J. A GENERAL EXPLANATION OF TRUSTS SUBJECT TO IRC 4947

1. Introduction

With the sweeping changes in the taxation of charities and charitable giving made by the Tax Reform Act of 1969 came the possibility that taxpayers would pursue devices to avoid the new restrictions. IRC 4947 was created as a sort of all-purpose loophole closer. Its provisions are designed to apply exempt organizations tax law, including the private foundation provisions, to trusts with charitable interests in situations in which there is the potential for tax avoidance.

Trusts subject to the provisions of IRC 4947 may or may not have non-charitable interests in addition to the charitable beneficiaries. IRC 4947(a)(1) applies to trusts that have only charitable interests. This article will refer to trusts covered by IRC 4947(a)(1) as nonexempt charitable trusts. Trusts which have both charitable and non-charitable interests, known as split interest trusts, are subject to the provisions of IRC 4947(a)(2).

The statutory language of IRC 4947 is somewhat involved. This is particularly true with the provisions applicable to split interest trusts. However, the section is not difficult once the problems underlying its creation are understood. It is hoped that this article will provide a useful introduction to IRC 4947 so that the complex statutory language of the section will not prove to be an insurmountable barrier to its proper application.

2. Nonexempt Charitable Trusts

The Tax Reform Act of 1969 imposed many new restrictions and requirements upon private foundations. However, were it not for the enactment of IRC 4947(a)(1), it would be possible to avoid all of these restrictions by the simple expedient of failing to meet the notice requirement of IRC 508, and thereby not be characterized as an IRC 501(c)(3) organization.

Consider the following example. The sole stockholder of a successful corporation creates a trust and transfers to it 49% of the stock of the corporation. The trust's stated purpose is to use all of its current income to grant scholarships to needy and deserving students. As the trust is organized and operated exclusively for charitable and educational purposes, the gift to the trust qualifies for a

charitable contribution deduction under IRC 170 and 2522. However, the trust does not apply for recognition of exemption. If it were not for IRC 4947(a)(1), by failing to apply for recognition of exemption, the trust would avoid all of the private foundation requirements. As a result, even though a charitable deduction would be allowed for the gift, there would be no guarantee that the trust would in fact do anything charitable. For example, as IRC 4943 would not apply, the trust would be allowed to continue to hold stock of the closely held corporation as its only asset. The majority stockholder, the creator of the trust, would retain the power to declare dividends. Therefore, there would be no guarantee that the trust would receive any income at all. As IRC 4942 would not apply, there would be no provision requiring the trust to actually distribute any money for charitable purposes. However, a trust created after October 9, 1969, would be subject to taxation if it did not distribute most of its net income. With the recent amendment to IRC 4942 requiring private foundations to distribute only their minimum investment return, a nonexempt charitable trust may, as a practical matter, distribute more money than an exempt trust.

To avoid this result, Congress enacted IRC 4947(a)(1). This section applies to trusts which are not exempt from taxation under IRC 501(a), which have all unexpired interests devoted to one or more purposes described in IRC 170(c)(2)(B), and for which a charitable deduction was allowed for income, estate or gift tax purposes. If a trust has all of these characteristics, it will be treated as a private foundation for purposes of the provisions of Chapter 42 (IRC 4940 through 4945) unless it is a "public charity" under IRC 509(a). If a nonexempt charitable trust is a private foundation, it will be subject to the termination provisions of IRC 507, and must have the special provisions in its governing instrument required by IRC 508(e). Finally, the rules of IRC 508(d) relating to the disallowance of charitable contributions in certain circumstances apply to nonexempt charitable trusts, except that of IRC 508(d)(2)(B). The notice requirements of IRC 508 do not apply to nonexempt charitable trusts, and therefore the regulations state that a charitable deduction will not be disallowed to a nonexempt charitable trust for failure to meet the notice requirements.

The role of IRC 4947(a)(1) as a "loophole closer" is illustrated by its effect upon the hypothetical organization described previously. The organization has all of the elements of a nonexempt charitable trust. Therefore, it is subject to Chapter 42 provisions as it is a private foundation. It may not hold a 49% interest in the closely held corporation, and even if no dividends are actually paid to it, it must nevertheless distribute money for charitable purposes under IRC 4942 equal to its minimum investment return.

There are differences between the taxation of nonexempt charitable trusts and organizations exempt under IRC 501(c)(3). As noted above, an IRC 4947(a)(1) trust is not exempt from income tax. If a nonexempt charitable trust in fact pays or uses all of its income for charitable purposes, there will be no taxable income because of the unlimited charitable deduction accorded trusts under IRC 642(c). However, failure to use all income for charitable purposes may result in tax. Furthermore domestic nonexempt charitable trusts which are private foundations are subject to the IRC 4940 excise tax on foundation investment income. Instead of the flat 2% tax imposed by IRC 4940(a), nonexempt charitable trusts are subject to IRC 4940(b) which essentially provides that such a trust will pay in combined excise and income taxes the greater of its normal income tax or the tax it would have paid if it were an exempt private foundation, including the tax on unrelated trade or business income. Foreign nonexempt charitable trusts are not subject to either the IRC 4940 or IRC 4948 excise taxes.

Nonexempt charitable trusts are most frequently encountered not as tax avoidance devices, but simply in the situation in which a trust has been created[1] but has not yet applied for recognition of exemption. Note that there is a critical difference between a nonexempt charitable trust which has not applied for recognition of exemption and a corporate charity which has not applied. IRC 508(d)(2)(B) disallows a charitable deduction to any organization which is not treated as an IRC 501(c)(3) organization for failure to meet the notice requirement of IRC 508(a). However, IRC 508(a) is not applicable to nonexempt charitable trusts, and therefore, as recognized by Reg. 1.508-2(b)(1)(vii), deductions for contributions to a nonexempt charitable trust will not be disallowed. However, a deduction for a contribution to a charitable corporation will be disallowed under IRC 508(d)(2)(B) if the organization does not satisfy the notice requirement of IRC 508.

---

[1] The question of when a nonexempt charitable trust is deemed to be created, as well as the interplay of IRC 508 and IRC 4947 is discussed in more detail, <u>infra</u>.

3. Split Interest Trusts

Under IRC 4947(a)(2), a split interest trust is made subject to some, but not all, of the private foundation restrictions and requirements. A split interest trust is just what it sounds like: it is a trust which has at least one non-charitable beneficiary, and also has amounts in trust for which a charitable deduction was allowed for income, estate, or gift tax purposes. An example of such a trust would be one that pays $10,000 per year to an individual for life, with all other income and the principal remaining going to an IRC 501(c)(3) organization.

The key to understanding IRC 4947(a)(2) as a "loop-hole closer" is to be found in those sections of the Code which provide for charitable deductions for income, estate, and gift tax purposes. The Tax Reform Act of 1969 imposed many restrictions on the form of a trust in which a creator of a split interest trust could obtain a charitable deduction. The abuse corrected in 1969 can best be explained by example. A trust's creator established a trust which pays all of its income to the creator's wife for the rest of her life, remainder to an IRC 501(c)(3) organization. Under the law prior to 1969, the creator would be allowed a current deduction for the value of the charitable remainder which would not be paid until the grantor's wife died. The amount of the deduction was based upon actuarial life tables that assumed a given interest rate. However, as explained by the Senate Finance Committee Report, allowing a current deduction for a remainder interest does

> not necessarily have any relation to the value of the benefit which the charity receives. This is because the trust assets may be invested in a manner so as to maximize the income interest with the result that there is little relation between the interest assumptions used in calculating present values and the amount received by the charity. For example, the trust corpus can be invested in high income, high-risk assets. This enhances the value of the income interest but decreases the value of the charity's remainder interest. Senate Report 91-552 at 1969-3 C.B. 479.

Recognizing the need for "a closer correlation between the charitable contributions deduction and the ultimate benefit to charity," the Tax Reform Act of 1969 provided that with three exceptions, no gift in trust with a charitable remainder interest would qualify for a charitable deduction until the gift was actually paid. See IRC 170(f)(2)(A), 2055(e)(2)(A) and 2522(c)(2)(A). The three exceptions were:

(1) Charitable remainder annuity trust. In this trust, a fixed dollar amount of no less than 5% of the initial fair market value of the property placed in trust is paid at least annually to an individual or non-charitable organization for up to 20 years or while the individual beneficiary is alive. By setting a fixed annuity, there is no incentive to favor income beneficiaries over remainder interests. Upon termination of the income interest, the remainder interest is transferred to, or for the use of, a charitable organization, or is retained by the trust for such use. See IRC 664(d)(1).

(2) Charitable remainder unitrust. The trust is similar to the annuity trust, but instead of a fixed dollar amount, the at-least-annual payments are determined by taking a fixed percentage of the value of the trust's total assets valued annually. By setting the payments as a percentage of corpus, there is no incentive to risk corpus to produce income. Again, when the income interest expires, the remainder is transferred to a charitable organization or is retained by the trust for such use. See IRC 664(d)(2).

(3) Pooled income fund. This is a trust administered by the charitable remainder organization in which contributors' funds are commingled or pooled together. The fund accepts gifts under terms by which income is paid to an individual for life, and where all remaining interests are given to the organization maintaining the trust. Income payments to a particular beneficiary are based on a pro rate portion of overall trust asset income, rather than being traced to specific assets. To qualify as a pooled income fund, a trust must comply with the several technical requirements set forth in IRC 642(c)(5) and the regulations thereunder.

The Tax Reform Act of 1969 enacted similar provisions to protect charities receiving income interests. A trust with a charitable income interest is commonly referred to as a charitable lead trust. No deduction will be allowed under income, estate, or gift taxation for the current value of a charitable income interest unless such interest is in the form of a guaranteed annuity or a fixed percentage of the value of the trust property, valued annually, and distributed yearly. See IRC 170(f)(2)(B), 2055(e)(2)(B), and 2522(c)(2)(B).

Charitable lead and remainder interests can be found within one trust. An example of a trust with a fixed annuity to a charity and an individual, with the remainder to a charity can be found in Reg. 53.4947-1(c)(2)(ii), Example (2).

Charitable remainder annuity and unitrusts are exempt from income tax under IRC 664(c). This opens the way for a potential abuse: an organization can take the annuity or unitrust form as a means to avoid private foundation restrictions. The creation of such a trust would allow a deduction much the same as the creation of a private foundation, but by being exempt under IRC 664(c) instead of IRC 501(c)(3), the organization would avoid the restrictions on private foundations.

Enter IRC 4947(a)(2), the loophole closer. By making these split interest trusts subject to some of the private foundation provisions, IRC 4947(a)(2) precludes abuse of the annuity and unitrust forms while not destroying their attractiveness as vehicles for charitable giving.

Returning now to the language of IRC 4947(a)(2), the phrase "amounts in trust for which a deduction was allowed under section 170" etc., usually can be established only if the trust takes one of the precise forms, or combination of the forms, discussed above. Not all trusts with both charitable and non-charitable interests will be subject to IRC 4947(a)(2). For example, a trust that provides that all income is to be paid to one individual with the remainder to an IRC 501(c)(3) charity is not subject to IRC 4947(a)(2) because it does not take the form of an annuity trust, unitrust, or pooled income fund, so that no charitable deduction is allowable at its creation.

An interesting question concerning this provision has arisen in a number of cases. Either an individual or a corporation creates and funds an irrevocable trust, T. The net income of T is to be distributed to organizations described in IRC 170(c)(2) and 2522(a)(2). All income of T is to be distributed before the close of the year following the year in which the income is received. Capital gains are to be added to T's corpus. The governing instrument of T provides that no additional property may be contributed to T after it is created. T will terminate ten years and one month from the date of creation. The creator has reserved the power to designate the recipients of income. Designation of the charitable beneficiary is made after T's income has been earned and, up until the actual distribution by T, may be modified, amended, or revoked by the creator. If the creator fails to designate the beneficiaries by the time the income must be distributed, T's trustees must select the charitable beneficiaries. Upon the termination of T, all the property comprising the corpus of T will be distributed to the creator. All the then undistributed income of T will be distributed to or for the use of charitable organizations described in IRC 170(c)(2) and 2522(a)(2).

T is not exempt from tax under IRC 501(a), and not all of the unexpired interests in T are devoted to purposes described in IRC 170(c)(2)(B). Thus, if T has amounts in trust for which a deduction was allowed under IRC 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522, it would be a split-interest trust described in IRC 4947(a)(2).

By reserving the power until distribution to modify, amend, or revoke any designation of a charitable beneficiary, the creator retains dominion and control of the income until the income is actually paid out. Therefore, the creator makes a completed gift to charity only when the distribution is made. See Rev. Rul. 77-275, 1977-2 C.B. 346, which discusses the gift tax consequences when a grantor retains the right to designate charitable beneficiaries of trust income. The creator is allowed a gift tax deduction under IRC 2522 of the Code at the time the trustee makes a distribution to a charitable beneficiary pursuant to the creator's designation or the trustee's designation.

T is allowed an income tax deduction under IRC 642(c) of the Code only for amounts of gross income paid out to charitable beneficiaries during its taxable year or by the close of the following taxable year and not for amounts permanently set aside for charitable purposes. See Rev. Rul. 79-233, 1979-2 C.B. 254, which holds that a similar trust will be allowed an income tax deduction under IRC 642(c)(1).

However, both income and gift tax deductions are allowed only when T makes distributions to charity. Thus, for purposes of IRC 4947(a)(2), at no time will T have amounts in trust for which a deduction was allowed under IRC 170, 545(b)(2), 556(b)(2), 2055, 2106(a)(2), or 2522. Thus, it appears that T is not a split-interest trust under IRC 4947(a)(2).

In addition, it is important to note that Reg. 53.4947-1(a) provides that absent proof to the contrary, if a deduction was allowable for a transfer, it will be presumed it was taken. However, if it is shown that no deduction was taken, the trust is not subject to IRC 4947(a)(2).

As noted above, unlike IRC 4947(a)(1) nonexempt charitable trusts, IRC 4947(a)(2) split interest trusts are not subject to all of the Chapter 42 restrictions on private foundations. IRC 4941 and 4945, self-dealing and taxable expenditures, apply in all cases, as do IRC 507 and 508(e). See Rev. Rul. 74-368, 1974-2 C.B. 390, for sample governing instrument provisions for split-interest trusts that satisfy IRC 508(e). IRC 4943 and 4944 apply except in two situations: one, if the remainder interests are entirely charitable, and the income interests entirely non-

charitable; and two, if all of the charitable deductible income interests comprise not more than 60% of the value of all of the assets of the trust, all of the income interests are charitable and there are no charitable remainder interests. Congress felt that in these situations, since the charitable interests were comparatively small or remote in time, the restrictions of an annuity or unitrust form offer enough protection under the circumstances.

Not only does IRC 4947(a)(2) not apply all Chapter 42 provisions to split interest trusts, it does not apply any provisions to the income interests of individuals under a charitable remainder annuity or unitrust. IRC 4947(a)(2)(A) provides that IRC 4947(a)(2) does not apply to income beneficiaries unless a beneficiary is a charity under a lead trust in annuity or unitrust form. Note that IRC 4947(a)(2)(A) does not remove the entire trust from the provisions of IRC 4947(a)(2), only the amounts payable to individuals. This ensures that the annuities paid to the individuals will not be treated as acts of self-dealing under IRC 4941.

A similar exception is provided by IRC 4947(a)(2)(B) for the situation in which the assets of a trust are segregated in such a way as to be the equivalent of two trusts, one of which has no charitable interests. The exception is applicable only where there are multiple assets, separately accounted for, with the income from some assets traceable solely to non-charitable beneficiaries. In these situations, the assets without charitable interests are considered as constituting a separate trust not subject to the provisions of IRC 4947(a)(2). If assets in which all interests are charitable are segregated from split interest assets, the exclusively charitable assets will be treated as an IRC 4947(a)(1) nonexempt charitable trust under Reg. 53-4947-1(c)(3)(iii).

The Code also provides in IRC 4947(a)(2)(C) that the provisions of IRC 4947(a)(2) will not apply to amounts transferred in trust before May 27, 1969. The regulations interpret this provision to exclude from the operation of IRC 4947(a)(2) assets actually transferred after this date, due to circumstances of estate administration, if the creator died prior to May 27, 1969. Similarly, even if the creator dies after May 26, 1969, if at all times on or after that date he was mentally incapacitated to change a will that provided for the creation of a split interest trust, the eventual testamentary transfer will be excluded from IRC 4947(a)(2).

It sometimes happens that a trust with assets transferred prior to May 27, 1969, has additional assets transferred to it later on. The subsequent transfer will not affect the earlier one if the assets are segregated. But if the assets are not

segregated, the subsequent transfer will cause all of the assets to be subject to IRC 4947(a)(2). See Reg. 53.4947-1(c)(5)(ii).

These various exceptions apply only to split interest trusts, and not to nonexempt charitable trusts. Because a split interest trust is not subject to all Chapter 42 taxes, and may have exceptions for some or all of its assets from any private foundation provisions, a trust may wish to argue that it is a split interest trust rather than a nonexempt charitable trust. For example, in one case, a charitable trust was created and funded by the gift of stock of a closely held corporation. A private individual who owned other shares was given voting rights in the stock transferred to the trust. The trust claimed that these voting rights constituted an interest, and therefore the trust was a split interest trust. In ruling that this was a nonexempt charitable trust, the Service held that "interest" in IRC 4947 means an income or remainder interest. Note that Rev. Rul. 81-282, 1981-2 C.B. 78, holds that a contribution of voting stock to a charitable organization with the donor retaining the right to vote the stock constitutes a contribution of a partial interest of property under IRC 170(f)(3) for which no charitable deduction under IRC 170 is allowable. Similarly, no gift or estate tax deduction would be allowable under IRC 2055 or 2522. Thus, in the example above, no IRC 170 deduction would be allowable when the trust was created. However, once the trust claimed a deduction under IRC 642(c) for amounts paid to its charitable beneficiaries, it would fall under IRC 4947(a)(1).

A more worrisome problem is the drafting of a trust instrument intended to avoid IRC 4947(a)(1). For example, consider a testamentary trust which could qualify under IRC 501(c)(3) but for a provision that if the testator's wife's income drops below $25,000 in any given year, the trust shall pay her the difference. At the testator's death, the wife is a multimillionaire with income interests in other trusts greatly in excess of $25,000. Because there is a contingent private benefit, the organization does not necessarily have all interests devoted to charitable purposes within the meaning of IRC 4947(a)(1). However, because of the remoteness of the possibility of actual use by the wife, it is possible that an estate tax deduction would be allowed under IRC 2055 and Reg. 20.2055-2(b). The result is arguably a split interest trust, avoiding both IRC 4947(a)(1) and the unitrust or annuity trust form. As the scope of IRC 4947(a)(2) is more limited than IRC 4947(a)(1), the potential for abuse should be considered in such circumstances.

On the other hand, Reg. 53.4947-1(b)(2)(vii) states that if a trust with unexpired charitable (IRC 170(c)(2)(b)) interests also has interests devoted to IRC 170(c)(3) (certain veterans organizations) or IRC 170(c)(5) (certain cemetery

companies) purposes, such a trust will be considered a charitable trust for IRC 4947(a)(1) purposes. See Rev. Rul. 80-97, 1980-1 C.B. 258, which holds that payments made by such a trust for IRC 170(c)(5) purposes are qualifying distributions under IRC 4942 and are not taxable expenditures under IRC 4945. A similar rule applies to IRC 170(c)(3) interests. Reg. 53.4947-1(b)(2)(vii).

4. Filing Requirements

IRC 6033(d) provides that, for taxable years beginning after 1980, nonexempt charitable trusts must file the same information returns as IRC 501(c)(3) organizations. Thus, IRC 4947(a)(1) trusts will file either Form 990 or 990-PF. In addition, a nonexempt charitable trust must file Form 1041 under IRC 6012 if it has any taxable income, or gross income of $600 or over (regardless of the amount of taxable income. However, if the trust has zero taxable income under Subtitle A of the Code, Form 990 or 990-PF can be used to satisfy the Form 1041 filing requirement.

Split-interest trusts having amounts in trust transferred after May 26, 1969, are generally required to file two separate information returns; Form 5227 as required by Reg. 53.6011-1(d) and Form 1041A as required by IRC 6034. Split-interest trusts having only amounts in trust transferred before May 27, 1969, are only required to file Form 1041A. In any case, Form 1041A is not required if all the net income of a trust is required to be distributed currently to its beneficiaries. Split interest trusts may also be required to file Form 1041 as discussed above.

5. Additional Problems Applicable to IRC 4947 Trusts

Determining the date on which a trust becomes subject to IRC 4947(a)(1) or 4947(a)(2) is a problem which arises in several contexts. It can arise by an estate being deemed a trust, by a revocable lifetime transfer becoming irrevocable at death, or in a dispute as to the date a trust comes into existence. A question might also arise as to the date a split interest trust with its non-charitable interests expiring becomes subject to IRC 4947(a)(1) as a nonexempt charitable trust.

The most important practical effect of determining the date on which a trust becomes subject to a provision of IRC 4947 is to be found in applying the 15 month notice rule of IRC 508 at such time as a nonexempt charitable trust applies for exempt status. However, the problem is also important for determining which, if any, Chapter 42 provisions apply, and for some applications of the tax on unrelated trade or business income.

Estates are not trusts, and as such are not subject to IRC 4947. However, under the provisions of Reg. 1.641(b)-3(a), if the administration of an estate is unduly prolonged, it may be considered terminated. In such a case, if the estate has solely charitable beneficiaries, Reg. 53.4947-1(b)(2)(ii) provides that the terminated estate will be treated as a nonexempt charitable trust. A similar provision in Reg. 53.4947-1(c)(6)(ii) results in an unduly prolonged estate being deemed a split interest trust where applicable. Without these provisions, an unduly prolonged estate could be used to avoid the reach of IRC 4947. Where these provisions apply, and an estate becomes subject to Chapter 42 provisions, taxes on self-dealing might be especially troublesome in transactions between the estate and its beneficiaries.

There is generally no problem as to the date of creation of a testamentary nonexempt charitable trust. Reg. 53.4947-1(b)(2)(i) provides that a charitable trust created by a will shall be considered a charitable trust under IRC 4947(a)(1) as of the date of death of the decedent-grantor, except as provided in Reg. 53.4947-1(b)(2)(v), as will be discussed below. Therefore, it could be argued that a testamentary charitable trust is deemed created on the date of the testator's death, and it is from this date that the 15 month notice period of IRC 508 should begin to run. On the other hand, it can be argued that the IRC 4947 regulations do not necessarily govern the notice requirement of IRC 508(a). It would be reasonable to conclude that a testamentary trust is created, for IRC 508(a) purposes, on the date of the first distribution of trust corpus to the trustee, or, if earlier, the date the estate is considered terminated for federal tax purposes.

Another common situation is that of a revocable lifetime trust which becomes irrevocable at death. This is the situation which is the subject of the exemption provided for by Reg. 53.4947-1(b)(2)(v) mentioned above. Such a trust does not become subject to IRC 4947(a)(1) on the date of death of the testator, nor would the 15 month notice period begin to run on that date. Instead, the trust is given a reasonable period of settlement for administrative purposes such as a final accounting or the filing of tax returns. At the termination of the reasonable period, or sooner if administration is actually completed, the trust will become subject to IRC 4947(a)(1). A similar rule for revocable split interest trust which become irrevocable is provided for in Reg. 53.4947-1(c)(6)(iii), although under certain circumstances, the provisions of IRC 4941 on self-dealing do become applicable. See Reg. 53.4941(d)-1(b)(3) for such circumstances. This type of trust is commonly used to avoid subjecting assets to state probate jurisdiction.

Another common situation with a similar result is that in which a split interest trust becomes a nonexempt charitable trust when its non-charitable interests expire. For example, a trust providing a fixed annuity for the life of the creator's wife with all other interests for charitable purposes is a split interest trust. At the death of the annuitant wife, however, all the unexpired interests remaining are charitable. However, under Reg. 53.4947-1(b)(2)(vi), such a trust is still considered an IRC 4947(a)(2) trust and not an IRC 4947(a)(1) trust during a reasonable period of settlement, or until actually settled, whichever is earlier. A split interest trust which terminates upon the expiration of non-charitable income interests likewise remains a split interest trust during settlement. It will become an IRC 4947(a)(1) trust only if settlement is unduly prolonged.

In each of the foregoing situations in which a nonexempt charitable trust is not deemed created until administration is either completed or a reasonable period has passed, the 15 month notice period of IRC 508(a) should not begin to run until the trust is subject to the provisions of IRC 4947(a)(1). Similarly, the organizational test of Reg. 1.501(c)(3)-1(b) should be considered as of this date, with prior non-charitable provisions disregarded. To do otherwise would preclude exemption for trusts becoming charitable trusts upon the expiration of non-charitable interests or the lapse of a power to revoke.

Nonexempt charitable trusts may be public charities, most often as supporting organizations under IRC 509(a)(3). As the notice requirements of IRC 508 do not apply to these trusts, they may be considered as not private foundations even though they do not seek recognition of exemption.[2] In this case too, the test of whether organized exclusively as a supporting organization is determined at such time as the trust is actually subject to the provisions of IRC 4947(a)(1). However, for meeting the historic relationship test for certain aspects of determining public charity status as a supporting organization, the trust may consider the applicable relationships prior to being subject to IRC 4947(a)(1), for example, its supporting role while a revocable trust or split interest trust.

---

[2] Rev. Proc. 72-50, 1972-2 C.B. 830, provides a procedure whereby a nonexempt charitable trust may seek recognition of public charity status without seeking exempt status if it so chooses.

The determination of unrelated business taxable income presents several problems. For IRC 4947(a)(1) nonexempt charitable trusts, the problems arise in the context of the charitable deduction of IRC 642(c). In the usual circumstances a nonexempt charitable trust will pay some or all of its income to a charity; and take a corresponding deduction under IRC 642(c). However, to the extent that the deduction allowable under IRC 642(c) is allocable to what would be unrelated business income were the trust exempt under IRC 501(c)(3), the deduction is disallowed under IRC 681.

Most IRC 4947(a)(2) split interest trust present more complicated problems. Charitable remainder annuity and unitrusts are exempt from income tax under IRC 664(c) unless the trust has any unrelated business taxable income during the year. Reg. 1.664-1(c) makes clear that, if an annuity or unitrust has any income that would be unrelated business taxable income if the trust were exempt under IRC 501(a), no part of the trust's income is exempt for that taxable year. Therefore, where a charitable remainder annuity or unitrust has any unrelated business taxable income, the trust is nonexempt, and is subject to the normal rules of Subchapter J dealing with the income taxation of trusts, including disallowance of the IRC 642(c) charitable deduction allocable to unrelated business taxable income under IRC 681. If not all of the unrelated business income is allocable to charitable contributions, such as where disbursed to pay the private annuity, the $1000 deduction of IRC 512(b)(12) must be allocated between the various uses.

A charitable lead trust is more likely to have deductions disallowed by IRC 681 than an IRC 664 trust. This is because charitable lead trusts always make annual charitable payments, while charitable remainder annuity or unitrusts frequently do not. However, where any of these trusts have unrelated business taxable income, they are taxed on their income in the same manner.

In the usual situation, trusts derive unrelated business income only because of debt financed income under IRC 514. However, it should be noted that under IRC 513(b)(1), a trust computing its unrelated business income under IRC 512 for purposes of IRC 681 must consider any trade or business regularly carried on by the trust or by a partnership of which the trust is a member to be an unrelated trade or business. A trust cannot escape taxation on income from a trade or business on the grounds that the income is related to a charitable purpose of the trust. It is not clear whether the volunteer labor, convenience, or donated goods exceptions in IRC 512(a)(1), (2) and (3) apply to IRC 513(b).

Finally, it should be noted that a taxable trust normally takes a distribution deduction under IRC 661 for payments of income it makes to private beneficiaries who then include this income in their own income pursuant to IRC 662. IRC 663(a)(2) prevents the application of these Code sections to a trust's charitable interests. Amounts paid or set aside for charitable purposes may qualify for a charitable deduction only by meeting the provisions of IRC 642(c).

Two other points deserve brief mention. Although a nonexempt charitable trust is not subject to the rule of presumption of private foundation status under IRC 508(b), and may seek retroactive recognition of public charity status (Rev. Proc. 72-50) even after 15 months have passed, this applies only for periods in which the organization in fact qualifies as a public charity. In one case, a trust became a supporting organization only after a period of time in which it was a private foundation. It was held that the trust was subject to the private foundation provisions up to such time as it qualified as a public charity, and that it had to comply with the termination provisions of IRC 507 to become a public charity. See Rev. Rul. 76-92, 1976-1 C.B. 160. Finally, it should be noted that Rev. Rul. 73-455, 1973-2 C.B. 187, provides an exception to the normal self-dealing rules of IRC 4941 in the situation in which a nonexempt charitable trust is a substantial contributor with respect to a private foundation. So as not to unduly restrict the activities of these charitable entities, for purposes of IRC 4941 only, the trust is treated the same as IRC 501(c)(3) organizations under Reg. 1.507-6(a)(2), and is not considered a substantial contributor with respect to the foundation.

6. Conclusion

IRC 4947 was enacted to preclude the use of certain trusts to avoid being subject to the normal statutory taxation of exempt organizations, particularly the requirements and restrictions upon private foundations enacted as part of the Tax Reform Act of 1969. Applying the rules of IRC 4947 is not difficult once an IRC 4947 trust has been identified. Special attention should be paid to determining the date on which a trust became subject to IRC 4947(a)(1) or 4947(a)(2); determining if the annuity or unitrust form has been complied with; determining the presence of unrelated business taxable income, especially with regard to split interest trusts; and identifying which private foundation provisions are applicable, again especially in connection with split interest trusts.