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Subject: Richard Fox on PLR 201713003 - Settlor Not Claiming Charitable Deduction Allows Charitable Remainder Trust to Escape Private Foundation Excise Tax Rules

"In recently issued Ltr. Rul. 201713003 (3/31/2017), a charitable remainder trust ("CRT") was able to avoid the application of the private foundation excise tax rules that are otherwise applicable under IRC § 4947(a)(2) because the settlor did not claim any charitable deduction, although such a deduction was otherwise allowable. By intentionally not claiming a charitable deduction to which the settlor was otherwise entitled, the CRT was shielded from the technical and often harsh private foundation excise tax regime.

This ruling demonstrates an escape hatch from the private foundation excise tax rules for an IRC § 4947(a)(2) split-interest trust. A similar result can be achieved in the case of a wholly charitable trust defined under IRC § 4947(a)(1). The key is the settlor (and any other person) not claiming, despite its availability, any charitable deduction, including for income, estate and gift tax purposes, and maintaining proof throughout the life of the CRT that no charitable deduction of any kind has been taken. 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 subject to the private foundation excise tax regime.

Recently issued Ltr. Rul. 201713003 is a reminder that the private foundation excise tax rules otherwise applied under IRC §§ 4947(a)(1) or (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 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 subject 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."

We close the week with **Richard Fox**'s commentary on PLR 201713003.

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 is the author of the treatise, Charitable Giving: Taxation, Planning and Strategies, a Thomson Reuters/Warren, Gorham and Lamont publication, writes a national bulletin on charitable giving, and writes and speaks frequently on issues pertaining to nonprofit organizations, estate planning and philanthropy.

Here is his commentary:

EXECUTIVE SUMMARY:

In recently issued Ltr. Rul. 201713003 (3/31/2017), a charitable remainder trust ("CRT") was able to avoid the application of the private foundation excise tax rules that are otherwise applicable under IRC § 4947(a)(2) because the settlor did not claim any charitable deduction, although such a deduction was otherwise allowable. By intentionally not claiming a charitable deduction to which the settlor was otherwise entitled, the CRT was shielded from the technical and often harsh private foundation excise tax regime.

This ruling demonstrates an escape hatch from the private foundation excise tax rules for an IRC § 4947(a)(2) split-interest trust. A similar result can be achieved in the case of a wholly charitable trust defined under IRC § 4947(a)(1). The key is the settlor (and any other person) not claiming, despite its availability, any charitable deduction, including for income, estate and gift tax purposes, and maintaining proof throughout the life of the CRT that no charitable deduction of any kind has been taken. 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 subject to the private foundation excise tax regime.

FACTS:

Background on Section 4947(a)(2)

Although exempt from income taxes under IRC § 664(c), a CRT is not an IRC § 501(c)(3) organization and, therefore, is not exempt from tax under IRC § 501(a). As such, a CRT cannot be classified as a private foundation under IRC § 509(a). A CRT is, however, included within the definition of a "split-interest trust" under IRC § 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 sometimes prove to be quite troublesome in the context of CRTs.

Specifically, IRC § 4947(a)(2) provides that a trust that is not exempt from income tax under IRC § 501(a), not all the unexpired interests in which are devoted to one or more IRC § 170(c)(2)(B) purposes and which has amounts in trust for which a charitable contribution deduction was allowed under IRC §§ 170, 545(b)(2), 642(c), 2055, 2106(a)(2), or 2522, will be subject to the following private foundation provisions: (1) IRC § 507 (relating to termination of private foundation status; (2) IRC § 508(e) (relating to governing instrument requirements (to the extent applicable to split-interest trusts); (3) IRC § 4941 (relating to taxes on

self-dealing); (4) IRC § 4943 (relating to excess business holdings); (5) IRC § 4944 (relating to investments, which jeopardize charitable purposes); and (6) IRC § 4954 (related to taxable expenditures).

During the split-interest period where annuity or unitrust payments are made to noncharitable beneficiaries, a CRT qualifying under IRC § 664 is subject to IRC § 4947(a)(2). Similar rules apply during the split-interest period for a charitable lead trust ("CLT") where annuity or unitrust payments are made to charitable beneficiaries.

Under special rules provided under IRC § 4947(b)(3), the excess business holdings rules of IRC § 4943 and the jeopardy investment rules of IRC § 4944 do not apply to a trust otherwise described in IRC § 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 IRC § 170(c)(2)(B) and all amounts in such trust for which a deduction was allowed under section IRC § 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 section 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, IRC §§ 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.

In the absence of proof to the contrary, a trust is presumed to have amounts in trust for which a deduction was allowed under IRC §§ 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. Reg. § 53.4947-1(a). See also, e.g., Ltr. Rul. 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.").

Background on Section 4947(a)(1)

To prevent various perceived abuses by private foundations classified under IRC § 501(c)(3) that are exempt from income tax under IRC § 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 the activities of private foundations described under IRC § 501(c)(3), Congress was concerned that taxpayers would seek to escape the effect of those rules by organizing charitable entities as trusts and intentionally avoiding IRC § 501(c)(3) status, and hence private foundation status, by simply failing to apply for exemption from income tax under IRC § 501(a).

Although these entities are not exempt from income tax (because they do not apply for tax-exempt status), they are essentially the practical equivalent of an IRC § 501(c)(3) tax-exempt entity by virtue of the charitable income tax deduction under IRC § 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 IRC § 501(c)(3) organizations, nonexempt charitable trusts do not have to notify the IRS to be described in IRC § 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 IRC § 501(c)(3) organizations, and particularly those applicable to private foundations under Chapter 42 of the Internal Revenue Code, Congress enacted IRC § 4947(a)(1) as part of the Tax Reform Act of 1969. IRC § 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

IRC § 501(c)(3) for purposes of the exemption from income tax under IRC § 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 IRC § 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 an IRC § 501(c)(3) organization.

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

1. It is wholly devoted to one or more purposes described in IRC § 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 IRC § 501(a) because it has not applied for exemption from tax as an organization described in IRC § 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 IRC § 4947(a)(1) and, therefore, will not be treated as an organization described in IRC § 501(c)(3). In such a case, the restrictions and limitations otherwise imposed on organizations described in IRC § 501(c)(3), including those applicable to private foundations, will not be applicable.

Thus, for example, where a charitable deduction has not been allowed or taken for a transfer of cash or property to the trust, IRC § 4947(a)(1) will not be applicable and the trust, therefore, will not be treated as an organization described in IRC § 501(c)(3). Such was the case in Ltr. Rul. 9726009, where although a testamentary trust was otherwise wholly devoted to charitable purposes (and did not apply for exemption from income tax), no charitable deduction was ever taken with respect to transfers to the trust. Because it did not meet all three of the enumerated requirements, the IRS ruled that the trust was not described in IRC § 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 Ltr. Rul. 9726009, because the charitable deduction referenced in IRC § 4947(a)(1) relates to transfers of cash or property transferred to a trust, there is no reason why the wholly charitable trust in this ruling subsequently claiming a charitable income tax deduction pursuant to IRC § 642(c), a deduction available to a trust that is not wholly charitable, should cause the trust to become subject to IRC § 4947(a)(1).

Ltr. Rul. 201713003

In Ltr. Rul. 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 IRC § 501(c)(3). The CRUT apparently met the requirements to qualify under IRC § 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 IRC § 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. (Emphasis added.)

COMMENT:

Recently issued Ltr. Rul. 201713003 is a reminder that the private foundation excise tax rules otherwise applied under IRC §§ 4947(a)(1) or (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 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 subject 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.

HOPE THIS HELPS YOU HELP OTHERS MAKE A POSITIVE DIFFERENCE!

Richard Fox

LISI Charitable Planning Newsletter #260 (May 4, 2017) at http://www.leimbergservices.com

CITES:

Ltr. Ruls. 201713003 and 9726009; IRC §§ 4947(a)(1) and (2); 664(a); 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), and 2522.