceases to be a private foundation.

Section 507(e) provides that, for purposes of § 507(c), the value of the net assets shall be determined at whichever time such value is higher: (1) the first day on which action is taken by the organization which culminates in its ceasing to be a private foundation, or (2) the date on which it ceases to be a private foundation.

Section 507(f) provides that, for purposes of determining liability for the tax imposed by § 507(c) in the case of assets transferred by the private foundation, such tax shall be deemed to have been imposed on the first day on which action is taken by the organization which culminates in its ceasing to be a private foundation.

Section 1.507-1(b)(1) provides that in order to voluntarily terminate its private foundation status, an organization must submit a statement to the district director of its intent to terminate its private foundation status under § 507(a)(1). Such statement must set forth in detail the computation and amount of tax imposed under § 507(c). Unless the organization requests abatement of such tax pursuant to § 507(g), full payment of such tax must be made at the time the statement is filed under § 507(a)(1). For purposes of subtitle F of the Code, the statement described in this subparagraph, once filed, shall be treated as a return.

Section 1.507-1(b)(8) provides that if a private foundation makes a transfer of all or a significant part of its assets to another organization and prior to, or in connection with, such transfer, liability for any tax under chapter 42 is incurred by the transferor foundation, transferee liability may be applied against the transferee organization for payment of such taxes.

Section 1.507-1(c)(2) provides that for purposes of § 507(a)(2)(A), a “willful and flagrant act (or failure to act)” is one which is voluntarily, consciously, and knowingly committed in violation of any provision of chapter 42 (other than section 4940 or 4948(a)) and which appears to a reasonable man to be a gross violation of any such provision.

Section 1.507-1(c)(4) provides that for purposes of § 507(a)(2), the failure to correct the act or acts (or failure or failures to act) which gave rise to liability for tax under any section of chapter 42 by the close of the correction period for such section may be a willful and flagrant act (or failure to act).

Section 4941 imposes an excise tax, paid by the disqualified person, on each act of self-dealing between a private foundation and a disqualified person for each year in the taxable period, and requires correction of the act of self-dealing. Under § 4941(d)(1)(E), an act of self-dealing includes a transfer to a disqualified person of the assets of a private foundation. The initial tax is 10% of the amount involved, with an additional tax of 200% if the act is not corrected within the taxable period. There is also an excise tax paid by the foundation manager on knowingly participating in the act (unless not willful and due to reasonable cause), in the amount of 5% of the amount

involved for each year within the taxable period, with an additional tax of 50% for refusing to agree to part or all of correction.

Section 4945 imposes an excise tax, paid by the private foundation, on each taxable expenditure by a private foundation, and requires correction of the taxable expenditure. Under § 4945(d)(5), a taxable expenditure includes an amount paid by a private foundation for a purpose other than a charitable purpose. The initial tax is 20% of the amount involved, with an additional tax of 200% if the expenditure is not corrected within the taxable period. There is also an excise tax paid by the foundation manager on knowingly agreeing to make the expenditure (unless not willful and due to reasonable cause), in the amount of 5% of the expenditure, with an additional tax of 50% for refusing to agree to part or all of correction.

Trust, a split-interest trust under § 4947(a)(2), proposes to distribute its assets to the unitrust income beneficiary, E, without regard to the interest of the charitable remainder beneficiary, pursuant to a court-ordered termination in a judicial proceeding brought by Trust for this purpose. This distribution, prior to termination of its private foundation status under § 507, would be a taxable expenditure under § 4945(d)(5) (which prohibits a private foundation's expenditure for non-charitable purposes), in the amount of the actuarial value of the charitable remainder interest. As E is a disqualified person with respect to Trust under § 4946(a)(1)(B) and (D), the distribution would also be an act of self-dealing under § 4941(d)(1)(E) (which prohibits transfer of a private foundation's charitable assets to a disqualified person). Correction of the taxable expenditure and act of self-dealing would be required, and failure to timely correct would result in liability for additional second-tier taxes under §§ 4941(a)(2) and 4945(b)(1). Such distribution, carried out after receipt of this letter ruling, may result in foundation manager taxes payable by E for knowing participation in the act (and additional second-tier taxes for any refusal to agree to correction).

Trust may avoid these chapter 42 taxes by voluntarily terminating its private foundation status under § 507(a)(1) prior to distribution of assets pursuant to the court order, under the procedures set forth in § 1.507-1(b). This process entails giving the IRS proper notice and computation and payment of § 507(c) tax. Pursuant to the Form 990-PF instructions, the notice with computation and payment of § 507(c) tax is provided to the Manager of Exempt Organizations Determinations, Internal Revenue Service, TE/GE—EO Determinations, PO Box 2508, Cincinnati OH 45201.

Moreover, such distribution of assets to E by Trust (prior to terminating private foundation status) may also be regarded as a willful and flagrant act giving rise to liability for tax under chapter 42 (as voluntarily, consciously, and knowingly in violation of chapter 42 and grossly contrary to the purpose of a split-interest trust, especially if E fails to correct in a timely manner), justifying involuntary termination of the private foundation status of Trust by the Service under § 507(a)(2) and assessment of tax under § 507(c) in the amount of the aggregate tax benefit under § 507(d)(1), with

transferee liability for the taxes owed by Trust. Because § 4947(a)(2) applies § 507 to Trust as if it were a § 501(c)(3) private foundation, the aggregate tax benefit for Trust includes the amounts set forth in § 507(d)(1)(A) and (C); however, because Trust was never exempt from tax under § 501(a), the aggregate tax benefit for Trust does not include the amount set forth in § 507(d)(1)(B).

CONCLUSIONS

Based on the foregoing, we conclude as follows:

1) Based on the principles as set forth in Estate of Atkinson, Trust is not respected as a CRUT because Trust did not function exclusively as a charitable remainder trust throughout its existence;
2) For reasons stated above, we do not rule on whether Court's declaration that Trust was void ab initio will not result in any additional federal tax;
3) Trust is described in § 4947(a)(2);
4) Distribution of Trust assets to the income beneficiary pursuant to the court order prior to termination of Trust's private foundation status under § 507(a) will result in excise taxes under §§ 4941 and 4945, which will require correction. A judicial termination of Trust may also result in additional tax under § 507(c) equal to the lower of (1) the amount that Trust substantiates by adequate records or other corroborating evidence as the aggregate tax benefit as determined under § 507(d)(1)(A) and (C), or (2) the value of the net assets of Trust as determined under § 507(e); and
5) Trust must file income tax returns and pay any income tax owed, plus interest and penalties, as a trust subject to taxation under Title 1, Subchapter J of the Code for any tax years that may remain open under § 6501(a) from the date of Trust's establishment.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

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

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

In accordance with the power of attorney on file with this office, we are sending a copy of this letter to Trust's authorized representative.

Sincerely,

Bradford R. Poston
Senior Counsel, Branch 3
(Passthroughs & Special Industries)

Enclosures(2):
Copy of this letter
Copy for § 6110 purposes