Internal Revenue Service

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Date:
February 12, 2014

Legend

Taxpayer =

Fund =

Trustee =

Dear :

This letter is in response to your request, dated August 16, 2013, on behalf of Taxpayer, seeking various rulings under the Internal Revenue Code on behalf of Fund.

Facts

Based on the materials submitted and representations within, we understand the relevant facts to be as follows. Taxpayer is a tax-exempt organization described in § 170(b)(1)(A)(iii) of the Internal Revenue Code (Code). Taxpayer created Fund, which operates as a valid trust under local law, to raise funds from donations of cash and property to purchase an undivided interest or the entire interest in land and/or one or more buildings (Building) owned by the Taxpayer.

Fund's sole Trustee is an organization that has been recognized as being described in § 501(c)(3) and as a supporting organization under § 509(a)(3). Taxpayer may remove Trustee and appoint a new trustee at any point given 30 days notice. Taxpayer is the remainder beneficiary of Fund.

Section 1.2 of Fund's Trust Agreement (Governing Instrument) provides that in transferring property to Fund, each donor shall retain a lifetime income interest in such property for the life of himself or herself, or of one or more income beneficiaries living at the time of such transfer, or both, as specifically designated in the Donor Agreement relating to the transfer of the particular property so transferred. In the event that more than one person is a beneficiary of an income interest, such beneficiaries shall enjoy their shares of income concurrently, consecutively, or both, as set forth in the Donor Agreement. A donor may retain in the Donor Agreement the power exercisable only by will to revoke or terminate the income interest of any designated income beneficiary. Income interests are otherwise irrevocable.

Section 3.1 of the Governing Instrument provides that "income" means net income less any deduction for Trustee or management fees in effect from time to time pursuant to agreement between Taxpayer and the Trustee. Furthermore, section 3.1 provides that gains from the sale of Fund assets (not otherwise allocated to income hereunder) and liquidating dividends and distributions shall be allocated to principal and all such gains, dividends and distributions shall be permanently set aside for the benefit of Taxpayer.

Section 3.4 of the Governing Instrument provides that "the income interest of a beneficiary shall terminate as of the date of his death. Income for the taxable year in which death occurs which is attributable to those Units as to which the decedent was beneficiary shall be pro-rated to the date of his death by multiplying the income so attributable for such taxable year by a fraction, the numerator of which is the number of days in such taxable year which precede the day of death and the denominator of which is the total number of days in such taxable year. Income for said taxable year attributable to such Units which is not paid to the estate of the deceased beneficiary pursuant to the preceding sentence shall be paid to the successor income beneficiary or, if there is no successor income beneficiary, to [Taxpayer]."

Section 7.5(g) of the Governing Instrument permits Trustee to set up and maintain depletion or depreciation reserves in accordance with Generally Accepted Accounting Principles for any Fund property by setting aside, in its sole and absolute discretion, trust income to a depletion or depreciation reserve; and any depletion or depreciation deduction in excess of the income so set aside as a reserve shall be apportioned between the income beneficiaries and Fund on the basis of the trust income (in excess of the income to set aside for the reserve) allocable to each.

Section 12 of the Governing Instrument provides prohibitions against, among other things, acts of self-dealing as defined under § 4941, expenditures that would be taxable expenditures under § 4945(d), the acquisition and retention of excess business holdings as defined in § 4943(c), and investments that are considered jeopardizing investments under § 4944.

Finally, Section 13.1 of the Governing Instrument provides that Taxpayer has the right to amend, in whole or in part, any or all of the provisions of the Governing Instrument. However, no such amendment shall (a) jeopardize the status of Fund as a pooled income fund within the meaning of § 642(c)(5); (b) impair the rights of any donor or beneficiary without his consent or affect the irrevocability of any transfer to Fund; or (c) affect the rights, duties or responsibility of Trustee without its written consent.

Taxpayer will sell Building to Fund, along with land underlying the Building. All property purchased by Fund will begin as property of Taxpayer. Taxpayer represents that Fund will then lease the Building and land back to Taxpayer for 25 years on a “net-net” lease basis, whereby Taxpayer will pay the property taxes and insurance in addition to the rent, and that the lease agreement will not provide for any renewals of this lease term (the sale-leaseback transaction). Taxpayer represents that the Building is nonresidential real property as defined in § 168(e)(2)(B) and the Building to be leased to Taxpayer is more than 35 percent of the property.

Taxpayer will pay rent in an amount intended to produce a fixed net rate of return to Fund’s income beneficiaries. All such net rental income will be distributed to, and taxable to, the income beneficiaries of Fund.

Rulings Requested

Taxpayer requests the following rulings:

1. The differences between the Fund’s Governing Instrument and the sample declaration of trust and instruments of transfer for pooled income funds provided in Revenue Procedure 88-53, 1988-2 C.B. 712, do not cause the Fund to fail to be a pooled income fund within the meaning of § 642(c)(5).

2. Fund’s cost basis in the Building is depreciable over 40 years under the straight line method.

3. To the extent that the depreciation deduction for a particular year exceeds the income set aside by Fund’s Trustee for the depreciation reserve, such depreciation deduction will be allocable to Fund’s income beneficiaries and Fund’s Trustee on the basis of the trust income (in excess of the income set aside for the reserve) allocable to each.

4. Whether Fund will be treated as a split interest trust under § 4947(a)(2) and whether the provisions of the governing instrument adequately meet the requirements of § 508(e).

5. Whether the sale-leaseback transaction outlined in this ruling will give rise to a self-dealing transaction.

Ruling 1

The difference between Fund's governing instrument and the sample declaration of trust and instruments for pooled income funds provided in Rev. Proc. 88-53, 1988-2 C.B. 712, do not cause Fund to fail to be a pooled income fund under § 642(c)(5).

Section 1.642(c)-5(a)(2) of the Income Tax Regulations provides that notwithstanding any other provision of chapter 1, a fund which meets the requirements of a pooled income fund as defined in § 642(c)(5) and § 1.642(c)-5(b), shall not be treated as an association within the meaning of § 7701(a)(3). Such a fund, which need not be a trust under local law, and its beneficiaries shall be taxable under part 1, subchapter J, chapter 1 of the Code, but the provisions of subpart E (relating to grantors and others treated as substantial owners) of such part shall not apply to such fund.

Section 4 of Rev. Proc. 2014-3, 2014-1 I.R.B. 117, lists issues on which the Service ordinarily will not issue letter rulings. The issues include whether a pooled income fund satisfies the requirements of § 642(c)(5) and whether a transfer to a pooled income fund is deductible as a charitable contribution under §§ 170(f)(2)(A), 2055(e)(2)(A), and 2522(c)(2)(A). In lieu of seeking the Service's advance approval of pooled income funds, taxpayers are directed to follow the sample trust provisions for a pooled income fund in Rev. Proc. 88-53, 1988-2 C.B. 712. Taxpayers who follow the sample trust provisions of Rev. Proc. 85-53 are assured that the Service will recognize the trust as meeting all the requirements for a pooled income fund under § 642(c)(5), provided the trust operates consistently with the terms of the trust instrument and is a valid trust under local law.

The sample declaration of trust and instruments of transfer in Rev. Proc. 88-53 are intended to meet all the applicable requirements for a pooled income fund under § 642(c)(5). They are not intended, however, to preclude other permissible provisions in the governing instruments. Provisions that vary from the sample provisions will not adversely affect the fund's qualification as a pooled income fund if those provisions are consistent the requirements of § 642(c)(5) and § 1.642(c)-5. In the present case, Fund's declaration of trust contains four provisions not addressed in Rev. Proc. 88-53. Because these provisions are not addressed in Rev. Proc. 88-53, we are ruling on whether these provisions adversely affect the qualification of Fund as a pooled income fund if it otherwise qualifies under § 642(c)(5).

Specifically, the Governing Instrument provides, in section 1.2, that "a donor may retain in the Donor Agreement the power exercisable only by Will to revoke or terminate the income interest of any designated beneficiary other than the Charity. Income interests are otherwise irrevocable." Section 3.4 of the Governing Instrument provides that "income for the taxable year in which death occurs which is attributable to those Units as to which the decedent was a beneficiary shall be prorated to the date of his death," while the sample trust agreement of Rev. Proc. 88-53 does not require the trustee to prorate any income payment to the date of the beneficiary's death. The Governing Instrument does not prohibit Trustee from investing in depreciable or depletable assets. It specifically provides, in section 7.5(g), that Trustee has the authority to set up and maintain depletion or depreciation reserves for any Fund property by setting aside trust income to a depletion or depreciation reserve. Any depletion or depreciation deduction in excess of the income so set aside as a reserve shall be apportioned between the income beneficiaries and Trustee on the basis of the trust income allocable to each. In addition, the scope of the amendment power in section 13.1 of the Governing Instrument is broader than the power of amendment in Rev. Proc. 88-53.

We conclude that sections 1.2, 3.4, 7.5, and 13.1 of the Governing Instrument are consistent with the requirements for a pooled income fund under § 642(c)(5) and do not adversely affect Fund's qualification as a pooled income fund if it is otherwise qualified. However, this ruling is limited to the effect of sections 1.2, 3.4, 7.5, and 13.1 of the Governing Instrument on the qualification of Fund under § 642(c)(5). No opinion is expressed concerning any other federal tax consequences of the formation or operation of the Fund, including whether the governing instruments meet all the requirements of § 642(c)(5).

Ruling 2

Section 167(a) provides that there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in a trade or business, or property held for the production of income.

The depreciation deduction provided by § 167(a) for tangible property placed in service after 1986 generally is determined under § 168. This section prescribes two methods of accounting for determining depreciation allowances. One method is the general depreciation system in § 168(a) and the other method is the alternative depreciation system ("ADS") in § 168(g). Under either depreciation system, the depreciation deduction is computed by using a prescribed depreciation method, recovery period, and convention.

Section 168(g)(1)(B) provides that in the case of any tax-exempt use property, the depreciation deduction allowed under § 167(a) shall be determined using the alternative depreciation system.

Section 168(g)(2) provides that for purposes of § 168(g)(1), the ADS is depreciation determined by using the straight line method (without regard to salvage value), the applicable convention determined under § 168(d), and a recovery period determined under the table prescribed under § 168(g)(2)(C). Pursuant to this table, nonresidential real and residential rental property have a 40-year recovery period.

Section 168(g)(3)(A) provides that in the case of any tax-exempt use property subject to a lease, the recovery period used for purposes of § 168(g)(2) shall in no event be less than 125 percent of the lease term.

Section 1.168(i)-2(a) of the Income Tax Regulations provides that for purposes of § 168, a lease term is determined under all the facts and circumstances. Section 1.168(j)-1T, Q&A 17, describes certain circumstances that will result in a period of time not included in the stated duration of an original lease (additional period) nevertheless being included in the lease term. These rules do not prevent the inclusion of an additional period in the lease term in other circumstances.

Section 1.168(j)-1T, Q&A 17 provides rules relating to what is included in determining the length of a lease term. Section 1.168(j)-1T, A-17(i) provides that the lease term includes not only the stated duration, but also any additional period of time that is within the "realistic contemplation of the parties at the time the property is first put into service." Hokanson v. Commissioner, 730 F. 2d 1245, 1248 (9^{th} Cir. 1984). A subsequent period of time is included in the term of the original lease if the circumstances indicate that the parties, upon entering into the original lease, had informally agreed that there would be an extension of the original lease.

With respect to real property, § 1.168(j)-1T, A-17(iii) provides that the lease term includes all periods for which the tax-exempt lessee or related party has a legally enforceable option to compel its renewal by the tax-exempt entity or a related party, unless the option to renew is at fair market value, determined at the time of renewal. The Hokanson facts and circumstances test may cause the term of a fair market value renewal option to be treated as part of the original lease term.

In this case, Taxpayer and Fund represent that the lease agreement pertaining to Fund's lease of the Building to Taxpayer will be for a 25-year period and this lease agreement will not provide for any renewals of this 25-year lease term. Based solely on these representations, if the Building is tax-exempt use property, it must be depreciated under the ADS over the greater of 40 years, as provided in the table under § 168(g)(2)(C), or 31.25 years (125 percent of the 25-year lease term).

Section 168(h) provides the rules relating to tax-exempt use property. For purposes of § 168, § 168(h)(1)(B)(i) provides that, in the case of nonresidential real property, the term "tax-exempt use property" means that portion of the property leased to a tax-exempt entity in a disqualified lease.

Section 168(h)(1)(B)(ii) provides that for purposes of § 168(h)(1)(B), the term "disqualified lease" means any lease of nonresidential real property to a tax-exempt entity, but only if (I) part or all of the property was financed (directly or indirectly) by an obligation the interest on which is exempt from tax under § 103(a) and such entity (or a related entity) participated in such financing, (II) under such lease there is a fixed or determinable price purchase or sale option which involves such entity (or related entity) or there is the equivalent of such an option, (III) such lease has a lease term in excess of 20 years, or (IV) such lease occurs after a sale (or other transfer) of the property by, or lease of the property from, such entity (or related entity) and such property has been used by such entity (or related entity) before such sale (or other transfer) or lease [i.e., a sale-leaseback or a lease-leaseback arrangement].

Section 168(h)(1)(B)(iii) provides that § 168(h)(1)(B)(i) shall apply to any property only if the portion of such property leased to tax-exempt entities in disqualified leases is more than 35 percent of the property.

Section 168(h)(2)(A)(ii) provides that for purposes of § 168(h), the term "tax-exempt entity" includes any organization (other than a cooperative described in § 521) that is exempt from tax imposed by Chapter 1 of the Internal Revenue Code.

Here, the property to be leased to Taxpayer is nonresidential real property. Under § 168(h), nonresidential real property is tax-exempt use property if it is leased to a tax-exempt entity under a disqualified lease and the portion of such property leased is more than 35 percent of the property. Thus, the proposed lease of buildings will be a disqualified lease if at least one of the four requirements provided in § 168(h)(1)(B)(ii) is met and § 168(h)(1)(B)(iii) is satisfied.

In this case, the Building will be leased to Taxpayer, a tax-exempt entity, for a term of 25 years. Accordingly, the Building will be tax-exempt use property because it will be leased to Taxpayer, a tax-exempt entity under a disqualified lease, i.e., a lease with a term exceeding 20 years, and at least 35 percent of such property will be leased to Taxpayer.

Based solely on Taxpayer's and Fund's representations and the law and analysis set forth above, we conclude that Fund's cost basis in the Building is depreciable over 40 years under the straight line method.

Ruling 3

Section 642(e) provides in pertinent part that an estate or trust shall be allowed the deduction for depreciation only to the extent not allowable to beneficiaries under § 167(d).

Section 167(d) provides that in the case of property held in trust, the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each.

Section 1.167(h)-1(b) provides that if property is held in trust, the allowable depreciation deduction is to be apportioned between the income beneficiaries and the trustee on the basis of the trust income allocable to each, unless the governing instrument (or local law) requires or permits the trustee to maintain a reserve for depreciation in any amount. In the latter case, the deduction is first allocated to the trustee to the extent that income is set aside for a depreciation reserve, and any part of the deduction in excess of the income set aside for the reserve shall be apportioned between the income beneficiaries and the trustee on the basis of the trust income (in excess of the income set aside for the reserve) allocable to each. For example, if under the trust instrument or local law the income of a trust is to be distributed to a named beneficiary, but the trustee is directed to maintain a reserve for depreciation in any amount, the deduction is allowed to the trustee (except to the extent that income set aside for the reserve is less than the allowable deduction). The same result would follow if the trustee sets aside income for a depreciation reserve pursuant to discretionary authority to do so in the governing instrument.

Accordingly, based solely on section 7.5(g) of Fund's trust agreement and the law set forth above, we conclude that, to the extent that the depreciation deduction for a particular year exceeds the income set aside by the Trustee for the depreciation reserve, such depreciation deduction will be allocable to Fund's income beneficiaries and the Trustee on the basis of the trust income (in excess of the income set aside for the reserve) allocable to each.

Rulings 4-5

Section 508(e)(1)(B) provides that the governing instrument of a private foundation must include language that prohibits the foundation from engaging in any act of self-dealing (as defined in § 4941(d)), from retaining any excess business holdings (as defined in § 4943(c)), from making any investments in such manner as to subject the foundation to tax under § 4944, and from making any taxable expenditures (as defined in § 4945(d)).

Section 4941 imposes an excise tax on private foundations and foundation mangers for each act of self-dealing and between a private foundation and a disqualified person. The term "self-dealing" includes any direct or indirect sale of exchange, or leasing, of property between a private foundation and a disqualified person, and lending of money or other extension of credit between a private foundation and a disqualified person.

Section 4946(a)(1) provides that a "disqualified person," with respect to a private foundation, includes a substantial contributor; a foundation director, trustee, or officer;

and any spouse, ancestor, child, grandchild, great grandchild, and any spouse of a child, grandchild, or great grandchild of that contributor, director, or officer.

Section 4947(a)(2) applies § 4941 self-dealing rules, § 4945 taxable expenditure rules, and § 508(e) governing instrument rules, to the extent applicable to split-interest trusts, to § 642(c)(5) pooled income funds as if they were private foundations, where such funds are not exempt from tax under § 501(a), not all of the unexpired interests in which are devoted to one or more of the purposes described in § 170(c)(2)(B), and have amounts in trust for which a deduction was allowed under § 642(c)(5).

Section 1.508-3(e)(2) provides that a split interest trust described in § 4947(a)(2) is subject to the provisions of 508(e)(1)(B).

Section 53.4941(d)-2(f)(2) provides that the fact that a disqualified person receives an incidental or tenuous benefit from the use by a foundation of its income or assets will not, by itself, make such use an act of self-dealing.

Section 53.4946-1(a)(8) deems organizations described in § 501(c)(3) (other than organizations described in § 509(a)(4)) as not disqualified persons for purposes of § 4941 only.

Fund is a split-interest trust under § 4947(a)(2) because: (i) it is not exempt from tax under § 501(a) since its purpose is not described in § 501(c); (ii) not all of the unexpired interests in it are devoted to one or more of the purposes described in § 170(c)(2)(B) since the donors to Fund have an ongoing income interest, and (iii) it has amounts in trust for which a deduction was allowed under §§ 642(c). Section 4947(a)(2) provides that a split-interest trust is treated as a private foundation for purposes of §§ 508(e), 4941, 4943, 4944, and 4945.

Section 508(e) requires a private foundation to include certain provisions in its governing instruments. These provisions must require the private foundation's income for each taxable year to be distributed at such time and in such manner as not to subject the foundation to tax under § 4942, and also prohibit the private foundation from engaging in any act of self-dealing (as defined in § 4941(d)), from retaining any excess business holdings (as defined in § 4943(c)), from making any investments in such manner as to subject the foundation to tax under § 4944, and from making any taxable expenditures (as defined in § 4945(d)). Section 1.508-3(e)(2) provides that only the provisions of § 508(e)(1)(B) apply to split interest trusts. Fund's Governing Instrument contains provisions with respect to each of the Code sections applicable to split-interest trusts under § 4947(a)(2) and found in § 508(e)(1)(B). Accordingly, the provisions of Fund's trust agreement conform to the requirements of § 508(e) imposed on private foundations.

Section 4941 applies self-dealing rules to certain transactions between disqualified persons and private foundation. Foundation is Fund's sole trustee, and Taxpayer has the power to remove and appoint the trustee at any time. Since § 4946(a)(1)(B) defines trustees, and those having control over a trust, as disqualified persons with respect to their trusts, Foundation as trustee of Fund, and Taxpayer having control over the trustee of Fund, are disqualified persons with respect to Fund unless an exception applies. Because Foundation and Taxpayer are both organizations described in § 501(c)(3) and § 53.4946-1(a)(8) provides that such charitable organizations are not disqualified persons for purposes of § 4941 only, Foundation and Taxpayer are not disqualified persons with respect to Fund for purposes of § 4941. Also, while Fund could be a disqualified person with respect to Foundation, any benefit to Fund from Foundation's use of Foundation assets will be incidental and tenuous under the facts; Foundation, as trustee of Fund, will be using Fund's assets in the transactions. Accordingly, the transactions between Foundation and Fund, as well as transactions between Taxpayer and Fund, are not direct or indirect self-dealing within the meaning of § 4941, including the sale, loan, and lease transactions.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and are accompanied by a perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of this request, it is subject to verification on examination.

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

In accordance with the Power of Attorney on file with this office, a copy of this letter ruling will be sent to the taxpayer's representatives.

Sincerely,

Melissa C. Liquerman
Chief, Branch 2
(Passthroughs & Special Industries)

Enclosure (1)
Copy of Letter for § 6110 purposes