TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

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Date: November 23, 2005

Contact Person:

Identification Number:

UIL:4941.00-00

Telephone Number:

Employer Identification Number:

Legend:

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Dear

This is in response to a letter dated February 10, 2005, which requested rulings on the application of sections 501(c)(3), 4941, 4942, 4945 and 507 of the Internal Revenue Code to a proposed settlement agreement that involves, among other things, a transfer of title to B's assets back to C's estate.

B was created on April 12, , and received a letter from the Internal Revenue Service dated July 2, , granting exempt status under section 501(c)(3) of the Code and classification as a private foundation under section 509(a). B's purpose is to provide scholarships to promising young adults with financial need.

B received all of its funding in July of , by a bequest from C after her death. C left a gross estate consisting principally of parcels of rental real estate held in a revocable trust named D. Based on the estate tax return filed for C's estate, these properties had a net fair market value of x on the date of C's death.

Under the terms of D, as amended prior to C's death, the trustees of D were directed, upon C's death, to distribute all property then held in D to B. Pursuant to this direction, all the properties were transferred to B. However, the transfer was completed before C's will was probated, before any creditors had the opportunity to present claims, and before any heirs had the opportunity to challenge C's estate plan.

On August 14, , several of C's relatives filed an equity complaint with the E Probate Court. The claimants challenged (i) the validity of wills executed by C in and , and/or (ii) the validity of amendments C made to D in the months preceding her death, and/or (iii) the legality of the funding of D. The suit also demanded that B transfer back to C's estate all of the assets it had received from C's estate. The complaint alleged that the directors of B had exercised undue influence over C and coerced her into making the final revisions to her estate plan that left her estate to B and cut out her relatives as beneficiaries.

A temporary restraining order was issued by the E Probate Court precluding B from taking any action with respect to the property held by B; and at a September hearing, a preliminary injunction was issued to the same effect. In late September , B filed a motion seeking a relaxation of the preliminary injunction, asserting that the property needed to be maintained and managed, that rents had to be collected and bills paid, and that the preliminary injunction paralyzed all of those actions. After a hearing on the motion, the court denied the motion, but the court appointed F as a receiver of B, pending resolution of the aforementioned claims.

Under the terms of the court appointment, the receiver was granted only limited powers relating to B's operation pending outcome of the litigation, such as the power to maintain rental real estate held by B and to file relevant tax returns. Such powers do not include the power to make distributions in furtherance of B's charitable purpose. The limitation on the receiver's powers applies to all of B's assets, including principal and income. B appealed the preliminary injunction. That appeal was denied despite the directors' assertions, and the filing of numerous pleadings, motions, and related documents with E Probate Court and the appeals court. Thus, as a result of the continuing litigation, B has no access to its assets and has been unable to begin any charitable activity.

H has served as a director and treasurer of B, and has served as co-trustee of D. He has also acted as property manager for C's real properties, and as her personal assistant, particularly in the year before her death. He was not paid for those services, due to the freezing of B's assets and the subsequent transfer of the assets to the receiver.

Because of the preliminary injunction, B has made no qualifying distributions under section 4942 of the Code. By order dated January 23, , the E Probate Court granted F as receiver of B authority to apply to the Internal Revenue Service under section 4942(g)(2) of the Code for approval of a contingent set-aside with respect to the minimum distributable amount that is otherwise required to distributed under section 4942, and to evidence the contingent set-aside through an entry on the books of B in the amount of y as a pledge for the calendar year 2002 to be paid as a qualifying distribution no later than the last day of the taxable year in which the litigation is finally resolved. The amount of the contingent set-aside was determined assuming that B ultimately would be entitled to retain all property that it has received to date, that the plaintiffs would recover nothing, and that B would not be required to make contributions towards payment of estate taxes or administrative expenses of the estate. The Service granted its approval of the contingent set-aside for on April 17, .

F as the receiver of B applied for approval to make a contingent set-aside on the same basis as the set-aside in the amount of t for calendar year . The Service granted the request on January 4, . F as the receiver of B applied for the approval to make a contingent set-aside on the same basis as the set-aside in the amount of v for calendar year , and the Service currently has that request under consideration.

The lawsuit is a complicated matter that has involved hundreds of hours of attorney time and resulted in over 100 pleadings and related documents being filed in different courts in the State of G. In addition to the equitable proceedings initiated in the E Probate Court, the plaintiffs, as well as other third parties, have also initiated at least four separate probate proceedings concerning the administration of C's estate. Other actions have also been initiated concerning the rightful ownership of a certain parcel of real estate owned by C, and a former employee has filed a complaint claiming that he is entitled to additional compensation from her estate and a monetary award from the individual directors for alleged emotional distress.

If all the cases proceed to trail, it may be years before they are finally resolved. The costs of additional litigation could severely deplete any benefit that B might ultimately receive at the termination of litigation. Furthermore, although B has defended its claim to the estate assets vigorously, and at this point it has prevailed in court proceedings, there is no assurance that it would be successful at trial.

B believes it is in its best interest to settle the litigation before trial because a settlement will maximize the assets ultimately available for its charitable purposes and will end the freeze that is currently preventing it from carrying out any of its charitable purposes. The E Probate Court appointed an experienced mediator who also is a litigation attorney in G, to engage the parties in settlement discussions. The parties have undergone intense negotiations, aided by the mediator, for more than a year. The extended duration of the settlement negotiations was due to the complex nature of the issues and the number of parties involved. At this point the parties have reached a settlement that would allow these matters to be resolved without further litigation.

The settlement agreement has been agreed to by the G Attorney General and by a court-appointed guardian ad litem. The G Probate and Family Court has also approved the agreement. This agreement includes the following key provisions, which will also be reflected in the revision of C's will: (1) all property in C's estate will be sold; (2) an independent third party named in the agreement will be appointed as executor of C's estate; (3) debts, taxes and expenses of C's estate will be paid, including compensation to H, in the amount of s, for services rendered to C, her estate, and B; a legacy to L in the amount of k; and any remaining assets will be divided one-half to B, and one-half to the plaintiffs.

The Board of Directors of B voted to approve the portion of the agreement that provides for compensatory payments to H. H recused himself from the vote and took no part in the discussions.

You have requested the following rulings:

1. Entering into the settlement agreement and carrying out its terms will not adversely affect B's exempt status under section 501(c)(3) of the Code.

2. Entering into the settlement agreement and carrying out its terms will not result in direct or indirect self-dealing transactions under section 4941 of the Code.

3. Entering into the settlement agreement and carrying out its terms, including the transfer of all contingent set-asides from B to the estate, will not result in a failure to distribute income under section 4942 of the Code, and B's obligations under section 4942 of the Code to make qualifying distributions or to make contingent set-asides will not commence until B receives a distribution from the estate pursuant to the settlement agreement.

4. Entering into the settlement agreement and carrying out its terms will not result in taxable expenditures under section 4945 of the Code.

5. Entering into the settlement agreement and carrying out its terms will not result in a taxable termination of B's status as a private foundation under section 507 of the Code.

Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations organized and operated "exclusively" for charitable, educational, scientific, or other specified exempt purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and which does not engage in proscribed legislative or political activities.

Section 1.501(c)(3)-1(c)(1) of the Income Tax Regulations states that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if engages primarily in activities which accomplish one or more of the purposes specified in section 501(c)(3) of the Code. An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Section 1.501(c)(3)-1(c)(2) of the regulations provides that an organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals. Section 1.501(a)-1(c) defines the words "private shareholder or individual" in section 501 of the Code as referring to persons having a personal and private interest in the activities of the organization.

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations provides that an organization is not organized or operated exclusively for one or more exempt purposes under section 501(c)(3) of the Code unless it serves a public rather than a private interest. Thus, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

Rev. Rul. 69-383, 1969-2 C.B. 113, holds that the section 501(c)(3) tax exempt status of a hospital will not be jeopardized where, after arm's length negotiations, it enters into an agreement with a hospital-based radiologist to compensate him on the basis of fixed percentage of the department's income. The rationale for the ruling is as follows: the parties had negotiated the agreement on an arm's length basis; the radiologist had no control over the hospital itself; the amount of compensation was reasonable in terms of the responsibilities and activities assumed; and, further, the amount was not excessive when compared to the amount received by other radiologists in comparable circumstances.

Sections 4941(a)(1) and 4941(b)(1) of the Code impose excise taxes upon any act of self-dealing between a private foundation and any of its disqualified persons. The taxes are to be paid by any disqualified person (other than a foundation manager acting only as such) who participates in the act of self-dealing.

Sections 4941(a)(2) and 4941(b)(2) of the Code impose excise taxes on a foundation manager who participates in an act of self-dealing between the private foundation and a disqualified person where the foundation manager knows that such act is an act of self-dealing under section 4941.

Section 4946(a)(1) of the Code states that the term "disqualified person" includes a foundation manager within the meaning of subsection (b)(1).

Section 4946(b)(1) of the Code provides that the term "foundation manager" means, with respect to a private foundation, an officer, director, or trustee of the foundation (or an individual having similar powers or responsibilities).

Section 4946(a)(1)(A)(D) of the Code provides a substantial contributor and a "member of the family" of a substantial contributor is also a disqualified person.

Section 53.4946-1(h) of the regulations provides a "member of the family" does not include siblings or descendants of siblings.

Section 4946(a)(1)(G) of the Code provides an estate or a trust is a disqualified person only if more than 35% of the beneficial interests are owned by disqualified persons.

Section 4941(d)(1)(D) of the Code provides generally that the term "self-dealing" means any direct or indirect payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person.

Section 4941(d)(2)(E) of Code provides payment of reasonable compensation for personal services rendered that are reasonably necessary to carrying out the charitable purposes of the foundation are not self-dealing.

Section 4941(d)(1)(E) of the Code provides that "self-dealing" also means the transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation.

Section 53.4941(d)-1(a) of the Foundation and Similar Excise Taxes Regulations provides that, for purposes of Section 4941 of the Code, the term "self-dealing" includes any direct or indirect transaction described in section 53.4941(d)-1 of the regulations.

Section 53.4941(d)-1(b)(3) of the regulations provides that the term "indirect self-dealing" shall not include a transaction with respect to a private foundation's interest or expectancy in property (whether or not encumbered) held by an estate (or revocable trust, including a trust which has become irrevocable on a grantor's death), regardless of when title to the property vests under local law, if:

1. The administrator or executor of an estate or trustee of a revocable trust either:

   (a) Possesses a power of sale with respect to the property,
   (b) Has the power to reallocate the property to another beneficiary, or
   (c) Is required to sell the property under the terms of any option subject to which the property was acquired by the estate (or revocable trust);

2. Such transaction is approved by the probate court having jurisdiction over the estate (or by another court having jurisdiction over the estate (or trust) or over the private foundation);

3. Such transaction occurs before the estate is considered terminated for federal income tax purposes pursuant to paragraph (a) of section 1.641(b)-3 of this Chapter (or in the case of a revocable trust, before it is considered subject to Section 4947 of the Code;

4. The estate (or trust) receives an amount which equals or exceeds the fair market value of the foundation's interest or expectancy in such property at the time of the transaction, taking into account the terms of any option subject to which the property was acquired by the estate (or trust); and

5. With respect to transactions occurring after April 16, 1973, the transaction either:

   (a) Results in the foundation receiving an interest or expectancy at least as liquid as the one it gave up,
   (b) Results in the foundation receiving an asset related to the active carrying out its exempt purposes, or
   (c) Is required under the terms of any option which is binding on the estate (or trust).

Sections 4942(a) and 4942(b) of the Code impose taxes on any private foundation that fails to make "qualifying distributions" of the entire "distributable amount" for any taxable year.

Section 4942(d) of the Code defines the "distributable amount' for a taxable year as the sum of the "minimum investment return" plus certain adjustments described in subsection 4942(f)(2)(C) reduced by the sum of taxes paid under subtitle A and section 4940.

Section 4942 of the Codes defines “Minimum investment return” as 5% of the excess of (A) the aggregate fair market value of all assets of the foundation other than used (or held for use) directly in carrying out the foundation’s exempt purpose, over (B) the acquisition indebtedness with respect to such assets.

Sections 4945(a)(1) and 4945(b)(1) of the Code impose excise taxes to be paid by a private foundation that makes a taxable expenditure, as defined in section 4945(d).

Sections 4945(a)(2) and 4945(b)(2) of the Code impose excise taxes to be paid by a foundation manager who agrees to the foundation’s making of an expenditure, “knowing” that it is a taxable expenditure, unless such agreement is not willful and is due to reasonable cause.

Section 4945(d)(5) of the Code defines the term “taxable expenditure” to mean any amount paid or incurred by a private foundation for any purpose other than one specified in section 170(c)(2)(B).

Section 53.4945-6(b)(1) of the regulations provides that expenditures to acquire investments and reasonable expenses thereof entered into for the purpose of obtaining income or funds to be used in furtherance of purposes described in section 170(c)(2)(B) ordinarily will not be treated as taxable expenditures under section 4945(d)(5) of the Code.

Section 507(a) of the Code provides that, except as provided in subsection (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 for that reason such organization is liable for the tax imposed by subsection (c),

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

Section 507(c) of the Code provides that there is hereby imposed on each organization which is referred to in subsection (a) a tax equal to the lower of –

(1) the amount which the private foundation substantiates by adequate records or other corroborating evidence as the aggregate tax benefit resulting from the section 501(c) status of such foundation, or

(3) the value of the net assets of the foundation.

Section 507(e) of the Code provides that for purposes of subsection (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.

The information submitted shows the settlement agreement is essential to furthering the exempt purposes of B under section 501(c)(3) of the Code because the agreement is necessary to carry out B's exempt purposes.

B has not been successful in its defense of the lawsuit brought by the plaintiffs and must consider the possibility if the matter proceeds to trial the plaintiffs might prevail in their claim against the assets of C's estate. Even if B ultimately prevails, the litigation costs could seriously deplete the assets available to B and it could be years before the litigation is resolved.

The Attorney General has assented to the settlement. The E Probate Court has approved the terms of the settlement as fair and reasonable. The payment to be made to H is similar to the payment made in Rev. Rul. 69-383, supra, in that the parties reached an agreement after extensive arms-length negotiations. Accordingly, entering into the settlement will allow B to resolve the dispute, gain access to a substantial sum of cash, and will allow it to carry out its exempt purposes, therefore, the settlement will not jeopardize the exempt status of B under section 501(c)(3) of the Code.

Section 4941 of the Code provides that a payment to a disqualified person may be self-dealing if made either directly by a private foundation or indirectly by a trust or an estate in which a private foundation has a beneficial interest. H is a disqualified person because he is an officer and a director of B. However, the payment to H for reasonable compensation for services provided is not an act of self-dealing under section 4941(d)(2)(E) of the Code. Further, the plaintiffs are members of C's family, but are not disqualified persons because they are siblings, nieces and nephews rather than ancestors or lineal descendants of C. Therefore, the payments to the plaintiffs is not self-dealing under section 4946-1(h) of the regulations.

In order to correct the previously described administrative error, the court agreed that temporarily transferring title to the real property to the independent executor is appropriate. While the executor is a disqualified person, the change in title will not affect the equitable interest of B; it will simply correct an administrative error until the E Probate Court resolves all claims against C's estate. Section 53.4941(d)-1(b)(3) of the regulations recognizes the possibility that a private foundation may find itself in the same situation as B; a decedent leaves a will or revocable trust directing assets to a private foundation, but family members, creditors, or others having an interest in the estate challenge the gift. In order to reach a settlement, B is obligated to agree to a payment to a disqualified person. Under section 53.4941(d)-1(b)(3) an estate is permitted to make payments to a disqualified person as long as certain conditions are satisfied. This is called the "estate administrative exception."

In this case, the terms of the settlement agreement meet all of the conditions set out in the estate administration exception as follows: (1) The executor of the estate has the power of sale with respect to the property and has the power to reallocate the property of the estate to a beneficiary other than B; (2) The settlement agreement has been approved by the E, Probate Court which has jurisdiction over the estate; (3) The settlement will occur before the estate is considered terminated for federal income tax purposes (the estate cannot be terminated for income or estate tax purposes until the litigation among the parties is resolved); (4) The estate will receive an amount that equals or exceeds the fair market value of B's interest or expectancy in the property at the time of the transaction because the court approved the settlement agreement; (5) The settlement agreement will result in B receiving an interest at least as liquid as the one it gave up and will result in B receiving an asset related to its exempt purposes.

Therefore, the settlement agreement satisfies all of the conditions to the estate administration exception and therefore, does not constitute self-dealing under section 4941 of the Code.

Section 4942 of the Code imposes taxes on a private foundation that, in any taxable year, fails to make qualifying distributions of the "distributable amount." Because the rights of B to retain any of its property is currently uncertain, the "distributable amount" cannot be determined, and all contingent set-asides under section 4942(g) could be transferred to claimants against the estate rather than paid as "qualifying distributions."

The settlement agreement corrects the trustees' administrative error by transferring title to the real property, together with cash and all section 4942(g) of the Code contingent set-asides made by B, back to the independent executor so the estate can be settled. Until B receives the property it is entitled to, it cannot make "qualifying distributions" or determine the "distributable amount." Therefore, section 4942 does not apply to B in any taxable year prior to the taxable year in which B receives a distribution from the estate pursuant to the settlement agreement.

Section 4945 of the Code defines a taxable expenditure as any expenditure paid or incurred by a private foundation for any purposes other than an exempt purpose. Section 53.4945-6(b)(1) of the regulations states amounts expended by a private foundation to acquire investments entered into for the purpose of obtaining income or funds to be used for charitable purposes will not be treated as taxable expenditures. B cannot gain access to the assets of C's estate until the litigation is resolved. By entering into the settlement agreement B will obtain cash to carry out its exempt purposes, will stop further attorney's fees and litigation expenses, and will eliminate the possibility of an adverse outcome in the litigation. For these reasons, B's participation in the settlement agreement is treated as a cost of acquiring income and assets to be used in furtherance of B's exempt purposes. Further, to the extent that B is not entitled to retain assets under the settlement agreement, the return of those assets to C's estate is not a taxable expenditure.

B states it has not notified the Internal Revenue Service that it intends to terminate its private foundation status, nor has B ever received notification that its status as a private foundation has been terminated. B states it has not committed 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. The transfer of title in the assets of B back to C's estate is being undertaken solely for the purpose of settling litigation pursuant to the terms of the settlement agreement. Thus, the transfer does not result in a termination of B's private foundation status under section 507 of the Code.

Accordingly, based on the information furnished, we rule as follows:

1. Entering into the settlement agreement and carrying out its terms will not adversely affect B's exempt status under section 501(c)(3) of the Code.

2. Entering into the settlement agreement and carrying out its terms will not result in direct or indirect self-dealing transactions under section 4941 of the Code.

3. Entering into the settlement agreement and carrying out its term, including the transfer of all contingent set-asides from B to C's estate, will not result in a failure to distribute income under section 4942 of the Code, and B's contingent set-asides will not commence until B receives a distribution from C's estate pursuant to the settlement agreement.

4. Entering into the settlement agreement and carrying out its terms will not result in taxable expenditures under section 4945 of the Code.

5. Entering into the settlement agreement and carrying out its terms will not result in a taxable termination of B's status as a private foundation under section 507 of the Code.

A ruling on your request for a set-aside for calendar year 2004 will be issued in separate correspondence. This ruling will be made available for public inspection under section 6110 of the Code 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 organization that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

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.

Sincerely,

Lawrence M. Brauer
Acting Manager, Exempt Organizations
Technical Group 1

Enclosure
Notice 437