DEPARTMENT OF THE TREASURY 200222037
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

TAX EXEMPT AND GOVERNMENT ENTITIES DIVISION

Date: [illegible] 5 2002

Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

LEGEND

A =
B =
C =
X =
Y =
Z =

U.I.L. Nos.
4941.04-00
4945.04-00

Dear Sir or Madam:

We have considered your ruling request dated May 2, 2000 for rulings concerning the consequences under sections 4941 and 4945 of the Internal Revenue Code of a private foundation's receipt of assets subject to an indemnification agreement, as described below.

X is a private foundation described in sections 501(c)(3) and 509(a) of the Code. X was founded by A and A's spouse, B. C is a foundation manager of X.

When A died, a testamentary trust, Y, was established primarily for the benefit of B during B's life. C is a trustee of Y.

B also established a revocable trust, Z. C is the sole trustee of Z. Recently, B died. B's will distributed B's assets to Z.

Under the terms of the Y and Z trust instruments and State law, the residue is payable to X after the payment of taxes and distribution of specific gifts. All taxes have been paid and specific gifts distributed.

Under State law, a trustee is personally liable for debts of the trust. However, a trustee has an equitable lien on the trust assets, with interest, as against the beneficiaries even after transfer of the assets to them, for expenses and liabilities sustained in the trust administration

20

(including attorney fees where necessary for administration or defense of the trust). See also Restatement (Second) of Trusts § 249(2).

The trustees would like to distribute the assets of Y and Z to X but are concerned about possible future (currently unknown) liabilities of the trusts. The trustees of Y and Z propose to distribute the remaining assets of Y and Z to X, subject to a proposed Indemnification Agreement between X and the trustees of Y and Z. Without such agreement, the trustees would withhold from X a substantial reserve for unknown liabilities for a number of years until applicable statutes of limitations expired.

Under the Agreement, X will defend and indemnify the trustees from all liabilities (including attorney fees) incurred in their capacity as trustees of Y and Z and as officers of several companies in which Y and Z have an ownership interest that are legally owed by the trusts and properly payable from the residue of the trusts. The Agreement is effective upon its approval by the State probate court and the Internal Revenue Service through a favorable letter ruling. The court has issued an order approving the Agreement, contingent upon a favorable ruling.

X represents that its indemnification under the Agreement of the trustees does not provide a benefit to which they would not otherwise be entitled under the equitable lien imposed by State law. Because of the complexity of the administration of Y and Z, the parties have determined that it is more appropriate to specifically set forth the indemnification provisions in an agreement rather than rely on the more general provisions of State law.

X will not make any payments under the Agreement unless and to the extent that a court of competent jurisdiction determines before a refund is made that the Trustee has an enforceable lien imposed by law for such expense against the Trust property transferred to X. The trustees agree to repay any amounts refunded to them or on their behalf if a court should subsequently determine that they breached their fiduciary duties with regard to the subject matter of any litigation or investigation. X has the right (but not the duty) to direct the defense of any claim for which it must provide indemnification.

X requests the following rulings:

1. The execution and implementation of the Indemnification Agreement will not constitute acts of self-dealing under section 4941 of the Code.

2. Any distribution made by X to the trustees of Y or Z pursuant to the indemnification agreement will not constitute a taxable expenditure under section 4945 of the Code, and will not require X to exercise expenditure responsibility as defined in section 4945(h).

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

Section 4941(d)(1) of the Code defines self-dealing as including any direct or indirect:

(A) sale or exchange of property between a private foundation and a disqualified person, or

(E) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation.

Section 4941(d)(2)(A) of the Code provides that the transfer of real or personal property by a disqualified person to a private foundation shall be treated as a sale or exchange if the property is subject to a mortgage or similar lien which the foundation assumes or if it is subject to a mortgage or similar lien which a disqualified person placed on the property within the 10-year period ending on the date of the transfer.

Section 4945 of the Code imposes a tax on taxable expenditures by a private foundation.

Section 4945(d) of the Code defines a "taxable expenditure" as including any amount paid or incurred by a private foundation:

(4) as a grant to an organization unless the organization is a public charity or an exempt operating foundation, or the private foundation exercises expenditure responsibility with respect to such grant.

(5) for any purpose other than one specified in section 170(c)(2)(B).

Section 4946 of the Code provides that the term "disqualified person" includes, with respect to a private foundation, a substantial contributor to the foundation and a foundation manager (including a director of a foundation).

Section 53.4941(d)-2(a)(2) of the Foundations and Similar Excise Taxes Regulations provides that a "mortgage or similar lien" shall include, but is not limited to, deeds of trust and vendors' liens, but shall not include any other lien if such lien is insignificant in relation to the fair market value of the property transferred.

Section 53.4941(d)-2(f)(1) of the regulations provides that if a private foundation makes a grant or other payment that satisfies the legal obligation of a disqualified person, such grant or payment shall ordinarily constitute an act of self-dealing.

Section 53.4945-6(b) of the regulations provides that reasonable expenses to carry out charitable purposes ordinarily will not be treated as taxable expenditures.

In Underwood v. United States, 461 F.Supp. 1382 (N.D.Tex. 1978), an individual agreed to contribute $100,000 per year to a law school for ten years, conditioned on his being able to deduct all of the contributions. The individual set up a private foundation for this purpose and made his contributions to the foundation (for ultimate distribution to the school) instead of directly to the school. Upon audit, the IRS determined that the individual's contributions to the foundation exceeded the maximum permissible percentages and disallowed part of his claimed

202

deductions. Thereafter, the foundation returned to the individual the amount of the contributions disallowed as a deduction, with the understanding that the individual would contribute the funds directly to the school upon receipt and obtain the benefit of the deduction, which he did. The IRS claimed that the refund to the individual was an act of self-dealing under section 4941(d)(1)(E) of the Code and a taxable expenditure under section 4945. The court held otherwise, reasoning that because the individual's commitment to the school was conditioned on the deductibility of the contributions, the foundation's refund was of amounts which the foundation should not have received and was not entitled to keep, and that the condition placed on the contribution was not void as against public policy.

If the Agreement is permissible, then any refund made under it will be a legitimate administrative expense of X rather than a transfer to or use by C (a disqualified person as foundation manager) of X's assets.

Since the Agreement merely restates and clarifies the terms of the trustee's equitable lien, and since any refund will be made only upon a court determination before the refund is made that the trustee has an enforceable lien (regardless of the Agreement) for these expenses against the trust property transferred to X, the Agreement and any refund under it will not involve a "transfer to, or use by or for the benefit of, a disqualified person of the income or assets" of X. The benefit to B or C is incidental to their legal right to indemnification under State law. The Agreement benefits X by allowing it to use funds for its charitable purposes that would otherwise would be withheld by the trustees as a reserve against unknown liabilities.

Moreover, X's duty to refund and indemnify under the Agreement does not constitute a "mortgage or similar lien" on the property transferred under the Agreement, within the meaning of section 4941(d)(2)(A) of the Code. Although the Agreement constitutes a "lien" on the property in the ordinary sense of the term, the term "mortgage or similar lien" generally involves a volitional act by the disqualified person in placing the lien on the property, whereas the equitable lien arises by operation of law.

Similarly, any refunds under the Agreement will not constitute expenditures for non-charitable purposes under section 4945(d)(5) of the Code. They will instead be considered necessary administrative expenses to carry out charitable purposes within the meaning of section 170(c)(2)(B) and section 53.4945-6(b) of the regulations. Such refunds will not constitute "grants," and thus X need not exercise expenditure responsibility with respect to them.

Accordingly, we rule as follows:

1. The execution and implementation of the Indemnification Agreement will not constitute acts of self-dealing under section 4941 of the Code.

2. Any distribution made by X to the trustees of Y or Z pursuant to the indemnification agreement will not constitute a taxable expenditure under section 4945 of the Code, and will not require X to exercise expenditure responsibility as defined in section 4945(h).

203

Except as we have ruled above, we express no opinion as to the tax consequences of X's transactions under the cited provisions of the Code or under any other provisions of the Code.

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

Because this letter could help resolve any future questions about your tax status, you should keep a copy of this ruling in your permanent records.

If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely yours,

(signed) Terrell M. Berkovsky

Terrell M. Berkovsky
Manager, Exempt Organizations
Technical Group 2