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Settlor Intentionally Not Claiming Charitable Deduction Avoids Application of Private Foundation Rules to Charitable Remainder Trusts and Wholly Charitable Trusts

By Richard L. Fox, Esq.[*]

In recently issued PLR 201713003, a charitable remainder trust (CRT) was able to avoid the application of the private foundation excise tax rules that are otherwise applicable under §4947(a)(2) because the settlor intentionally failed to claim any charitable deduction, even though a charitable deduction was otherwise allowable under both §170 and §2522.[1] By intentionally not claiming any charitable deduction, the CRT was shielded from the technical and often harsh private foundation excise tax regime made applicable to CRTs under §4947(a)(2).

This ruling demonstrates an escape hatch from the private foundation excise tax rules for a §4947(a)(2) split-interest trust. A similar result can be achieved in the case of a wholly charitable trust defined under §4947(a)(1). The key is the settlor (and any other person making a contribution to the trust) not claiming, despite it being allowable, any charitable deduction, including for income, estate and gift tax purposes, and maintaining proof throughout the life of the trust that no charitable deduction of any kind has been taken. The negative tax consequences of not claiming any charitable deduction, including for gift and estate tax purposes, when establishing either a split-interest trust or a wholly charitable trust should be weighed against the benefit of the trust not being subject to the private foundation excise tax regime imposed under Chapter 42 of the Internal Revenue Code.

BACKGROUND ON SECTION 4947(a)(2)

Although exempt from income taxes under §664(c)(1),[2] a CRT is not a §501(c)(3) organization and, therefore, is not exempt from tax under §501(a). As such, a CRT cannot be classified as a private foundation under §509(a). A CRT is, however, included within the definition of a ''split-interest trust'' under §4947(a)(2) and, as such, is subject to certain Chapter 42 excise tax provisions otherwise applicable to private foundations. The private foundation excise tax provision can often prove to be quite troublesome and present certain obstacles in the context of CRTs.

Specifically, §4947(a)(2) provides that a trust that is not exempt from income tax under §501(a), not all the unexpired interests in which are devoted to one or more §170(c)(2)(B) purposes and which has amounts in trust for which a charitable contribution deduction was allowed under §170, §545(b)(2), §642(c), §2055, §2106(a)(2), or §2522, will be subject to the following private foundation provisions:

(1) §507 (relating to termination of private foundation status);

(2) §508(e) (relating to governing instrument requirements (to the extent applicable to split-interest trusts));

(3) §4941 (relating to taxes on self-dealing);

(4) §4943 (relating to excess business holdings);

(5) §4944 (relating to investments, which jeopardize charitable purposes); and

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[*] Richard L. Fox (richard.fox@bipc.com) is a shareholder and attorney in the Philadelphia office of Buchanan Ingersoll & Rooney, PC (www.bipc.com). Richard writes and speaks frequently on issues pertaining to philanthropic planning.

[1] Unless otherwise noted, all section references are to the Internal Revenue Code, as amended, and the regulations promulgated thereunder.

[2] Note, however, that under §664(c)(2)(A), a CRT is subject to a 100% excise tax on any unrelated business taxable income as defined under §512.

(6) §4954 (related to taxable expenditures).

In the absence of proof to the contrary, a trust is presumed to have amounts in trust for which a deduction was allowed under §170, §545(b)(2), §556(b)(2), §642(c), §2055, §2106(a)(2), or §2522 if a deduction would have been allowable under one of these sections.[3]

During the term of the trust where annuity or unitrust payments are being made to noncharitable beneficiaries, a CRT qualifying under §664 is subject to §4947(a)(2). Similar rules apply during the term of a charitable lead trust (CLT) where annuity or unitrust payments are made to charitable beneficiaries.

Under special rules provided under §4947(b)(3), the excess business holdings rules of §4943 and the jeopardy investment rules of §4944 do not apply to a trust otherwise described in §4947(a)(2) if: (1) all the income interest (and none of the remainder interest) of such trust is devoted solely to one or more of the purposes described §170(c)(2)(B) and all amounts in such trust for which a deduction was allowed under section §170, §545(b)(2), §642(c), §2055, §2106(a)(2), or §2522 have an aggregate value not more than 60% of the aggregate fair market value of all amounts in such trusts, or (2) a deduction was allowed under §170, §545(b)(2), §642(c), §2055, §2106(a)(2), or §2522 for amounts payable under the terms of such trust to every remainder beneficiary but not to any income beneficiary. Therefore, §4943 and §4944 would not apply to a CLT where the charitable deduction taken does not exceed 60% of the value of the initial trust assets or to a CRT.

BACKGROUND ON SECTION 4947(a)(1)

To prevent various perceived abuses by private foundations classified under §501(c)(3) that are exempt from income tax under §501(a), Congress enacted a multitude of statutory provisions as part of the Tax Reform Act of 1969 to ensure that private foundations are operated exclusively to further charitable and other permissible purposes, rather than for the private purposes of their founders or family members. Although these provisions were primarily aimed at regulating transactions involving private foundations described under §501(c)(3), Congress was concerned that taxpayers would seek to escape the effect of those provisions by organizing charitable entities as trusts and intentionally avoiding §501(c)(3) status, and therefore private foundation status as well, by simply intentionally failing to apply for exemption from income tax under §501(a) by filing a Form 1023.[4]

Although these entities are not exempt from income tax (because they do not apply for tax-exempt status), they may essentially be the practical equivalent of a §501(c)(3) tax-exempt entity by virtue of the charitable income tax deduction under §642(c), generally available to trusts that are not exempt from tax. Moreover, contributions to nonexempt charitable trusts are generally deductible for income, gift, and estate tax purposes although, unlike §501(c)(3) organizations, nonexempt charitable trusts do not have to notify the IRS to be described in §4947(a)(1) or for transfers to such trusts to be deductible as charitable contributions.

To prevent the use of nonexempt charitable trusts to escape the restrictions and limitations otherwise imposed on §501(c)(3) organizations, and particularly those applicable to private foundations under Chapter 42 of the Internal Revenue Code, Congress enacted §4947(a)(1) as part of the Tax Reform Act of 1969. Section 4947(a)(1) specifically provides that a nonexempt charitable trust described in that section "shall be treated as an organization described in section 501(c)(3)," thereby subjecting the trust "to the same requirements and restrictions as are imposed on private foundations." A nonexempt charitable trust is not, however, treated as an organization described in §501(c)(3) for purposes of the exemption from income tax under §501(a) and, accordingly, is required to file Form 1041, *U.S. Income Tax Return for Estate and Trusts*, for any tax year in which it has taxable income. It is also generally required to file a Form 990-PF, the annual tax return filed by private foundations. If, however, the trust is classified as a "supporting organization" under §509(a)(3), in which case it is considered a public charity rather than a private foundation, a Form 990, rather than a Form 990-PF, should be filed.

A nonexempt charitable trust is most frequently encountered not as a tax-avoidance device, but simply in the situation in which a wholly charitable trust has been created, or otherwise comes into existence (such as where a split-interest trust subsequently becomes wholly charitable by virtue of the noncharitable interests in the trust expiring), but has not yet applied, or never applies, for recognition of exemption from tax as a §501(c)(3) organization.

A trust will be described under §4947(a)(1) if it meets all three of the following requirements:

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[3] Reg. §53.4947-1(a). *See also* PLR 200009058 ("The Trust is presumed (in the absence of proof to the contrary) to have amounts in trust for which a deduction was allowed if a deduction would have been allowable under those sections."); IRM 7.26.15.2.3(1) ("If a charitable deduction was allowable, it will be presumed to have been taken and allowed in the absence of proof to the contrary.").

[4] Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*.

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1. It is wholly devoted to one or more purposes described in §170(c)(2)(B) (e.g., religious, educational, charitable, scientific, or literary purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals).

2. It is not exempt from income tax under §501(a) because it has not applied for exemption from tax as an organization described in §501(c)(3) (by filing Form 1023).

3. It has received a transfer of cash or property for which a charitable deduction has been allowed with respect to such transfer under §170, §545(b)(2), §642(c), §2055, §2106(a)(2), or §2522.

Absent a trust meeting of all three of these enumerated requirements, it will not be described under §4947(a)(1) and, therefore, will not be treated as an organization described in §501(c)(3). In such a case, the restrictions and limitations otherwise imposed on organizations described in §501(c)(3), including those applicable to private foundations, will not apply to the trust.

Therefore, for example, where a charitable deduction has not been allowed for a transfer of cash or property to a wholly charitable trust, §4947(a)(1) will not be applicable and the trust will not be treated as an organization described in §501(c)(3). Such was the case in PLR 9726009, where although a testamentary trust was otherwise wholly devoted to charitable purposes and did not apply for exemption from income tax, no estate tax charitable deduction under §2055 was ever taken with respect to transfers to the trust. Because it did not meet all three of the enumerated requirements, i.e., no charitable deduction was claimed, the IRS ruled that the trust was not described in §4947(a)(1), stating:

> Based on your trustee's representations that no deductions were ever taken in connection with the amounts in trust and on the condition that no deductions will be taken in connection with those amounts, we rule that you are not described in section 4947(a)(1) of the Code. Accordingly, you are not subject to the same requirements and restrictions as are imposed on private foundations. You need not file Form 990-PF but your trustee must continue to file a fiduciary income tax return, Form 1041, as required.

Although not addressed in PLR 9726009, because the charitable deduction referenced in §4947(a)(1) relates to transfers of cash or property to a trust, there is no reason why a wholly charitable trust not subject to §4947(a)(1) subsequently claiming a charitable income tax deduction pursuant to §642(c), a deduction available to a trust that is not wholly charitable, should cause the trust to become subject to §4947(a)(1).

PLR 201713003

In PLR 201713003, the grantor created an inter vivos charitable remainder unitrust (CRUT) providing unitrust payments to the settlor for a period of 20 years, with the remainder to be distributed to a charitable beneficiary described in §501(c)(3). The CRUT apparently met the requirements to qualify under §664(a). The ruling specifically stated that the "Grantor has not claimed a deduction under section 170, 545(b)(2), §556(b)(2), 642(c), 2055, 2106(a)(2), or 2522 of the Code with respect to the Trust, for any tax year, since its inception." The IRS ruled that §4947(a)(1) did not apply, stating that:

> Because no deduction has ever been taken (allowed) under section 170, 545(b)(2), 642(c), 2055, 2106(a)(2), or 2522, the Trust is not subject to section 4947(a)(2) of the Code, even though a deduction under section 170, 545(b)(2), 642(c), 2055, 2106(a)(2), or 2522 was allowable. For future tax years, the burden will be on the taxpayer to keep the records to show, through the life of the unitrust, that no deduction is ever taken. Without this proof, that no deduction has ever been taken, section 53.4947-1(a) of the regulations would cause section 4947(a)(2) of the Code to be applied.

CONCLUSION

Recently issued PLR 201713003 is a reminder that the private foundation excise tax rules otherwise applied under §4947(a)(1) or §4947(a)(2) can be avoided where no charitable deduction of any kind is claimed for a transfer to a split-interest or wholly charitable trust. It is imperative, however, that the taxpayer maintain proof throughout the term of the trust that no charitable deduction of any kind has been taken (such as maintaining copies of all tax returns for such period on which no such charitable deduction is reflected) because absent such proof, a trust is presumed to have amounts in trust for which a charitable deduction was allowed if a charitable deduction would have been allowable.

The negative tax consequences of not claiming any charitable deduction when establishing either a split-interest trust or wholly charitable trust must be weighed against the benefit of the trust not being sub-

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ject to the private foundation excise tax regime. While an individual establishing such a trust may be willing to forego, or for that matter may not need or be able to utilize, a charitable income tax deduction, transfers to such a trust are subject to the estate and gift tax regime, and not claiming a charitable estate or gift tax deduction could potentially result in harsh consequences.

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