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Department of the Treasury

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Refer Reply To:
CC:PSI:4 - PLR-112401-02
Date: DECEMBER 24, 2002

Re:

Legend:

Date 1	=
Taxpayer	=
Trust Agreement	=
Bank	=
Company	=
Corporation	=
w	=
Date 2	=
Court	=
Date 3	=
Exercise of Special Power of Appointment	=
Foundation	=
x	=
y	=
z	=
State	=

Dear :

This is in response to a letter dated October 3, 2002, and prior correspondence, submitted on behalf of the Taxpayer, requesting rulings regarding the proposed termination of a charitable remainder unitrust.

Facts

The facts submitted and representations made are as follows:

On Date 1, Taxpayer executed Trust Agreement, establishing a charitable remainder unitrust (Trust) with Taxpayer as Trustee and Bank as Independent Special Trustee. The Independent Special Trustee acts alone in performing such specified tasks as determining the value of a difficult to value asset in administering Trust and making investment decisions regarding that asset.

Trust was funded with the stock of Company, which was an entity that the Taxpayer owned and sold shortly after transferring w shares into the Trust.

On Date 2, Court issued Order Reforming Trust. Under the terms of Trust Agreement as reformed, during his life, Taxpayer receives a unitrust amount equal to 12 percent of the net fair market value of the assets of Trust valued as of the first day of each taxable year and payable quarterly on the last day of each quarter. Trust income in excess of the unitrust amount is added to principal.

At Taxpayer's death, subject to a retained power in Taxpayer, the Trustee is to distribute the remaining trust assets in specified amounts to three designated charities. If any of these charities is not then an organization described in §§ 170(c), 2055(a) and 2522(a) of the Internal Revenue Code, the trustee must distribute the trust assets to one or more organizations that are so described, as the trustee selects. Taxpayer retained the right to change the charitable remainder beneficiaries as follows:

> Donor retains the right, by acknowledged written instrument, to change the charitable remaindermen by adding new Charitable Organizations and/or omitting certain Charitable Organizations or by altering the share one or more Charitable Organizations is to receive. The Retained Right to Change Charitable Remaindermen shall be exercised by Donor, if at all, while Donor is living, provided that the Charitable Organization(s) designated by the Donor satisfy section170(c), section 2055(a) and section 2522(a) of the Code at the time when any principal or income of the Unitrust is to be distributed to such Charitable Organization(s).

On Date 3, Taxpayer executed Exercise of Special Power of Appointment, designating Foundation as the sole remainder beneficiary of Trust. The Exercise provides that, if Foundation is not an organization described in §§ 170(c), 2055(a) and 2522(a) at the time when any principal or income is to be distributed to Foundation, then Trustee, in its sole discretion, shall select one or more other Charitable Organizations. Foundation is classified as an organization described in § 501(c)(3) and is a private foundation within the meaning of § 509(a). Taxpayer and Taxpayer's wife are trustees of Foundation.

Trust currently holds assets valued at $x which are comprised of $y of marketable securities and $z of value remaining in a patent on items developed by the Company. The patent was transferred as part of the sale of the Company to Corporation.

Taxpayer and Foundation have determined that it is in each of their respective best interests to have Trust terminated and the assets distributed. Trust will petition Court to request an order terminating Trust and stating the date of termination value of the assets to be distributed to Taxpayer and Foundation.

It is represented that applicable state law allows the early termination of Trust, and that the consent of the Attorney General of State is not required. However, it is represented that when the petition is filed with Court, the Attorney General of State and the Secretary of State will be given notice of the hearing.

Upon its termination, Trust proposes to distribute to Taxpayer as the income beneficiary and to Foundation as the remainder beneficiary lump sums equal to the present value of their respective interests on the date of termination. Trust represents that the values will be determined using the discount rate in effect under § 7520 on the date of termination and using the methodology under § 1.664-4 of the Income Tax Regulations for valuing interests in charitable remainder trusts.

It is represented that Taxpayer's last physical was in January 2002, and that there was no indication he would have any condition that would cause his life expectancy to be less than the average person of his age.

Law and Analysis

Section 664(b) provides that the amounts distributed by a charitable remainder trust to the beneficiary of the annuity or unitrust payment are characterized in the hands of the recipient first as ordinary income, second as capital gain, third as other income, and fourth as trust corpus. Both current and prior undistributed amounts from a tier must be exhausted before distributions are deemed to be made from the next tier.

Section 664(b) provides rules to determine the character of the annual unitrust amounts distributed by a charitable remainder unitrust to the unitrust beneficiary. Any regular unitrust amount distributed to a beneficiary prior to the termination of the trust will have the characteristics in the hands of the beneficiary determined under § 664(b).

However, money and property received by a beneficiary upon the termination of a trust do not represent a distribution of an annual unitrust amount; therefore, § 664 is inapplicable to this amount. Rather, the beneficiary is disposing of his interest in the trust in exchange for money and property in a transaction that is governed by § 1001.

Section 1001(a) provides that the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in § 1011 for determining gain.

Section 1001(b) provides that the amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of any property received.

Section 1001(c) provides that, the entire amount of the gain or loss, determined under § 1001, on the sale or exchange of property shall be recognized.

Section 1001(e)(1) provides that, in determining gain or loss from the sale or other disposition of a term interest in property, that portion of the adjusted basis of such interest which is determined pursuant to § 1015 (to the extent that such adjusted basis is a portion of the entire adjusted basis of the property) shall be disregarded. Under § 1001(e)(2), a "term interest in property" includes an income interest in a trust. Section 1001(e)(3) provides that the general rule of § 1001(e)(1) does not apply to a sale or other disposition which is a part of a transaction in which the entire interest in property is transferred to any person or persons.

Section 1015(b) provides that, if property was acquired after December 31, 1920, by a transfer in trust (other than by a transfer in trust by a gift, bequest, or devise), the basis shall be the same as it would be in the hands of the grantor increased in the amount of gain or decreased in the amount of loss recognized to the grantor on such transfer.

Section 1.1001-1(f)(1) of the Income Tax Regulations provides that, for purposes of determining the gain or loss from the sale or other disposition of a term interest in property, a taxpayer shall not take into account that portion of the adjusted basis of such interest, which is determined pursuant to § 1015 (relating to the basis of property acquired by gift or by a transfer in trust), to the extent that such adjusted basis is a portion of the adjusted uniform basis of the entire property (as defined in § 1.1014-5).

Section 1.1014-5(a)(1) defines the term "adjusted uniform basis" as the uniform basis of the entire property adjusted as required by §§ 1016 and 1017 to the date of sale or other disposition of any interest in the property.

Section 1.1015-1(b) provides that, property acquired by gift has a single or uniform basis although more than one person may acquire an interest in such property. The uniform basis of the property remains fixed subject to proper adjustment for items under §§ 1016 and 1017. However, the value of the proportionate parts of the uniform basis represented, for instance, by the respective interests of the life tenant and remainderman are adjustable to reflect the change in the relative values of such interest on account of the lapse of time. The portion of the basis attributable to an interest at the time of its sale or other disposition shall be determined under the rule provided in § 1.1014-5. In determining gain or loss from the sale or other disposition after October 9, 1969, of a term interest in property (as defined in § 1.1001-1(f)(2)) the adjusted basis of which is determined pursuant, or by reference, to § 1015, that part of the adjusted uniform basis assignable under the rules of § 1.1014-5(a) to the interest sold or otherwise disposed of shall be disregarded to the extent and in the same manner provided by § 1001(e) and § 1.1001-1(f) See also § 1.1015-2(a)(2) (regarding transfers in trust).

Revenue Ruling 72-243, 1972-1 C.B. 233, provides that the sale of an income interest in a trust is a sale of a capital asset within the meaning of § 1221. See McAllister v. Commissioner, 157 F. 2d 235 (2d Cir. 1946).

Section 4941(a)(1) imposes an excise tax on each act of self-dealing between a disqualified person and a private foundation.

Section 4941(d)(1)(E) provides that the term “self-dealing” means any direct or indirect transfer to, or the use by or for the benefit of, a disqualified person of the income or assets of a private foundation.

Section 4946(a) provides the term “disqualified person” with respect to a private foundation includes a substantial contributor to the foundation (including the creator of a trust), a family member of a substantial contributor (including children), and a foundation manager (including a trustee).

Section 4946(a)(1)(D), together with § 4946(d), define the term “disqualified person” to include a spouse of a substantial contributor, among others.

Section 4947(a)(2) provides generally that split-interest trusts are subject to the provisions of §§ 507, 4941 and 4945 in the same manner as if such trusts were private foundations, but, under § 4947(a)(2)(A), not with respect to any amounts payable under the terms of such trust to income beneficiaries, unless a deduction was allowed under §§ 170(f)(2)(B), 2055(e)(2)(B), or 2522(e)(2)(B).

Section 53.4947-1(c)(2)(i) of the Foundation and Similar Excise Taxes Regulations provides that under § 4947(a)(2)(A), § 4941 does not apply to any amounts payable under the terms of a split-interest trust to income beneficiaries unless a deduction was allowed under §§ 170(f)(2)(B), 2055(e)(2)(B), or 2522(e)(2)(B) with respect to the income interest of any such beneficiary.

As a charitable remainder unitrust under § 664(d)(2), Trust is a split-interest trust described in § 4947(a)(2) and is, therefore, subject to § 4941, which imposes an excise tax on acts of self-dealing. Taxpayer is a disqualified person with respect to Trust, under § 4946, because he is a substantial contributor to Trust and is a trustee. Because Trust is a split-interest trust, it is treated as a private foundation under § 4947(a)(2).

The critical question is whether early termination may be expected to result in a greater allocation of Trust's assets to the income beneficiary, to the detriment of the charitable beneficiary, Foundation, than would a termination at Taxpayer's death as provided under Trust Agreement. Taxpayer's proposed allocation method is reasonable if the income beneficiary has no knowledge of a medical condition or other circumstance likely to result in a shorter life expectancy than that predicted by the actuarial tables. Otherwise, an early termination would tend to deprive Foundation of its benefit and would be inconsistent with the charitable deduction allowed to Taxpayer.

Accordingly, we conclude as follows: Taxpayer is selling his interest in Trust to the remainderman. Provided that the money and other property received by Taxpayer are distributed to Taxpayer in accordance with his interest in Trust, the amount Taxpayer will realize from the sale of his interest in Trust is the amount of money and the fair market value of the property received by Taxpayer.

Pursuant to § 1001(e)(1), the portion of the adjusted uniform basis assigned to Taxpayer's interest in Trust is disregarded. The exception contained in § 1001(e)(3) is not applicable, because the entire interest in Trust's assets is not being sold, or otherwise disposed of, to a third party. Accordingly, Taxpayer will be treated as though he has no basis in his interest in Trust and, therefore, Taxpayer will realize gain under §1001(c) in the amount received from the disposition of his interest in Trust. The amounts Taxpayer receives are subject to taxation as long-term capital gain.

We further conclude that no direct or indirect act of self-dealing within the meaning of § 4941 will result from the termination of Trust and the distribution of the assets of Trust to Taxpayer and Foundation.

The above conclusions are based on the assumptions that: state law allows the early termination; all beneficiaries favor the early termination; the amounts distributed to Taxpayer and Foundation are determined and distributed pursuant to the rules set forth in § 1.664-4 and § 7520; and Taxpayer has signed an affidavit under penalties of perjury that he is aware of no medical condition expected to result in a shorter-than-average longevity.

Except as specifically ruled herein, we express no opinion on the federal tax consequences of the transaction under the cited provisions or under any other provisions of the Code.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely yours,

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Lorraine E. Gardner
Senior Counsel, Branch 4
Office of Associate Chief Counsel
(Passthroughs and Special
Industries)

Enclosure
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