P. THIRTY YEARS AFTER THE 1969 TRA – RECENT DEVELOPMENTS UNDER CHAPTER 42

by
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> ***"Chiefs! Our road is not built to last a thousand years, yet in a sense it is. When a road is once built, it is strange thing how it collects traffic, how every year as it goes on, more and more people are found to walk thereon, and others are raised up to repair and perpetuate it, and keep it alive."***
> Vailima Letters. Address to the Chiefs on the Opening of the Road of Gratitude, October, 1894.
> Robert Louis Stevenson (1850-1894)

1. Introduction

The Private Foundation provisions in the Internal Revenue Code are now approaching their pearl anniversary. Enacted in the TRA of 1969, Chapter 42 and related sections such as IRC 507 and IRC 4947 have provided the Service and the private foundation community (including 4947 trusts) with a workable and fair regulatory mechanism. There has been relatively minor tinkering with the provisions either through statutory change or administrative action. As with any complex body of law, there has been evolution in interpretation and application to meet changes in society and technology. There has been a steady increase in the number of entities subject to Chapter 42, especially in the rolls of IRC 4947(a)(2) trusts. There are now over 130,000 organizations that file 990 PFs or 5227s. No one knows whether the private foundation provisions of the Code, like Robert Louis Stevenson's road, will survive the next millennium. Presently, however, Chapter 42 serves as a vehicle in good repair to cross the bridge into the 21st century regulation of the private foundation sector of the EO universe.

This topic will provide discussions of recent private foundation developments and update CPE articles in 1995 (Topic O); 1996 (Topic G); and 1997 (Topic K). Court cases, private letter rulings (PLRs), technical advice memorandums (TAMs), General Counsel Memorandums (GCMs), new law and proposed regulations under IRC 664 will be highlighted. The Topic will also include a listing of Chapter 42 issues that may be resolved by Key District determination letters.

2. IRC 4940

Treatment of Distributions from an Employee Qualified Plan or IRA

In PLR 9341008, July 14, 1993, the Service was asked to rule that a private foundation is not subject to the federal excise tax on investment income under IRC 4940(a) when the donor's individual retirement accounts (IRAs) pass to the private foundation. The donor had several IRAs whose designated beneficiary was a private foundation expected to be exempt under IRC 501(c)(3). As part of this same ruling request, the Service concluded that proceeds payable from the IRAs will be income in respect of a decedent to the private foundation under IRC 691(a)(1)(B) when distributed to the private foundation. As to the 4940 issue, the Service concluded that the private foundation would not be subject to the federal excise tax on investment income under IRC 4940 when the donor's IRAs pass to the private foundation.

PLR 9633006, May 9, 1996, involved virtually the same set of facts as PLR 9341008, except that the properties of the donor passing to a private foundation were proceeds of a Keogh plan rather than an IRA. On the 4940 issue, the Service reached the opposite conclusion from the earlier ruling; the private foundation would be subject to tax on investment income under IRC 4940(a) of the Code on the proceeds from the donor's Keogh account which are in excess of the contributions made to the account. The ruling also held that the Keogh proceeds were income in respect of a decedent to the private foundation under IRC 691(a)(1)(B), but the private foundation would not recognize tax because it is exempt under IRC 501(c)(3), subject to UBTI modifications under IRC 512(b).

The Service is presently resolving the conflict between the holdings of these two private letter rulings. The following supports a view that the position should reflect the bottom line in PLR 9341008, holding that a distribution from a Qualified Employee Plan do not constitute income for purposes of IRC 4940(a).

Even though a Qualified Employee Plan distribution typically includes interest, dividends, capital gains and other earnings, the Service treats the entire distribution as deferred compensation. The Qualified Employee Plan has received contributions from employees in respect to personal services. The pension fund also generates investment income on the employer contributions. However, once a distribution is made to an employee, the distribution is entirely taxed as deferred compensation. Unlike other trusts, a pension trust does not pass through the character of income to the recipient of trust distributions. For example, an employee is taxed on a distribution from a pension plan even though part consists of interest on tax-exempt municipal bonds. See Rev. Rul. 55-61, 1955-1 C.B. 40. Also, employees are not entitled to the dividend received exclusion where part of a pension distribution was attributed to dividends. All the rules applicable to pension distributions apply to the distributions as a whole without regard to the source of payments. See Rev. Rul. 72-3, 1972-1 C.B. 105. Thus, a pension is viewed as a substitute for earning power and the entire amount of the pension distribution constitutes deferred compensation. This is its only character. The same considerations are applicable to IRA distributions for purposes of IRC 4940(a). Finally, deferred compensation is not listed as an item that is included in gross investment income under IRC 4940(c) or Reg. 1.512(b)-1(a). Consequently, it is difficult to classify qualified employee plan distributions including IRA distributions as gross investment income for IRC 4940 purposes.

A new private letter ruling on this issue will be issued.

3. IRC 4941

A. Personal Services Exception and Foundation Managers Tax

In a recent case, John W. Madden, Jr. v. Commissioner, T.C. Memo 1997-395 (1997), the Court addressed both UBIT and self-dealing issues. This synopsis considers only the self-dealing issues of that decision.

(1) Personal Services

The Petitioner is a founder of the Museum, an entity exempt under IRC 501(c)(3) and classified as a private foundation. The Petitioner, his wife, and his daughter are each foundation managers within the meaning of IRC 4946(b). The Museum displays sculpture and other artwork, primarily outdoors. Most of the artwork is displayed along public thoroughfares that run throughout a commercial office building complex. The museum conducts tours of the artwork and also offers outdoor music concerts and theatrical and dance performances.

The Museum relies on the building owners (including a company related to the Petitioner) to provide space inside and outside the commercial complex to display the sculptures and artwork. The Petitioner owns a 75 percent interest in Greenway Management Co. (hereafter "GMC"), a service company providing custodial, maintenance, and janitorial services. GMC performed services for some of the office buildings in the complex and also contracted with the museum to perform comparable services for the Museum.

The parties agreed that GMC is a disqualified person as to the museum. The petitioner had agreed that payments made by the museum to repair artwork owned by the petitioner constituted acts of self-dealing. The question at issue is whether the furnishing of maintenance, janitorial, and security services by GMC is an act of self-dealing under

IRC 4941(d)(1)(C). The Petitioner asserted that the services performed by GMC fall within the exception of IRC 4941(d)(2)(E) for the performance of personal services.

In its holding, the Court focused on the definition of personal services. It cited the examples of personal services found under Reg. 53.4941(d)-3(c)(2). The examples include legal services, investment management services, and general banking services. The Court found that the personal services in the regulations were of a professional and managerial nature as distinguished from the services rendered by GMC. Further, the Court found that Petitioner's interpretation of personal services contravened Congressional intent. In the Court's terms ". . . any exceptions to the self-dealing transactions rules should be construed narrowly."

The issue of the expanded definition of personal services for purposes of the exception provided by IRC 4941(d)(2)(E) has been an issue under debate for several years. The personal services exception was discussed at some length in the 1995 CPE Text, Topic O, page 247, 269 to 274. The argument asserted by the Petitioner in the Madden case, supra, had been asserted by other entities. The argument asserted in Madden is that any service is a personal service where capital is not a major factor in the production of income. The Court held that the Petitioner's argument, if accepted, would nullify the prohibition against furnishing services in IRC 4941(d)(1)(C). The Court stated:

> "The statute draws an explicit distinction between a 'charge' for 'furnishing of goods, services, facilities', see sec. 4941(d)(1)(C) and (2)(C), and the payment of 'compensation' 'for personal services', see sec. 4941(d)(1)(D) and 2(E). GMC's argument equating a charge for services with compensation for personal services significantly erodes this distinction."

(2) Foundation Managers Tax- Nature of Knowing

The second self-dealing issue is whether Petitioner, his wife and his daughter are liable under IRC 4941(a)(2) for the tax on foundation managers with respect to the self-dealing transaction with GMC. Under Reg. 53.4941(a)-1(b)(1), the tax is imposed when the participating manager knows that the act is an act of self-dealing and the participation is willful and not due to reasonable cause. Reg. 53.4941(a)-1(b)(3) provides guidelines as to the foundation manager's knowing participation in an act of self-dealing. Based on the facts of the case, the Court concluded that the managers had actual knowledge of sufficient facts concerning the transactions with GMC. The Court also found that they acted willfully in not obtaining advice of counsel concerning the implications of the arrangement with GMC. See also TAM 9627001, July 15, 1996, discussed in part 9.

However, the tax under 4941(a)(2) was not imposed on certain other acts of self-dealing. Thus, this case provides several examples of when the tax under IRC 4941(a)(2) may or may not be applied to foundation managers in a given situation.

B. Charitable Remainder Trusts- Income Deferral Issues Revisited

The 1997 EO CPE Text, "Charitable Remainder Trusts: The Income Deferral abuse and Other Issues", Topic K, page 139, examined whether the income deferral technique by charitable remainder unitrusts constitutes self-dealing in violation of IRC 4941.

Topic K describes how the net income and makeup provisions of IRC 664 may be used not to gain flexibility in the normal management of the portfolio, but for a tax deferral purpose not contemplated by Congress. To achieve a maximum deferral for a noncharitable beneficiary, a trust's assets must be manipulated in such a manner so that the net income and makeup provisions can be used to avoid payout in the early years of the trust and to realize income, including the makeup amount, only in later years when the noncharitable income beneficiary may be in a lower tax bracket. This device is called an income deferral NIMCRUT.

Topic K then continues to suggest that self-dealing may be asserted using the authority of Reg. 53.4941(d)-2(f)(1) to counter the income deferral NIMCRUT technique when the facts justify the position. The position suggested was that self-dealing occurs only under a specific factual situation where the assets were being manipulated for a specific personal purpose of the disqualified person and income beneficiary. The manipulation required for the self-dealing act is intentional manipulation.

The income deferral technique under consideration in the article involved two types. The first type is gain realized on the sale of an appreciated asset of the NIMCRUT at some time during the term of the trust, presumably after enough time has passed to allow the trust asset to have appreciated in value significantly prior to its sale. Another form of income deferral discussed in the article was income earned by a partnership in which the NIMCRUT holds a significant interest as partner. If the partnership deliberately fails to distribute partnership earnings to the partners including the NIMCRUT, income could have been deferred for years. One form of income deferral not discussed in that article was deferred annuities.

As applied in an actual case in TAM 9825001, June 19, 1998, the Service position evolved into consideration, to a significant extent, of whether the deferral of income of the trust has an unreasonable detrimental effect on the charitable interest. The type of deferred income under consideration in the TAM was a deferred annuity.

An extract of the facts of TAM 9825001 is helpful:

> X is a charitable remainder unitrust, which was intended to qualify under section 664 of the Internal Revenue Code. X was created by A by a trust instrument dated June 25, 1990. The trust instrument provides that the Trustee shall pay to A, and upon A's death, to A's wife, a unitrust amount equal to the lesser of (1) the trust income for the year or (2) eight percent of the aggregate fair market value of the trust assets for the year. The Trust instrument includes a make-up provision so that for any year that the unitrust payment is less than eight percent, the shortfall for prior years may be made-up in subsequent years when trust income exceeds eight percent. B is the trustee of X and is also the nephew of A.
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> Upon the death of the survivor of A or A's wife, the trust shall terminate and the balance of trust assets are to be distributed to designated charities.
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> In December, 1991, X entered into a contract to purchase two deferred annuity contracts from R, a commercial life insurance company. In one policy A is named the annuitant and in the other policy A's wife is named the annuitant. In other respects the two policies are identical. X is the owner of the policy and is beneficiary of the policies should either annuitant fail to reach the maturity date of the policies which is age 80. As a result of the endorsement of the two policies in 1997, the Trust, X, became the annuitant. Additional information relating to the policies is discussed hereafter in greater detail.

Before addressing the income deferral issue raised by the annuity, the Service addressed another self-dealing issue. In purchasing the annuities, the substantial contributor A and his wife were named annuitants. The private ruling explains that there is a real potential for self-dealing in that if the donor and his wife reach age 80, the contract will be annuitized and A his wife could receive all payments under the contract leaving nothing to charity. This is the worst case of self-dealing in that the disqualified persons regain all amounts in the trust and leave nothing to charity. However, TAM 9825001 explains that the annuity contracts are contingent and can be defeated by several factors including failure of A and his wife to survive to age 80 and by actions of the trustee of X including a partial withdrawal or surrender of the policy.

TAM 9825001 then goes on to consider the income deferral issue as self-dealing based on the following extract of additional facts:

> At the time X was created by A, it was funded with 86 shares of stock of V, a business previously owned and managed by A. On March 7, 1997, A transferred an additional 7 shares of V to X. Consequently, X held 93 of 94 outstanding shares of V.

> In the Summer of 1991, A became aware of a third party's offer to purchase V. In September or October of 1991, the trustee of X became aware of the proposal for the purchase of V, which included payment to A for a five year period pursuant to an employment agreement and noncompetition agreement. Since A's income would be provided for a five year period without the need for income from X, A and the trustee had discussions with T, a tax planning consultant, about the possibility of investing X's assets in deferred annuities. Based on T's recommendations, the trustee believed investing in deferred annuities was a solid choice in light of other investment alternatives available and the flexibility it offered the trustee to defer trust income until A's employment agreement and noncompetition payments ceased.
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> Consequently, in December 1991, X entered into a contract to purchase two deferred annuity policies from R, a commercial life insurance company. On January 15, 1992, the following three events occurred more or less contemporaneously: (1) substantially all the assets of V were sold to an unrelated purchaser for m; (2) X's stock holdings in V were redeemed for n, which X deposited into its account; and (3) X wrote two identical checks for o for each of the annuities purchased. The representatives for the Trust made the following representations: (1) C, an attorney who is trusted by A and B, served as the sole trustee of X from the time after the stock was contributed to X until before the sale of such stock to the unrelated purchaser; and (2) soon after the annuity contracts were acquired by X, C resigned as trustee and B again became the trustee. In fact, C signed as trustee on the contract to purchase the two deferred annuity policies.

The income deferral issue was posed as follows:

> We have examined the transaction with the intention of ascertaining whether B, acting in concert with A on an ongoing basis, manipulated the assets of X for the personal benefit of A, by furthering his income, retirement and tax planning goals. There was a concern that the entire transaction taken as a whole; the purchase of a deferred annuity, the failure to make withdrawals from the annuity policies, and the intention to subsequently make unitrust payments to A under the "make-up" provision of the Trust; could be construed as an act of self-dealing under section 4941(d)(1)(E) of the Code by virtue of the authority provided by section 53.4941(d)-2(f)(1) of the Regulations.

The Service ultimately concluded in the TAM that the transaction did not constitute self-dealing for two reasons. First, IRC 4947(a)(2) charitable remainder trusts are different from regular IRC 501(c)(3) private foundations because a disqualified person and income beneficiary of the trust is entitled to receive income from the trust as provided in the trust instrument. IRC 4947(a)(2)(A) specifically excludes from self-dealing such amounts. Second, the Service did not find that the facts clearly indicated that the disqualified person and trustee were acting in concert to manipulate the assets for the benefit of the disqualified person.

As to the first issue, the Service stated in the TAM that "rather than focusing on whether the income is a use of trust assets, the relevant question is whether deferral of income is a permitted use." Further, "the presence of an unreasonable effect on the charitable remainder interest distinguishes a permissible use of trust assets from an impermissible use."

Thus the negative inference of the ruling is that in some rare situations, the Service may, perhaps, be willing to find self-dealing. However, to find self-dealing of this sort, three tests must be satisfied.

The first two tests relate to the "manipulation" requirement based in Reg. 53.4941(d)-2(f)(1). (1) For the requisite "manipulation" to occur, the disqualified person and income beneficiary must control the decision of the trustee as to investment decision. Thus, such person must be serving as trustee or the facts of the case must establish that such person is acting in concert with the trustee as to these investment decisions. This is not an easy burden of proof to carry, as is demonstrated by the facts of the TAM. (2) The second element of manipulation is that the manipulation of the assets and investments is to serve the personal advantage and benefit of the income beneficiary beyond merely the receipt of the income provided by the trust instrument. There must be specific evidence of manipulation to benefit the income beneficiary in this manner. Again, not an easy burden of proof to carry.

Finally, (3) the third test is determining whether the deferral is a permitted use, meaning the lack of a presence of an unreasonable effect on the charitable remainder interest. As a practical matter, one might speculate that it will be quite a rare situation where an income deferral NIMCRUT would disadvantage a charity to the extent that it could be said that there is an unreasonable effect on the charitable remainder interest. The unreasonable affect on the charitable remainder interest would include an evaluation of the income realized by the charitable interest as well as the appreciation in value of the charitable assets over the term of the NIMCRUT. Since the Service does not second guess the investment decisions of the trustee in this regard, the "unreasonable effect" means something more than just bad investment judgment.

In the TAM, the Service has, in theory, left open the door to apply the self-dealing prohibition for the income deferral NIMCRUT in a truly egregious situation. As a practical matter, the vast majority of income deferral NIMCRUTs adhering to ordinary fiduciary standards under state law will not run afoul of this problem. The more realistic view is that the theory aired in 1997 EO CPE Text as modified, when applied to an actual case, will rarely be applied. As such, much of the discussion in the 1997 Text suggesting an aggressive approach on IRC 4941 issues with NIMCRUTS is modified pursuant to TAM 9825001 and this article.

As discussed below, the Service is still considering whether the partnership or annuity income deferral technique causes the trust to fail to function exclusively as an IRC 664 trust.

C. Extension of Credit Prohibition and the Estate Administration Exception

The Service issued PLR 9814050, April 3, 1998, relating to the exception from self-dealing found in Reg. 53.4941(d)-1(b)(3).

The facts of PLR 9814050 provide as follows: A and B are married and have executed a Living Trust to dispose of their property. The Living Trust provides that upon the death of the first taxpayer, two separate trusts will be established. The survivor's trust will consist of the surviving taxpayer's property after the death. The second trust is a marital trust qualifying for the marital deduction under IRC 2056(b)(7). After the death of the survivor, the marital trust property will pass to a private foundation, called "D", established by the two taxpayers, A and B. The residue of the estate of the second to die also passes to D.

The taxpayers, their 3 children, and certain partnerships are disqualified persons as to D. The main property held by A and B is various partnership interests. To facilitate the sale of the partnership interests after their deaths, the taxpayers have entered into two option agreements. The first such agreement deals with the right of the surviving partners in partnership F to purchase the partnership interest of any deceased partner. A and B's children are the remaining partners. The second agreement gives A and B's children an option to purchase most of the remaining partnership interests. This option relates to partnership E.

It is proposed that on the first to die of A and B, the F partners (excluding the surviving spouse) will purchase the partnership interest with 5 percent cash and the remainder in an interest bearing promissory note. The notes will be held by the marital trust for the surviving spouse. The other partnership interests of the first to die will become assets of the marital trust. On the death of the second to die, the option to purchase the remaining partnerships, through E, will occur both with respect to the survivors own trust and with respect to the marital trust. It is represented that both option purchases will occur in such a way as to qualify for the exclusion from self-dealing provided by Reg. 53.4941(d)-1(b)(3)(v). This is an important exception. Without the existence of an option, specifically allowing for a promissory note, binding on an estate or trust, an extension of credit relationship would result in acts of self-dealing.

One might question how the option purchase from the martial trust qualifies for the exclusion from self-dealing since the marital trust is not, on the death of the second to die, an estate or revocable trust.

Background information on PLR 9814050 suggests that the Service based its ruling on a representation that on the second death, the jurisdiction of the local court will be invoked and that the purchase will be submitted for court approval. Such procedure includes the purchase from the QTIP (qualified terminable interest property) trust. On this issue, the Service ruled that the exercise of the option under the purchase agreement to purchase the partnership interests on the death of the second of the taxpayers to die will not constitute an act of direct or indirect self-dealing pursuant to IRC 4941, because it comes within the exception provided by Regs. 53.4941(d)-1(b)(3)(v).

A similar result was reached in PLR 9752071, October 1, 1997, also involving a QTIP trust and application of the exception provided by Reg. 53.4941(d)-1(b)(3). This PLR also held that the exception would apply at the termination of the surviving spouse's QTIP trust. PLR 9724018, March 17, 1997, involving a non QTIP marital deduction trust, reaches the same result. See also PLR 9112012, December 24, 1990.

D. Foundation Manager and Self-dealing - The Sale of Financial Products Between Related Corporations

Consider the following hypothetical situation. A financial company called "Parent" directly or through its agents sells to its clients and customers a financial product involving charitable remainder unitrusts funded with Parent's life insurance or its other financial products . The transaction is structured so that the Parent's wholly owned subsidiary (T1) is appointed to serve as trustee of the CRUT. The funds transferred to the CRUT by the trust creator is used by the trustee, T1, to purchase the Parent financial product previously agreed to by the Parent or its agent and the customer. The customer is advised of the corporate relationship between the Parent and T1 and the fact that the trustee may purchase the Parent financial products to fund the trust. Does the purchase of the Parent's financial products constitute a self-dealing transaction under IRC 4941?

If T1 purchased its own financial product or that of its wholly owned subsidiary, T1 would have participated in an act of self-dealing under IRC 4941(d)(1)(A) or (E). T1, as trustee, is a disqualified person under IRC 4946(a)(1)(B). Purchasing its own product would fall under a self-dealing transaction described in IRC 4941(d)(1)(A). T1's wholly owned subsidiary is a disqualified person by virtue of IRC 4946(a)(1)(E). Thus, the purchase of the subsidiary's financial product is an act of self-dealing under IRC 4941(d)(1)(A).

However, it is asserted that Parent is not a disqualified person to T1 even though Parent holds 100 percent of the stock of T1, and, thus has voting control of T1. It is asserted that there is no so-called "upstream" attribution in this situation. There is no authority for finding Parent is a disqualified person merely by virtue of its ownership interest in T1. For example, 4946(a)(1) or (3) would not provide the kind of attribution for treating Parent, in this hypothetical as a disqualified person.

Notwithstanding this assertion, there is an argument or arguments to be made that T1's purchase of Parent's financial product is an act of self-dealing. In GCM 39107, the Service applied self-dealing to a situation where a foundation manager utilizes the assets of private foundations which it manages for its own business advantage. The Foundation Manager in the GCM is a large bank. The bank negotiates with various borrowers large loans in the form of master notes. The borrowers are often existing bank customers but some borrowers may not be current bank customers. The private foundations for which the bank is trustee provides the assets for funding the Master Notes, and, hence the loans to borrowers. No fees are charged in this transaction. The Master Notes represent reasonable investment opportunities for the foundations.

The GCM concluded that the exception for incidental and tenuous benefits under Reg. 53.4941(d)-2(f)(2) was not applicable. For the bank, the providing of loan arrangements is an essential and substantial activity of the bank. This activity may not be considered incidental and tenuous. Further, the GCM concluded that the general banking exception found in Reg. 53.4941(d)-2(c)(4) is not applicable. The kind of major investment represented by the Master Notes is not the ordinary banking activity coming under the banking exception. As a result the GCM concluded that self-dealing occurred under IRC 4941(d)(1)(E).

The Service reached a similar conclusion in GCM 39632. The goodwill generated by the foundation manager by use of the private foundation's assets constituted self-dealing under IRC 4941(d)(1)(E).

If one views Parent as a customer of T1, the investment of the CRUT assets in the financial product of the Parent is enhancing the reputation and business standing of T1 with its customer. However, more than generating goodwill with a substantial and longstanding client, T1 directly receives a business benefit in that the referral of the CRUT to T1 to serve as trustee is in fact the heart of the business activity conducted by T1. There is a quid pro quo in this hypothetical. T1 gets the trustee business and it then invests in the financial products of the Parent.

The counter argument is that in today's marketplace with an expanded and integrated role for banks, trust companies, and financial institutions, the investment of the assets of a CRUT or private foundation with an institution with which the trustee has business relations as a customer may be unavoidable.

There is a second argument to find self-dealing. Section 4946(a)(1)(B) defines foundation manager as a disqualified person. Section 4946(b) of the Code further defines the term "foundation manager" as an officer, director, or trustee of a foundation (<u>or an individual having powers or responsibilities similar to those of</u> officers, directors, or <u>trustees of the foundation</u>). Emphasis added.

In the transactions described above, Parent may be treated as a foundation manager because it has assumed powers or responsibilities similar to a trustee of the CRUTs. The entire transaction is prearranged by Parent or Parent's agents, the insurance salesman. The customer is sold an insurance product up front with the understanding from the beginning that the trust will purchase the insurance product of Parent, and at the same time Parent's subsidiary, T1, will serve as trustee of the CRUT. The customer is purchasing Parent's insurance product rather than negotiating the terms of the trust document. It is Parent's agent who has sold the customer on the need for the insurance product. The trust document is on a prescribed company form in which blanks are filled in with respect to pertinent information relating to grantor, trust recipient, and trust payment amount. Parent receives a profit from the sale of the insurance product and Parent's agent receives a fee from the commission on the sale of the insurance product.

Since it is Parent or Parent's agent that arranges with the customer the asset to be acquired by the trust, the actions of Parent's agents preempt the actions of the trustee in the determination of the investment of trust assets. In preempting the trustee in this regard, Parent's agent assumes the role of the trustee with respect to this very important trustee function.

In addition to the factors described in the preceding two paragraphs, Parent is in control of T1 in that T1 is a wholly owned subsidiary of Parent.

The counter to this argument is that Parent and T1 are truly separate corporations with separate histories and operations. The facts do not support the conclusion that Parent is, in substance, acting as trustee.

Just prior to publication of this topic, the EO Division and the EBEO office of Chief Counsel reached a tentative consensus that under the facts described above, involving a long term and significant business relationship, the actions of Parent and T1 would constitute acts of self-dealing under IRC 4941(d)(1)(A) and 4941(d)(1)(E). In any case, the issue discussed in this part may be a harbinger of many new issues involving a changing financial world where financial institutions of all varieties are merging.

4. IRC 4943, 4946, and 4941 – Nonvoting Stock Scenarios

A. Attribution of Stock Holdings and a Twist of Self-Dealing-PLR 9752074

In PLR 9752074, October 3, 1997, the Service addressed the problem of stock of a corporation held by a private foundation, which constituted an excess business holding within the meaning of IRC 4943. The facts disclose the following:

a. The HMO was exempt under IRC 501(c)(4). To facilitate a conversion to for profit status, "B" was formed to serve as the parent company of HMO.

b. In year 1, HMO employees purchased B's voting stock for nominal amounts from B. Later the employees transferred the voting stock to a five-year voting trust. The voting trust was subsequently amended to require that the trust expire in five years, in year 7.

c. In year 2, HMO contributed $x to a recently formed private foundation ("Foundation"). In year 4, HMO contributed $30x to Foundation.

d. In year 3, HMO's state of incorporation approved the conversion of HMO to a for profit corporation.

   i. As a condition to the conversion, the State required HMO to transfer to the Foundation $6000x and B nonvoting stock. The Foundation paid a minimal amount for the B nonvoting common stock.

   ii. The $6000x consisted of $1500x cash plus two notes equaling $4500x issued by HMO. (An extension of credit discussed in item 2, below).

e. After the conversion, the voting trust owned all of B's voting stock and the Foundation owned all of B's nonvoting stock.

f. In year 5, HMO merged with "C", a publicly held company. As a result of the merger, the voting trust held 26.2 percent of C's class A voting common stock. The Foundation held C's class B nonvoting common stock. Only C's class A stock was publicly traded.

g. For various bona fide reasons, the Foundation would not be able to dispose of its "B" or "C" stock during the initial five year grace period provided by IRC 4943(c)(6).

(1) IRC 4943- Attribution of Holdings; Voting Trust Termination

PLR 9752074 stated that assuming, but without so ruling, that A (HMO) and C were disqualified persons, the nonvoting shares held by the Foundation would have been treated as excess business holdings under IRC 4943(c)(2)(A). The private ruling did not explicitly explain that the voting trust is a disqualified person under IRC 4946(a)(1)(C)(i) by virtue of attribution rules provided by section IRC 4946(a)(3) and IRC 267(c). Since the voting trust holds all the stock of B and B holds all the stock of HMO, which the ruling assumes is a disqualified person, the attribution rules treat the voting trust, the shareholder of B, as a disqualified person as to the Foundation. It is "assumed" that HMO and B are substantial contributors to the Foundation. For purposes of IRC 4941, the only IRC 501(c) organizations excepted from the category of "disqualified persons" are IRC 501(c)(3) organizations. Reg. 53.4946-1(a)(8).

The private ruling goes on to explain that under IRC 4943(c)(6)(A), the Foundation would be treated as having acquired the nonvoting shares other than by purchase and the nonvoting shares would be treated as held by a disqualified person for the five year period. Of course, this simply means that the five year grace period provided by 4943(c)(6)(A) is applicable.

Finally, the ruling explains that when the voting trust expires at the end of the five year period, the voting control of the stock held by the trust reverts to each of the individual shareholder beneficiaries. None of these individuals owned, either directly or indirectly, or together, 20 percent or more of the voting stock of C. Accordingly, following IRC 4943(c)(2)(A), Foundation's holding of the C nonvoting stock would constitute a permitted holding.

(2) IRC 4941 – Extension of Credit

An interesting aspect of this ruling is the PLR's disclaimer paragraph:

> These rulings do not address whether A's (HMO's) transfer of the two promissory notes resulted in continuing acts of self-dealing under IRC 4941(d)(1)(B).

Under IRC 4941(d)(1)(B) the lending of money or other extension of credit is an act of self-dealing. In PLR 9752074, one may not raise the "first bite" exception in Reg. 53.4941(d)-1(a) because the status of HMO as a disqualified person arose prior to the transaction in which HMO extended credit to the Foundation. HMO made a substantial cash gift to the Foundation in year 2.

It may be argued that Reg. 53.4941(d)-2(c)(3) would apply to except the promissory notes transaction from self-dealing. This self-dealing exception is contingent, however, "to the extent motivated by charitable intent and unsupported by consideration." The Service first had a concern whether HMO and B would be substantial contributors by virtue of the requirement of the state to transfer the sum of $6000x (consisting in part of the note of HMO) and the non-voting stock of B to the Foundation since the transfer was a condition of the state for HMO going public. The Service's concern was whether the transfer could be considered a gift or contribution for purposes of IRC 507(d)(2). If the stock, cash, and note is treated as if received for valuable consideration and not as a gratuitous transfer, then HMO and B would not be treated as substantial contributors, and thus not as disqualified persons (but for the earlier year 2 transfer of $x).

This same consideration applies to the self-dealing issue and Reg. 53.5941(d)-2(c)(3). May it be said that the transfer is motivated by charitable intent and unsupported by consideration? The argument could be made that HMO received valuable consideration, not from the Foundation but from the State. HMO was seeking approval to operate as a for profit entity. As a condition to this approval, the State required HMO to make the transfers described. On the other hand, Reg. 53.4941(d)-2(c)(1) provides that an act of self-dealing occurs where a note, the obligor of which is a disqualified person, is transferred by a third party to a private foundation which becomes the creditor under the note. In effect, is not the State the third party in PLR 9752074 which is constructively transferring the note to the foundation? In the private ruling, the Service did not rule on this issue since no ruling was requested. However, the appropriate Key District Office was provided a copy of the PLR.

B. <u>Nonvoting Stock - Permissible Holdings – PLR 9551034</u>

In PLR 9551034, September 28, 1995, the settlors created two trusts. One trust is created as a charitable trust which is a non-exempt trust under IRC 4947(a)(1). The other trust, designated as "Z", is a revocable trust which becomes irrevocable on the death of the last to die of the settlors. Z is a noncharitable trust which will pay all of its income to the charitable trust annually after Z becomes irrevocable. The settlors owned all the stock of two corporations, X and Y. The stock of each will be recapitalized in voting and nonvoting stock. Nine shares of nonvoting stock will be issued for each share of voting stock outstanding. Upon the death of the last to die of the settlors, all nonvoting stock will be transferred to the charitable trust and all shares of voting stock will be transferred to Z. The Trustees of Z will not be disqualified persons in respect to the charitable trust. At this point, Z will own the voting stock. There will be no charitable, estate, or gift tax deductions taken. These transfers are to avoid the fragmentation of management.

Under 4947(a)(1) a nonexempt charitable trust shall be treated, in effect, as if it were a private foundation, subject to the various provisions of chapter 42.

PLR 9551034 held that the nonvoting stock to be held by the IRC 4947(a)(1) trust would not constitute excess business holdings since the trust would not hold 20 percent of the voting stock.

The PLR did not focus on, or even cite, the last sentence of IRC 4943(c)(2)(A) which provides:

> In any case in which all disqualified persons do not own more than 20 percent of the voting stock of an incorporated business enterprise, nonvoting stock held by the private foundation shall also be treated as permitted holdings.

The PLR did not consider the possibility of the status of Z as a disqualified person by virtue of it becoming a substantial contributor after paying its income to the IRC 4947(a)(1) trust. See also Reg. 1.507-6(c)(1). The bottom line in the PLR may still be correct if Z never becomes a disqualified person. In any case, the Service is presently reviewing this issue.

5. IRC 4945

A. Expenditure Responsibility and Partial Transfers Under IRC 507(b)(2)

Under IRC 507(b)(2), in the case of a transfer of assets of any private foundation to another private foundation pursuant to any liquidation, merger, redemption, recapitalization, or other adjustment, organization or reorganization, the transferee foundation shall not be treated as a newly created organization. Thus, generally, the IRC 507(b)(2) transfer is not a termination or relinquishment of private foundation status. Further, the transferee private foundation succeeds to the aggregate tax benefit of the transferor private foundation under Reg. 1.507-3(a)(2).

There is some debate, particularly because of conflicting PLRs, however, as to whether the transferor private foundation in a IRC 507(b)(2) transfer involving a transfer of less than 100 percent of its assets must exercise expenditure responsibility over the assets transferred to the transferee foundation.

See for example, PLR 9747027, August 22, 1997, which holds that a transfer of 50 percent of a private foundation's assets to newly formed private foundation would not require IRC 4945 expenditure responsibility. In contrast, PLR 9802037, October 14, 1997, holds the opposite. See also the 1989 EO CPE, Topic J, page 124.

Reg. 1.507-3(c)(1) provides that for purposes of IRC 507(b)(2), the terms "other adjustment, organization, or reorganization shall include any partial liquidation or any other significant disposition of assets to one or more private foundations. . ."

For purposes of IRC 507(b)(2), the cut off for a partial transfer is 25 percent of the private foundation's net assets. Reg. 1.507-3(c)(2) provides that the term significant disposition of assets to one or more private foundations includes any disposition for a taxable year where the aggregate of the dispositions to one or more private foundations for the taxable year is 25 percent or more of the fair market value of the net assets of the distributing foundation at the beginning of the taxable year.

However, and generally, Reg. 1.507-3(a)(7) provides that IRC 4945 expenditure responsibility be exercised. To interpret the provision otherwise would weaken the 4945(d)(4) and (h) rules requiring expenditure responsibility over grants or "transfers" made by one private foundation to another. Example (2) of Reg. 1.507-3(a)(9)(iii) describes a situation where all the assets of the transferor foundation are being transferred to three successor foundations and holds that no expenditure responsibility need be exercised.

PLR 9401032, Jan. 17, 1994, revoked the holding in PLR 9208021 which relieved the transferor foundation of expenditure responsibility when it transferred 50 percent of its assets to a newly created exempt private foundation. With the publication of its revised IRC 4945 Private Foundation Handbook chapter, the Service believes this issue will be resolved. Chapter 17.5(3) provides:

> Partial transfers of assets from one private foundation to another pursuant to IRC 507(b)(2) requires that the transferor foundation exercise expenditure responsibility.

6. <u>IRC 664 Legislation - Charitable Remainder Trusts</u>

Charitable Remainder Trusts described in IRC 664 have interest to the EO community by virtue of the provisions of IRC 4947(a)(2). Generally, under IRC 4947(a)(2), split interest trusts, in certain respects, are treated as private foundations and are subject to IRC 4941 and IRC 4945 and, in some situations, certain other provisions of Chapter 42. For a more detailed description of charitable remainder trusts and IRC 4947(a)(2), see the 1996 EO CPE Text, Topic G, page 159.

Section 1089 of the Taxpayer Relief Act of 1997 (the "Tax Act") amended IRC 664 of the Code in a way that has a bearing on the application of IRC 4941 to split interest trusts. The Tax Act amended IRC 664(d)(1)(A) and (2)(A) to add the language "nor more than 50 percent" to describe the permissible income payout to a noncharitable income recipient annually. IRC 664(d)(1) and (2) were amended to add new paragraph (D) providing generally that the value of the remainder interest (in such charitable remainder trust) is at least 10 percent of the net fair market value of property placed in (or contributed to) the trust.

The language of the Tax Act limiting the charitable trust income payout to no more than 50 percent has direct bearing on the problem of accelerated charitable remainder trusts described in the 1996 EO CPE Text, Topic G.

Congress, in the 1997 Tax Act, attempted a legislative solution to the problem defined in Notice 94-78 with the amendment of the payout requirement to a maximum of 50 percent annually. The Congressional purpose was described in the General Explanation of Tax Legislation Enacted in 1997, the Joint Committee on Taxation, December 17, 1997. The General Explanation states as follows:

> The Congress was concerned that the interplay of the rules governing the timing of income from distributions from charitable remainder trusts (i.e. Treas. Reg. 1.664-1(d)(4) and the rules governing the character of distributions (i.e., sec. 664(b)) created the opportunities for abuse where the required annual payouts are a large portion of the trust and realization of income and gain can be postponed until a year later than the accrual of such large payments.

The General Explanation continues with an explanation of the mechanics of the provision. Under the Tax Act, any charitable remainder trust failing this 50 percent rule will not be a charitable remainder trust whose taxation is governed by IRC 664, but will be treated as a complex trust and, accordingly, all its income will be taxed to its beneficiaries or to the trust.

The General Explanation also addresses the new provision requiring a minimum 10 percent value for the charitable remainder interest.

> Congress was concerned that certain charitable remainder trusts had been created primarily to obtain the tax benefit of the trust's exemption from income tax under section 664(c) and not to provide for charity. The Congress was aware that many charitable remainder trusts have been created where the actuarial value of the charitable remainder interest at the time of creation is insignificant.

Additional rules provide relief to charitable remainder trusts that do not meet the 10 percent test. The rules provide for the reformation of the terms of the trust in some cases or for the application to a court to declare that a trust is void ab initio. It is unclear if any of these rules have implications with respect to self-dealing, but such prospect appears unlikely.

7. Proposed IRC 664 Regulations - Charitable Remainder Trusts

On April 17, 1997, the Service released proposed amendments to the Regulations under IRC 664 and related provisions. It is expected that the proposed regulations will become final in 1998. The most significant of the regulations for purposes of Chapter 42 are discussed below.

A. "Flip" Unitrusts

The proposed regulations explain the purpose for allowing the so-called "flip" unitrusts as follows:

> The governing instrument of a CRUT must specify the method of computing the uniturst payments. Section 664(d)(3) provides that the income exception methods (either the net income method or the NIMCRUT method) may be used to pay the unitrust amount "for any year." The legislative history, however, provides that the method used to determine the unitrust amount may not be discretionary with the trustee. [citation omitted]
>
> Some donors may fund a CRUT with unmarketable assets that produce little or no income. These donors often want the income beneficiary or beneficiaries of the CRUT to receive a steady stream of payments based on the total return available from the value of the assets. The donors recognize, however, that the CRUT cannot make these payments until it can convert the unmarketable assets into liquid assets that can be used to pay the fixed percentage amount. These donors establish CRUTs that use one of the income exception methods to calculate the unitrust amount until the unmarketable assets are sold. Following the sale, the donors may prefer that the CRUT use the fixed percentage method to calculate the unitrust amount. A trust using such a combination of methods would be a "flip unitrust."

The proposed regulations permit the donor to establish a "flip unitrust" provided certain specific requirements are met. These conditions are roughly summarized as follows:

1. At least 90 percent of the fair market value of the assets held in the trust immediately after the initial contribution or any subsequent contribution (prior to the switch in methods) must consist of unmarketable assets (within the meaning of IRC 731(c)).

2. The governing instrument must provide that the CRUT use an income exception method until the earlier of (a) the sale of specified unmarketable assets or group of unmarketable assets contributed at the time the trust was created or (b) the sale of unmarketable assets such that immediately following the sale, any remaining unmarketable assets total 50 percent or less of the fair market value of the trust's assets.

3. The CRUT must switch exclusively to the fixed percentage method for calculating all remaining unitrust payments payable to any income beneficiary at the beginning of the first taxable year following the year in which the earlier of the above events occurs.

4. Any makeup amount described in IRC 664(d)(3)(B) is forfeited when the trust switches to the fixed percentage method.

The issue of concern for Chapter 42 purposes has, in prior years involved the flip trust where the income beneficiary and disqualified person have applied to the court for reformation of the trust document (or have unilaterally "reformed" the trust document). A court ordered reformation improves the income position of the income beneficiary where the trust document is amended to provide for a fixed payment payout under IRC 664(d)(2)(A) in place of the lesser of trust income or fixed payment payout provided under IRC 664(d)(3)(A) originally provided in the trust document.

By allowing the change of the terms of the trust, it is arguable that the reformation of the trust (and the subsequent higher fixed payment amount) is an act of self-dealing under IRC 4941. For example, a NIMCRUT that is invested in low yield assets falling short of the fixed percentage payment, when amended to allow exclusively the higher fixed payment percentage (rather than the lesser of trust accounting income or fixed percentage payment) may necessitate the use of trust principal to supplement trust income to meet the fixed payment payout. Thus, arguably, by allowing the reformation to provide for the fixed payment payout, less assets would then be left to charity.

It is clear that the self-dealing prohibition does not apply to the proper income payout to the noncharitable income beneficiary. See Reg. 53.4947-1(c)(2). It is also true that the action of the disqualified person to receive more than the amount provided as the proper unitrust amount (the income payout) is an act of self-dealing. See IRM 7752:(18)73(2). Thus, if a donor, trustee, or beneficiary controlling the NIMCRUT arbitrarily distributes income in excess of the unitrust amount or acts in concert with others to change the terms of the trust to provide for a higher unitrust amount, such person or persons may be engaging in an act of self-dealing. By the same token, the unauthorized payment of a fixed percentage amount when the trust is operating under income exception method which would require the income distribution of the lesser trust accounting income, may similarly constitute an act of self-dealing.

An income exception CRUT containing a "flip" unitrust provision in the trust document complying with the requirements of the proposed IRC 664 regulations, as finalized, that converts to a fixed percentage method pursuant to the terms of that trust document will not be engaging in an act of self-dealing. The provision of the proposed regulations relating to flip trusts eliminates this self-dealing problem because the terms of the noncharitable income interest are established up front in the trust document and the conversion to fixed percentage method occurs automatically on the events described in the proposed regulations. The proposed regulations limit the discretion of the trustee to change the payment method other than by the sale of trust assets for which the trustee has a fiduciary duty as to all parties. In applying the self-dealing prohibition, the Service does not normally question the investment decisions of the trustee or foundation manager. See discussion in 3.B. above.

A conversion of an income exception CRUT to a fixed percentage method for a trust that does not have a trust provision meeting the requirements of the proposed regulations as finalized will not be insulated from the assertion that such conversion is an act of self-dealing.

The amendments allowing a flip trust apply to CRUTS created after the final regulations are published. The Transition Rules to the proposed regulations allow a NIMCRUT created before such effective date which has a flip provision already existing in the trust document to amend or reform its trust document to comply with the final regulations. In response to comments on the proposed IRC 664 regulations, Chief Counsel is also considering allowing other existing NIMCRUTs to amend the trust document to add a flip provision on the theory that such trusts should not be disadvantaged with respect to existing trusts containing some form of flip provision in the trust document.

B. Time for Paying Annuity or Unitrust Amount

The proposed regulations would amend existing IRC 664 regulations to provide that the payment of the annuity and unitrust amount determined under the fixed percentage method must be made before the close of the taxable year in which it is due. For CRUTS using an income exception method, the proposed regulations continue to provide that if the CRUT pays the unitrust amount within a reasonable time after the close of the trust's taxable year, the trust is not deemed to have engaged in an act of self-dealing, to have unrelated debt-financed income, to have received an additional contribution, or to have failed to function exclusively as a charitable remainder trust.

The intent of these proposed regulations is to address the problem of accelerated charitable remainder trusts described in Notice 94-78, which was discussed in the preceding material of this article under part 6. The tax scheme described in Notice 94-78 is effective only for CRATs and CRUTs using the fixed percentage method. Thus, since

CRUTS utilizing the income exception method are not used as a vehicle to further such scheme, the proposed regulations allow NIMCRUTS to continue to pay the unitrust amount after the year end.

For 1997, Notice 97-68, 1997-48 I.R.B. 11, modifies these requirements for certain trusts. The modifications permitted under Notice 97-68 address only those trusts that are not deemed as abusive accelerated charitable remainder trusts within the meaning of Notice 94-78.

Thus, the problem associated with accelerated charitable remainder trusts is addressed both by the legislation described above under part 6 of this article and by the proposed regulations.

C. Appraising Unmarketable Assets

The legislative history for the charitable remainder trust rules indicates that an independent trustee should value a trust's unmarketable assets. The proposed regulations address the issue by providing that if a charitable remainder trust holds unmarketable assets and the trustee is the grantor of the charitable remainder trust, a noncharitable beneficiary, or a related or subordinate party to the grantor or the noncharitable beneficiary with the meaning of IRC 672(c), the trustee must use a qualified appraisal, as defined in Reg. 1.170A-13(c)(3), from a qualified appraiser, as defined in Reg. 1.170A-13(c)(5), to value the such assets. Others not in the relationship prescribed in the preceding sentence need not use a qualified appraisal.

D. Application of Section 2702 to Certain Charitable Remainder Unitrusts

The proposed regulations amend estate and gift tax regulations under IRC 2702 to address a perceived abuse due to the fact that charitable remainder trusts were previously excluded from coverage by IRC 2702 regulations. The proposed regulations are intended to prevent the shifting of a beneficial interest in a charitable remainder trust from one noncharitable beneficiary to another noncharitable beneficiary who is a family member.

E. Prohibition of Allocating Precontribution Gain to Trust Income.

For the income exception unitrust, the proposed regulations require that the proceeds from the sale of trust assets must be allocated to such trust's principal and not its income, at least to the extent of the fair market value of the asset when contributed to the trust.

F. Request for Comments on Income Exception CRUTs Holding Certain Investments

Part 3.B. of this article, set forth above, describes the problem of income deferral associated with the NIMCRUT. That discussion addresses whether the income deferral attribute may be addressed under a self-dealing theory under IRC 4941. The same income deferral problem is also addressed in the proposed regulations in the context of IRC 664. That is, "whether investing the assets of an income exception CRUT to take advantage of the timing difference between the receipt of trust income and income for federal tax purposes causes the trust to fail to function exclusively as a charitable remainder trust."

The proposed regulations indicate that this is currently a matter of study by IRS and Treasury, and comments are requested on drafting future guidance on this issue. Thus, the proposed regulations do not contain concrete proposals to amend the IRC 664 regulations. Further, the proposed regulations may be taking a somewhat narrower scope in dealing with the type of income deferral techniques under study. The study is limited to income deferral by virtue of receipt of trust income from a partnership or a deferred annuity contract. In contrast, one of the examples of income deferral in the self-dealing context, discussed above under Part 3.B., involved the realization of income on the sale of an appreciating asset held by the NIMCRUT.

The proposed regulations state that the Service would publish a no-rule position on the income deferral issue in Rev. Proc. 97-23. In Rev. Proc. 97-23, 1997-1 C.B. 654, the Service stated that it will not issue advance rulings on whether a unitrust that will calculate the unitrust amount under IRC 664(d)(3) qualifies as a IRC 664 charitable remainder trust when a grantor, a trustee, a beneficiary, or a person related or subordinate to a grantor, a trustee, or a beneficiary can control the timing of the trust's receipt of income from a partnership or a deferred annuity contract for an income deferral purpose.

The study initiated by the proposed regulations is not complete and the proposed regulations under IRC 664 that will likely become final in 1998 probably will not address this issue. Perhaps there may be some resolution of the IRS and Treasury study on this issue in the following year.

8. Key District Determinations Under Chapter 42

In recent years, Headquarters has delegated a number of private letter ruling issue areas to the Key District including some areas under Chapter 42. Section 7.04 of Rev. Proc. 98-4, 1998-1 I.R.B. 113, 125, continues this trend. The Key District Director now issues determination letters involving:

A. Advance approval of grant making procedures under IRC 4945;
B. Exempt operating foundations described under IRC 4940(d); and
C. Advance approval of voter registration programs described in IRC 4945(f).

9. Abuse Case - IRC 4941, 4944, 501(c)(3), 507(a)(2) – TAM 9627001

TAM 9627001, dated July 15, 1996, involved a commercial commodities and securities trader (A) which formed and funded private foundation M which was controlled by A and his family. A and his family owned an investment partnership that acted as a futures commission merchant. A and his family used the assets of M as collateral to meet the margin requirements imposed on A and his family's personal trading account contracts.

The TAM's first focus was on IRC 4941 and held that the collateralization was self-dealing, following Janpol v. Commissioner, 101 T.C. 518 (1993), which held that guarantees are to be included within the terms "lending of money or other extension of credit" in IRC 4975(c)(1)(B). TAM concluded that the Tax Court's interpretation of the Employee Plan prohibited transaction provision was equally applicable to the parallel Exempt Organizations self-dealing provision under IRC 4941(d)(1)(B).

The TAM turned to IRC 4944, a provision often viewed as having a less meaningful detrimental effect on foundation wrongdoing than IRC 4941. The TAM resoundingly held that the collateralization constituted a jeopardizing investment:

> Following Janpol v. Commissioner, supra, and our discussion under section 4941 above, guarantees or collateralizations constitute a loaning of money which is an investment activity for purposes of section 4944. All of M's assets were placed in a margin account for the purpose of collateralizing A's investments in futures contracts which are "closely scrutinized" investments under the regulations. Placing all of M's investments assets at risk in A's undermarginalized accounts did nothing to improve M's investment portfolio or economic posture, but, instead, jeopardized the exempt purposes of M ...
>
> We do not believe that a "prudent trustee" approach was applied here and view this type of investment move, which would produce no potential economic gain for M as the very type of act that Congress prohibited when it enacted section 4944. See General Explanation of the Tax Reform Act of 1969, prepared for the staff of the Joint Committee on Internal Revenue Taxation, December 3, 1970, page 46, and section 53.4944-1(a)(2) or the regulations.

The TAM continued, holding A was subject to the IRC 4944(a)(2) manager's tax:

> Under these facts and the standards under section 53.4944-1(b)(2) of the regulations, A, as an experienced commodities trader, clearly knew the facts pertaining to the collateralizing transaction. It appears evident that A either knew that the transaction would be a jeopardizing investment, or at least, from a reasonable person's standpoint, A was negligent in not verifying whether such a transaction was not in violation of section 4944. A has provided no evidence that he made any attempt to obtain a written legal or qualified investment counsel opinion that the transaction, a transaction involving all of M's assets, would not be a jeopardizing investment ...

In regard to exempt status, the TAM concluded that the M should have its IRC 501(c)(3) exemption revoked:

> The transfer of M's assets for use by its disqualified persons resulted in the earnings of M impermissibly inuring to the benefit of insiders ... and a family partnership controlled by insiders .... M allowed A (who is M's president/director, principal contributor, and founder) and the other insiders to use M's assets as collateral without consideration.

Finally, the TAM suggested involuntary termination under IRC 507(a)(2):

> We also believe that consideration should be given to involuntarily terminating M's private foundation status since the transactions described above resulted in M and A engaging in a willful and flagrant act giving rise to liability for tax under sections 4941 an 4944 of the Code. A voluntarily, consciously, knowingly, and intentionally committed acts in violation of the self-dealing and jeopardizing investment rules.

This case demonstrates that the Service is not hesitant to use the panoply of remedies that Chapter 42 and related Tax Reform Act of 1969 provisions provide, as well as revocation of exempt status, when the facts and circumstances warrant such action. For other examples of the application of Chapter 42 remedies in abuse situations, see 1995 EO CPE Text, Topic O, page 313.