Rev. Rul. 77-74, 1977-1 C.B. 352

Private foundations; undistributed income. Amounts accumulated by a private foundation created in 1968 to award scholarships to qualified individuals from a specific high school, such accumulations being required by the trust instrument, do not reduce the amount required to be distributed under section 4942 of the Code, even though a probate court of competent jurisdiction denied the trustee's request to be excused from compliance with the provision of the trust requiring the accumulation.

Advice has been requested whether amounts accumulated by a private foundation in the circumstances described below will reduce its distributable amount under section 4942(d) of the Internal Revenue Code of 1954.

An inter vivos trust was created on December 10, 1968, to award scholarships to qualified individuals from a specific high school. The indenture of trust requires that a specific portion of the trust's income be accumulated each year. Pursuant to this provision in the indenture of trust, amounts have been accumulated in each year of the trust's existence and such accumulated amounts have not been disbursed.

Prior to December 31, 1971, the trustee requested a probate court having jurisdiction over the indenture of trust to review the instrument and either to reform or to excuse the trust from complying with the accumulation provision of the instrument. The court refused the requested relief and ruled that the accumulation provisions remain in force.

Section 4942(a) of the Code imposes an excise tax on the undistributed income of a private foundation for any taxable year, which has not been distributed before the first day of the second taxable year following such taxable year.

Section 53.4942(a)-2(e)(1)(i) of the Foundation Excise Tax Regulations and section 101(1)(3)(B) of the Tax Reform Act of 1969 provide that section 4942 of the Code shall not apply to an organization to the extent its income is required to be accumulated pursuant to the mandatory terms (as in effect on May 26, 1969, and at all times thereafter) of an instrument executed before May 27, 1969, with respect to the transfer of income producing property to such organization. the exception to the application of those rules is that section 4942 shall apply to such organization if the organization would have been denied exemption if section 504(a) had not been repealed by the Tax Reform Act of 1969 (Pub. L. 91-172, 1969-3 C.B. 10).

Section 53.4942(a)-2(e)(1)(ii) of the regulations provides that section 4942 of the Code shall not apply to an organization which is prohibited by its governing instrument or other instrument from distributing capital or corpus to the extent the requirements of section 4942 are inconsistent with such prohibition.

Section 53.4942(a)-2(e)(3) of the regulations provides that for taxable years beginning after December 31, 1971, the above two paragraphs shall apply only during the pendency of any judicial proceeding by the private foundation which is necessary to reform or to excuse such foundation from compliance with its governing instrument or any other instrument (in effect May 26, 1969) in order to comply with the provisions of section 4942 of the Code, and in the case of section 53.4942(a)-2(e)(1)(i) for all periods after the termination of such judicial proceeding during which the governing instrument does not permit compliance with such provisions.

Section 504 of the Code provides, with certain exceptions not here pertinent, that an organization described in section 501(c)(3) to which section 503 (relating to denial of exemption to organizations engaged in prohibited transactions) is applicable will be denied exemption under section 501 for the taxable year if amounts accumulated out of income during the taxable year or any prior taxable year and not actually paid out by the end of the taxable year are unreasonable in amount or duration in order to carry out the charitable, educational, or other purpose of function constituting the basis for the organization's exemption under section 501. Section 1.504-1(a) of the Income Tax Regulations provided that the restrictions enumerated in section 504 are in addition to and not in limitation of the restrictions contained in section 501(c)(3).

Rev. Rul. 67-106, 1967-1 C.B. 126, holds that an organization will be denied exemption where it is created for the sole purpose of accumulating income for a mandatory period of 20 years in order to make a gift to a tax exempt organization since the organization was created to accumulate all its income in a manner which violates the provisions of section 504 of the Code. The Revenue Ruling further holds that the mandatory accumulation by an organization of indeterminable amounts of income for 20 years merely to enable the organization to make a gift of its entire funds to an exempt educational institution at the end of that period is not a program which, in the light of existing circumstances, is reasonable.

Rev. Rul. 67-108, 1967-1 C.B. 127, holds that an organization otherwise exempt from Federal income tax under section 501(c)(3) of the Code that is subject to the provisions of sections 503 and 504 will be held not exempt if its charter or any other organizational document contains a provisions for the mandatory accumulation of income for an indefinite period solely to increase principal since the organization was created to accumulate a specified percentage of its income in a manner which violates the provisions of section 504. The Revenue Ruling further holds that the mandatory accumulation of a specified amount of income for an indefinite period of time solely to increase principal is not a reasonable program for accumulation and, therefore, any accumulation of income pursuant to such a provision would be unreasonable within the meaning of section 504.

Accordingly, accumulations made pursuant to the trust instrument in the instant case providing for the mandatory accumulation of a specific portion of income so as to increase corpus would have been a violation of section 504 of the Code and exemption would have been denied. Therefore, the exception from compliance with the provisions of section 4942 is not applicable, notwithstanding the decree of the probate court, and the amounts accumulated under the governing instrument will not reduce the distributable amount under section 4942(d) of the Code.