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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Date: JUL 21 2003

Contact Person:

Identification Number:

Telephone Number:

Uniform Issue List: 4941.04-00
507.00-00
4945.00-00

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Legend:
C =
D =
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F =
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X =
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Dear Sir or Madam:

This is in reply to your request for rulings, as amended, under sections 507, 4941, and 4945 of the Internal Revenue Code, arising from your private foundation's reorganization and its proposed payments of liabilities, as allowed by a court and described below.

T is a charitable trust, created pursuant to the will of a decedent sole contributor, that 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.

C is a charitable nonprofit corporation, successor to trust T, that is exempt from federal income tax under section 501(c)(3) of the Code, is a private foundation under section 509(a) of the Code, and is an operating foundation under section 4942(j)(3) of the Code. T and C have been, and are, effectively controlled by the same persons because corporation C was incorporated to carry on the trust T's funds and activities as a corporate, not trust, entity, for administrative reasons. T has an agreement with C to transfer all of T's assets to C.

T is the primary named beneficiary of the Estate of D, who died several years ago. Several claimants, K, sued the Estate for all of its assets. The trustees of T, who had special knowledge of the decedent's complex business holdings, performed considerable work in marshalling the assets and negotiating a settlement with the claimants. The trustees of T were the only persons volunteering to pay the costs of defending the Estate for charity, including when the probate court required the Executor to remain neutral in the claimants' litigation. During this time, T had no funds under the Estate or will with which to pay compensation to the trustees for their services on T's behalf, including T's defense its rights under the will. There was also litigation regarding the Executor's billings. The litigation took place in more than one jurisdiction.

T, now having funds of its own after the years of litigation, has agreed to pay a stated amount of compensation (the X payments) to its trustees for their services during the estate administration process. T has agreed to indemnify E, a trustee, for attorneys fees expended (the Y payment). T has also agreed, as a settlement of claims against the Estate, to pay F, who is now a trustee (but was not a disqualified person with respect to T at the time of the services), for F's services performed and expenditures on behalf of T's interest in the Estate (the Z payment to F). A probate court, with the concurrence of the State attorney general, has approved all of these payments as reasonable and ordered payment pending IRS approval.

The X and Y payments include prejudgment and postjudgment interest at the rate of r percent, which was determined to be a reasonable rate at the time (less than the legal judgment rate), measured by the accrued but unpaid compensation amounts at the close of each calendar year of service until payment. The Z payment includes interest at the same r percent rate from the date of the court order until payment. The court has approved these interest claims as well. State law allows as damages interest prior to judgment as well as post-judgment.

T represents that the X, Y, and Z payments, and the interest thereon, to be paid by private foundations T or C, are reasonable and necessary expenses for the benefit of the private foundations T or C and that such amounts are not excessive.

The following rulings are requested:

1.a. T's transfers of assets to C will not result in termination tax under section 507(c) of the Code.
1.b. T and C are required to file Form 990-PF for each tax year in which each has assets or activities.
1.c. T will not be required to file Form 990-PF when T no longer has any assets or activities.

2. C shall not be treated as a newly created organization and shall be treated as possessing all of the attributes and characteristics of T, as provided in section 507(b)(2) of the Code.

3. That portion of the compensation to be paid to T's trustees in the X payments which is calculated as an interest charge does not reflect a loan or an extension of credit within the meaning of section 4941 of the Code.

4. The addition of an interest charge to the reimbursement of attorney fees to be paid in the Y payment does not reflect an extension of credit within the meaning of section 4941 of the Code.

5. Indemnification payments in the Y payment will not constitute self-dealing within the meaning of section 4941 of the Code or taxable expenditures under section 4945 of the Code.

6. The settlement payment Z, including interest from date of the court's order to date of payment, will not constitute self-dealing within the meaning of section 4941 of the Code or a taxable expenditure within the meaning of section 4945 of the Code.

Section 501(c)(3) of the Code provides for the exemption from federal income tax of nonprofit organizations organized and operated exclusively for the charitable and/or other exempt purposes stated in that section.

Section 509(a) of the Code describes organizations exempt from federal income tax under section 501(c)(3) of the Code that are private foundations subject to the provisions of Chapter 42 of the Code, including section 4941.

Section 1.507-3(a)(3)(1) of the regulations provides that certain tax benefits and attributes of the transferor private foundation stated in section 507(d) of the Code are transferred to the transferee private foundation in a transfer of assets pursuant to section 507(b)(2) of the Code.

Section 1.507-3(a)(9)(i) of the regulations provides that, if a private foundation transfers all of its net assets to one or more private foundations which are effectively controlled (within the meaning of section 1.482-1(i)(4)), directly or indirectly, by the same person or persons which effectively controlled the transferor private foundation, for purposes of chapter 42 (section 4940 et seq.) and part II of subchapter F of chapter 1 of the Code (sections 507 through 509) such a transferee private foundation shall be treated as if it were the transferor foundation.

Section 1.507-3(a)(9)(ii) of the regulations provides that a transfer of assets under section 507(b)(2) of the Code does not relieve the transferor private foundation from filing its own final tax year return as required by section 6043(b) of the Code.

Section 1.507-4(b) of the regulations provides that the tax on termination of private foundation status under section 507(c) of the Code does not apply to a transfer of assets under section 507(b)(2) of the Code.

Sections 1.507-1(b)(7) and 1.507-3(d) of the regulations provide that a transferor foundation's transfer of assets pursuant to section 507(b)(2) of the Code will not constitute a termination of the transferor foundation's private foundation status under section 509(a) of the Code.

Revenue Ruling 2002-28, 2002-1 C.B. 942, describes such section 507(b)(2) transfers of assets by one private foundation to one or more other private foundations. It indicates, in its holding (1), that the termination tax under section 507(c) of the Code does not apply to a transferor private foundation unless the transferor has a termination of its private foundation status under section 507(a) of the Code. It indicates, in its holding (2)(b), that a private foundation is no longer required to file its annual return Form 990-PF when it no longer has any assets or activities. It indicates, in its holding (4), that the transferor foundation's aggregate tax benefits under section 507(d) of the Code are transferred to the transferee foundation in the section 507(b)(2) transfer.

Section 4941 of the Code imposes excise tax on any act of self-dealing between a private foundation and any of its disqualified persons under section 4946 of the Code.

Section 4941(d)(2)(E) of the Code and section 53.4941(d)-3(c) of the Foundation and Similar Excise Tax Regulations provide that the payment of compensation (and the payment or reimbursement of expenses) by a private foundation to a disqualified person for personal services which are reasonable and necessary to carrying out the exempt purpose of the private foundation shall not be an act of self-dealing if the compensation (or payment or reimbursement of expenses) is not excessive. Example 1 of the regulation indicates that a private foundation trust can make payments to disqualified persons who are its trustees for legal services which are reasonable and necessary.

Section 4941(d)(2)(B) of the Code and section 53.4941(d)-2(c) of the regulations provide, in pertinent part, that any lending of money or other extension of credit between a private foundation and a disqualified person is an act of self-dealing.

Section 53.4941(d)-2(f)(3)(i) of the regulations provides generally that section 4941(d)(1) shall not apply to the indemnification by a private foundation of a foundation manager, with respect to the manager's defense in any civil judicial or civil administrative proceeding arising out of the manager's performance of services on behalf of the foundation, against all expenses including attorneys' fees, judgments and settlement expenditures if--

(i) Such expenses are reasonably incurred by the manager in connection with such proceeding, and

(ii) The manager has not acted willfully and without reasonable cause with respect to the act or failure to act which led to such proceeding or to liability for tax under chapter 42.

Section 4945 of the Code imposes excise tax on any "taxable expenditure" by a private foundation.

Section 4945(d)(4) of the Code provides that a taxable expenditure includes any amount paid by a private foundation that is not for a purpose in furtherance of its exempt purposes.

Section 53.4945-6(b)(2) of the regulations indicates that taxable expenditures do not include reasonable expenses, including reasonable compensation and fees for services rendered, that are paid by a private foundation exercising reasonable care and prudence in that regard.

Section 4946 of the Code defines the disqualified persons subject to section 4941 of the Code.

Section 4946(a)(1)(B) of the Code provides that a disqualified person includes a foundation manager under section 4946(b)(1) of the Code.

Section 4946(b)(1) of the Code provides that a foundation manager is an officer, director, or trustee of the private foundation (or an individual having powers or responsibilities similar to those of officers, directors, or trustees of the foundation).

Section 53.4946-1(a)(8) of the regulations provides that, for purposes of self-dealing under section 4941 of the Code, an exempt organization under section 501(c)(3) of the Code is not a disqualified person.

Analysis

1.a.

Under sections 1.507-1(b)(7) and 1.507-3(d) of the regulations, and in accord with holding (1) in Revenue Ruling 2002-28, T's transfer of assets to C under section 507(b)(2) of the Code does not constitute termination of T's private foundation status under section 509(a) of the Code. Because T's transfer does not constitute a termination of its private foundation status, T's transfer of assets to C will not result in termination tax under section 507(c) of the Code.

1.b. and 1.c.

Under section 1.507-1(b)(9) of the regulations, and in accord with holding (2)(b) in Revenue Ruling 2002-28, a private foundation transferring its assets under section 507(b)(2) of the Code is not required to file an annual return, Form 990-PF, under section 6033 of the Code for any tax year, subsequent to the tax year in which it transfers all of its assets, when it has assets and no activities. Thus, T and C are required to file Form 990-PF for each tax year in which each of them has assets or activities. T will not be required to file Form 990-PF when T no longer has any assets or activities.

2.

Under section 507(b)(2) of the Code and section 1.507-3(a)(1) of the regulations, and in accord with holding (4) in Revenue Ruling 2002-28, in this transfer of assets under section 507(b)(2) from T to C, T's aggregate tax benefits under section 507(d) of the Code will be transferred to C. Given the common control of T and C by the same persons, section 1.507-3(a)(9)(i) of the regulations also applies.

3. and 4.

Based on the facts presented, including the taxpayer's representation and the probate court's finding that the compensation amounts (the X payments) are reasonable, we find that the X payments as compensation to T's trustees and C's directors will not constitute acts of self-dealing. Also, the amounts designated as interest, although separately stated, were considered by the court in determining the overall reasonableness of compensation for services provided, and are properly treated as payments of compensation, rather than interest on any loans or extensions of credit for purposes of section 4941 of the Code. Similarly, the interest to be paid by T or C in the Y and Z payments does not constitute any loan between a private foundation and a disqualified person.

5. and 6.

Section 4941(d)(2)(E) of the Code and section 53.4941(d)-3(c) of the regulations provide that the payment of compensation (and the payment or reimbursement of expenses) by a private foundation to a disqualified person for personal services which are reasonable and necessary to carrying out the exempt purpose of the private foundation shall not be an act of self-dealing if the compensation (or payment or reimbursement of expenses) is not excessive. Example 1 of the regulation indicates that a private foundation trust can make payments to disqualified persons who are its trustees for legal services which are reasonable and necessary. Therefore, indemnification payments made by the Y payment to a disqualified person, E, will not constitute self-dealing within the meaning of section 4941 of the Code or taxable expenditures under section 4945 of the Code and section 53.4945-6(b)(2) of the regulations as to the parties involved, based on the facts presented.

The Z settlement payment to a now disqualified person, F, similarly involves administrative expenses represented as reasonable and not excessive and, therefore, will not be a taxable expenditure under section 4945 of the Code. The services were performed for the Estate and were for T's benefit as named beneficiary of the Estate. T settled with F to avoid a quantum meruit claim by F against T based on the value of those services. Moreover, the settlement payment was approved by the probate court. Such settlement payment will not give rise to an act of self-dealing.

Accordingly, we rule that:

1.a. T's transfers of assets to C will not result in termination tax under section 507(c) of the Code.
1.b. T and C are required to file Form 990-PF for each tax year in which each of them has assets or activities.
1.c. T will not be required to file Form 990-PF when T no longer has any assets or activities.

2. C shall not be treated as a newly created organization and shall be treated as possessing all of the tax benefits, attributes, and characteristics of T as provided by section 507(d) of the Code.

3. The portion of the compensation amounts to be paid to T's trustees and C's directors which is calculated as an interest charge in the X payments to trustees and directors does not reflect a loan or an extension of credit within the meaning of section 4941 of the Code, based on the facts presented, including your representation that the payments and interest thereon are reasonable and necessary foundation expenses and that such amounts are not excessive.

4. The addition of an interest charge to the reimbursement of attorney fees to be paid in the Y payment to E does not reflect a loan or an extension of credit within the meaning of section 4941 of the Code, based on the facts presented, including your representation that the payment and interest thereon are reasonable and necessary foundation expenses and that such amounts are not excessive.

5. Indemnification payments made in the Y payment to E will not constitute self-dealing within the meaning of section 4941 of the Code or taxable expenditures under section 4945 of the Code, based on the facts presented, including your representation that the payment and interest thereon are reasonable and necessary foundation expenses and that such amounts are not excessive.

6. The settlement payment Z to F, including interest from the date of the court's order to the date of payment, will not constitute self-dealing under section 4941 of the Code or a taxable expenditure under section 4945 of the Code, based on the facts presented, including your representation that the payment and interest thereon are reasonable and necessary foundation expenses and that such amounts are not excessive.

Except as we have ruled above, we express no opinion as to the tax consequences of the transactions under the cited provisions of the Code or under any other provisions of the Code.

Because this rulings letter could help to resolve any questions, please keep it in your permanent records.

This rulings letter is directed only to the organizations that requested it. Section 6110(k)(3) of the Code provides that this rulings letter may not be used or cited as precedent.

Sincerely,

(signed) Terrell M. Berkovsky

Terrell M. Berkovsky
Manager, Exempt Organizations
Technical Group 2