Leimberg Information Services, Inc.

Steve Leimberg's Charitable Planning
Email Newsletter Archive Message #289

Date:02-Dec-19

Subject: Richard L. Fox and Jonathan G. Blattmachr on PLR 201907004 - IRS Rules that Transfer to CLAT of Non-Voting Membership Interest in LLC Owning Promissory Notes Issued by Disqualified Persons Does Not Result in Self-Dealing under IRC Section 4941

"In recently issued Ltr. Rul. 201907004, the taxpayer wanted to use promissory notes he held from various family trusts to fund a newly formed charitable lead annuity trust ("CLAT"). However, a direct transfer of the promissory notes to the CLAT would have resulted in an impermissible act of self-dealing under IRC § 4941. This is the case because a CLAT, which is subject to the self-dealing rules of IRC § 4941, cannot hold a note under which a 'disqualified person' is the obligor and, here, the family trusts that issued the promissory notes to the taxpayer were classified as 'disqualified persons.' Therefore, if the taxpayer transferred the notes to the CLAT, disqualified persons would have been obligated to make payments to the CLAT, which is not permissible under the self-dealing rules of IRC § 4941.

To avoid an act of self-dealing, but still have the promissory notes serve as the funding source of the CLAT, a structure was created whereby the promissory notes were transferred to a newly formed limited liability company in which the taxpayer held only a non-voting membership interest. The taxpayer then transferred to the CLAT the non-voting membership interest in the LLC, whose only asset (other than some cash initially transferred) was the promissory notes issued by the family trusts. The IRS ruled that the transfer of the non-voting membership interest in the LLC to the CLAT did not result in an act of self-dealing, notwithstanding that the LLC held the promissory notes issued by a 'disqualified person' which if transferred directly to the CLAT would have triggered the self-dealing rules of IRC § 4941.

The key to this favorable ruling was the fact that the CLAT was not considered to control the LLC; otherwise, an indirect act of self-dealing would have occurred upon the transfer of the LLC to the CLAT."

Richard Fox and **Jonathan Blattmachr** provide members with commentary on PLR 201907004.

Richard L. Fox is an attorney and shareholder at **Buchanan Ingersoll & Rooney** (www.bipc.com). Richard is the author of the treatise, Charitable Giving: Taxation, Planning and Strategies, a Thomson Reuters/Warren, Gorham and Lamont publication, writes a national bulletin on charitable giving, and writes and speaks frequently on issues pertaining to nonprofit organizations, estate planning and philanthropy. Richard is also a Fellow of the American College of Trust and Estate Counsel (ACTEC).

Jonathan G. Blattmachr is director of estate planning for **Peak Trust Company**, formerly Alaska Trust Company, and a director of **Pioneer Wealth Partners LLC**, a boutique wealth advisory firm in Manhattan. He is a retired member of Milbank, Tweed, Hadley & McCloy and of the New York and California bars. He is the author and co-author of eight books and over 500 articles, and has been chair of several committees of the New York and American Bar Associations and the American College of Trust and Estate Counsel. He is co-developer of Wealth Transfer Planning, a computerized system for lawyers that automatically generates estate planning documents such as wills and trusts, and provides specific client advice using a form of artificial intelligence. Jonathan served two years of active duty in the US Army, rising to the rank of Captain and was awarded the Army Commendation Medal. He is an instrument rated land and seaplane pilot and a licensed hunting and fishing guide in the Town of Southampton, New York.

Here is their commentary:

EXECUTIVE SUMMARY:

In recently issued Ltr. Rul. 201907004, the taxpayer wanted to use promissory notes he held from various family trusts to fund a newly formed charitable lead annuity trust ("CLAT"). However, a direct transfer of the promissory notes to the CLAT would have resulted in an impermissible act of self-dealing under IRC § 4941. This is the case because a CLAT, which is subject to the self-dealing rules of IRC § 4941, cannot hold a note under which a "disqualified person" is the obligor and, here, the family trusts that issued the promissory notes to the taxpayer were classified as "disqualified persons." Therefore, if the taxpayer transferred the notes to the CLAT, disqualified persons would have been obligated to make payments to the CLAT, which is not permissible under the self-dealing rules of IRC § 4941.

To avoid an act of self-dealing, but still have the promissory notes serve as the funding source of the CLAT, a structure was created whereby the promissory notes were transferred to a newly formed limited liability company in which the taxpayer held only a non-voting membership interest. The taxpayer then transferred to the CLAT the non-voting membership interest in the LLC, whose only asset (other than some cash initially transferred) was the promissory notes issued by the family trusts. The IRS ruled that the transfer of the non-voting membership interest in the LLC to the CLAT did not result in an act of self-dealing, notwithstanding that the LLC held the promissory notes issued by a "disqualified person" which if transferred directly to the CLAT would have triggered the self-dealing rules of IRC § 4941.

The key to this favorable ruling was the fact that the CLAT was not considered to control the LLC; otherwise, an indirect act of self-dealing would have occurred upon the transfer of the LLC to the CLAT.

FACTS:

Background on Self-Dealing Rules Generally

The self-dealing provisions under IRC § 4941, which by virtue of IRC § 4947(a)(2) apply to charitable lead trusts (as well as charitable remainder trusts), impose substantial excise tax where a private foundation and a disqualified person with respect to the foundation engage in a transaction that constitutes an act of self-dealing. The scope of transactions covered by the self-dealing rules is extremely broad, and it is immaterial whether a transaction results in a benefit or a detriment to the private foundation in determining whether an act of self-dealing occurs.

But for certain very narrow exceptions, virtually every financial transaction between a private foundation and a disqualified person results in an act of self-dealing. IRC § 4941(d)(1)(B) specifically includes "any lending of money or other extension of credit between a private foundation and a disqualified person" among the enumerated acts of self-dealing under IRC § 4941(d). See also Reg. § 53.4941(d)-2(c)(1). Even where a promissory note issued by a disqualified person may not initially be subject to the self-dealing rules because it is payable to a third-party and not to a private foundation, an act of self-dealing will occur where the note is subsequently assigned to a private foundation, as a result of which a disqualified person then becomes indebted to the private foundation. See Reg. § 53.4941(d)-2(c)(1) ("an act of self-dealing occurs where a note, the obligor of which is a disqualified person, is transferred by a third party to a private foundation which becomes the creditor under the note").

The self-dealing excise taxes are imposed under a two-tier regime. It provides that substantial and sometimes draconian excise taxes may be imposed on the disqualified person engaging in the act of self-dealing, and in some cases on a foundation manager. These taxes are imposed on the disqualified person who participates in the act of self-dealing, not on the private foundation. IRC § 4941(a) imposes an initial tax of 10% of the amount involved with respect to a self-dealing transaction for each year (or part thereof) in the "taxable period." Therefore, the 10% tax could be assessed for multiple years, and the total could be multiples of 10%.

A second-tier tax of 200% of the amount involved is imposed by IRC § 4941(b) upon the disqualified person if the act of self-dealing is not "corrected" during the taxable period. For this purpose, "corrected" basically means, with respect to any act of self-dealing, undoing the transaction to the extent possible, but in any case placing the private foundation in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards. See IRC § 4941(e)(3).

Indirect Self-Dealing Involving Entity Controlled by Private Foundation

The self-dealing tax regime is not limited to direct transactions between a private foundation and a disqualified person, but extends to indirect acts of self-dealing, including those carried out through some form of a "middleman" or third-party. See IRC § 4941(d)(1) (referencing an act of self-dealing to include those that are "director or indirect.") While direct acts of self-dealing are generally apparent on their face, indirect acts of self-dealing may result from transactions that are not so obviously an act of self-dealing, thereby presenting a trap for an unwary disqualified person or foundation manager who may unwittingly become subject to the two-tier excise tax regime of IRC § 4941 by engaging in an act of self-dealing, albeit one that is indirect but just as prohibitive under the self-dealing rules as a direct act of self-dealing.

Where a private foundation is considered to be in control of another organization, a transaction between the controlled organization and a disqualified person with respect to the foundation is subject to the indirect self-dealing rules of IRC § 4941. This is the case because the organization controlled by the foundation is in essence considered to be acting as an intermediary between the foundation and the disqualified person. The "controlled" organization need not be a private foundation. For example, it may be any type of exempt or nonexempt organization including a school, hospital, operating foundation, social welfare organization, or for-profit company. Reg. §53.4941(d)-1(b)(5).

Reg. § 53.4941(d)-1(b)(8), Example (1), provides the following example of an indirect act of self-dealing involving a loan by a corporation controlled by a private foundation to a disqualified person with respect to the foundation:

> Private foundation P owns the controlling interest of the voting stock of corporation X, and as a result of such interest, elects a majority of the board of directors of X. A disqualified person with respect to P, the private foundation, requested and received a loan in the amount of $4 million from X. The making of the loan by X, a corporation controlled by a private

foundation, to Y, a disqualified person with respect to the foundation, constitutes an indirect act of self-dealing between P and Y.

In this example, although there was no direct transaction between the private foundation and a disqualified person, the lending of funds to the disqualified person results in an indirect act of self-dealing because the loan was made by a corporation controlled by the private foundation, and a loan by the private foundation itself in this situation would have be an act of self-dealing.

Under Reg. § 53.4941(d)-1(b)(5), an organization is considered to be controlled by a private foundation in either of the following two tests of control:

(1) ***First Test of Control:*** If the foundation or one or more of its foundation managers (**acting only in such capacity**) may, only by aggregating their votes or positions of authority, require the organization to engage in a transaction which if engaged in with the private foundation would be self-dealing. For these purposes, an organization will be considered to be controlled by a private foundation if the private foundation has the right to exercise veto power over the actions of such organization relevant to any potential acts of self-dealing.

(2) ***Second Test of Control:*** In the case of a transaction between the organization and a disqualified person, if such disqualified person, together with one or more persons who are disqualified persons by reason of such a person's relationship (within the meaning of Sections 4946(a)(1)(C) through (G)) to such disqualified person, may, **only by aggregating their votes or positions of authority with that of the private foundation**, require the organization to engage in such a transaction.

In determining whether control is present, Reg. § 53.4941(d)-1(b)(5) provides that an organization is considered to be controlled by a private foundation or by a private foundation and disqualified persons “if such persons are able, in fact, to control the organization (even if their aggregate voting power is less than 50 percent of the total voting power of the organization's governing body) or if one or more of such persons has the right to exercise veto power over the actions of such organization relevant to any potential acts of self-dealing.”

Under the “first test of control,” an organization is considered to be controlled by either the private foundation or foundation managers of the foundation in one of following four separate ways:

(1) The private foundation alone can control the organization;

(2) The private foundation, by aggregating its votes or positions of authority with those of one or more foundation managers (acting only in such capacity), can control the organization;

(3) A foundation manager (acting only in such capacity) alone can control the organization; or

(4) The foundation managers (acting only in such capacity), by aggregating their votes or positions of authority with one another, can control the foundation. See Ltr. Rul. 201510050 (not precedent).

Under the second test of control, a private foundation is only considered to control an organization if the disqualified person involved in the transaction and disqualified persons related to such person (within the meaning of IRC § 4946(a)(1)(C) through (G)) are in a position of control only by aggregating their votes or positions of authority with that of the foundation. Therefore, where such disqualified persons own more than 50 percent of the voting power of an organization, the private foundation will not be considered to control the organization under the second test of control because the disqualified persons alone can control the organization without aggregating their votes with the foundation.

In Rev. Rul. 76-158, 1976-1 CB 354, for example, a private foundation, owning 35% of the voting stock of a corporation and having a foundation manager ***personally owning*** the remaining 65% of the voting stock, but not holding a position of authority in the corporation by virtue of being the foundation manager of the private foundation, was determined not to control the corporation for purposes of the self-dealing provisions of IRC § 4941. Because the foundation manager held a majority of the voting stock personally and was not in a controlling position of the corporation by virtue of his foundation manager status, the private foundation was not considered to be in control of the corporation under the first test of control of the regulations. And, because the foundation manager, a disqualified person, held sufficient stock to control the corporation on his own (i.e., without aggregating his votes with those of the private foundation), the private foundation does not control the corporation under the second test of control of the regulations. In further support of its conclusion, the ruling noted that the private foundation did not have the right to exercise veto power over the actions of the corporation, and the private foundation did not have authority over the actions of the corporation other than that represented by the 35 percent of the voting stock that it owns.

Ltr. Rul. 201907004: Wrapping Promissory Notes Issued by Disqualified Person in an LLC Not Considered to be Controlled by CLAT Avoids Self-Dealing

In Ltr. Rul. 201907004 (not precedent), an individual ("Father") transferred certain business interests to noncharitable trusts established for the benefit of his descendants ("Beneficiary Trusts") in exchange for promissory notes that pay interest only for a term of 30 years, with the total principal amount due at the end of the term. The beneficiaries of each of the Beneficiary Trusts are the Father's descendants. The Father then assigned the promissory notes to a limited liability company ("LLC"). The members of the LLC are the Father, who holds all of the nonvoting interests in LLC, and another limited liability company ("LLC 2"), which holds all of the voting interests in LLC. The members of LLC 2 are the Father's descendants and each holds an interest in LLC 2 individually.

After the assignment of the promissory notes by the Father, the LLC would hold all of the promissory notes and receive payments of interest and principal on the promissory notes from the Beneficiary Trusts. Aside from the cash initially contributed by LLC 2 for the voting interests in LLC, which were used to fund LLC expenses, the LLC's sole assets and source of income will be the promissory notes. Presumably, therefore, the non-voting membership interest in the LLC represented virtually the entire ownership interest in the LLC, although such interest had no voting rights.

The power to manage the affairs of LLC is vested in the manager, who is selected and may be removed by a vote of the members holding at least a majority of the voting interests in LLC (currently LLC 2, which holds 100 percent of such voting interests). The Father's daughter ("Daughter") is sole the trustee of the family trusts and is the initial manager of LLC. The Daughter holds interests in LLC only in an individual capacity indirectly through her interests in LLC 2, not in her capacity as trustee of the CLAT. The members holding nonvoting interests (currently the Father, who holds 100 percent of such nonvoting interests) possess no management rights or rights to vote on who will be the manager of LLC. LLC may be dissolved only with written approval of all members, whether holding voting or nonvoting interests.

The Father created a charitable lead annuity trust ("CLAT"), the charitable interest in which is a right to a guaranteed annuity, distributed annually to a public charity. The trustee of the CLAT was the Daughter. The remainder interests in the CLAT benefit the Father's descendants. The Father proposed to fund the CLAT by transferring his nonvoting interests in LLC to Trust. The annuity amount would be paid from the CLAT's income, including distributions from LLC, and, to the extent income is insufficient, from the CLAT's principal. It was represented to the IRS that the CLAT is subject to IRC § 4941 under IRC § 4947(a)(2).

In its analysis, the IRS began by stating that the CLAT, as a split-interest trust described in IRC § 4947(a)(2), is subject to the requirements of IRC § 4941 as if it were a private foundation. The IRS identified the Father as a disqualified person under IRC § 4946(a)(1)(A) with respect to the CLAT as a "substantial contributor" because the Father created and funded the

CLAT. The Daughter, as the trustee of the CLAT, was identified as disqualified person under IRC § 4946(a)(1)(B) with respect to the CLAT as a “foundation manager.” The IRS then identified the family trusts as disqualified persons under IRC § 4946(a)(1)(G) with respect to CLAT because they are trusts in which the Father’s descendants, who are disqualified persons as family members of the Father under IRC § 4946(a)(1)(D), hold more than a 35-percent beneficial interest.

The IRS specifically acknowledged that an “act of self-dealing would occur if [Father] transferred the promissory notes to [the CLAT), which would become the creditor under the notes. See Reg. § 53.4941(d)-2(c)(1).” This would constitute a direct act of self-dealing because the debtor, the family trusts, are disqualified persons and the creditor would be the CLAT, with payments to be made under the notes by disqualified persons directly to the CLAT. Because the promissory notes themselves were not assigned by the Father to the CLAT, a direct act of self-dealing was avoided.

The IRS then noted that even though the promissory notes would not be transferred to the CLAT (thereby avoiding the CLAT from becoming a creditor of a disqualified person), an indirect act of self-dealing would still occur if the CLAT was considered to “control” the LLC within the meaning of Reg. § 53.4941(d)-1(b)(5), in which case the CLAT “would be considered to be the creditor, indirectly, under the note by reason of its ownership interest in LLC.” Turning to the issue of whether the CLAT controlled the LLC, the IRS pointed out a number of factors indicating a lack of any such control on the part of the CLAT or one or more of its foundation managers (acting only in such capacity).

The IRS stated that as “holder of the nonvoting interests, [CLAT] will have no management rights or right to vote on the manager of LLC, but that that LLC 2 will own all of the voting interests, giving LLC 2 the right to select and remove the manager LLC.” The IRS further noted that “as a holder of nonvoting interests, [CLAT] will have a right to receive distributions only if LLC dissolves or chooses to make current distributions, but the timing and amount of such distributions will be uncertain and could not be compelled by [CLAT].” Instead, the IRS stated that “only LLC 2, as the holder of the voting interests which may elect or remove the manager of LLC, and such manager will have the sole power to manage the affairs of LLC and determine the timing and amount of distributions.”

Thus, the IRS stated that for purposes of § 53.4941(d)-1(b)(5), the CLAT and the CLAT's trustee, a foundation manager acting only in such capacity, "will not have sufficient votes or positions of authority to cause LLC to engage in a transaction." Additionally, the IRS noted that the CLAT will not have the power to compel dissolution of the LLC since the LLC may only be dissolved with written approval of all members, including LLC 2. With respect to the nonvoting interests in the LLC to be transferred to the CLAT, the IRS stated that the "power associated with the nonvoting interests of LLC as a necessary party to vote on the liquidation of LLC is not considered equivalent to a 'veto power' within the meaning of Treas. Reg. § 53.4941(d)-1(b)(5) because the power cannot be exercised over an action relevant to any potential act of self-dealing."

Accordingly, the IRS ruled that the CLAT's receipt of nonvoting interests in the LLC from the Father will not constitute a loan or extension of credit between a "private foundation" and a "disqualified person" within the meaning of IRC § 4941(d)(1)(B) and Treas. Reg. §53.4941(d)-2(c)(1) because the CLAT will not acquire an interest in the promissory note but, instead, the CLAT will acquire nonvoting interests in LLC, with respect to which it will not have any management rights or control over distributions. Therefore, the IRS ruled that the Father's proposed transfer of nonvoting interests in LLC to the CLAT would not constitute an act of self-dealing described in IRC § 4941.

COMMENT:

This ruling is a reminder of the need to be mindful of the broad application of the private foundation self-dealing rules and their applicability to charitable lead trusts (and charitable remainder trusts), including in the context of disqualified persons engaging in a transaction with an entity that may be considered to be controlled by the foundation under the applicable regulations. Here, but for the use of an intermediary LLC that was not controlled by the CLAT to hold the promissory notes issued by disqualified persons, an act of self-dealing would have occurred upon the direct transfer of the promissory notes to the CLAT. By placing the notes in an entity that the CLAT was not considered to control, the notes could be used as the funding source of the CLAT, as the taxpayer had originally desired, without causing an act of self-dealing. Using an LLC to avoid what would otherwise result in an act of self-dealing has been considered and approved in other private letter rulings. See, e.g., Ltr. Ruls. 201446024 and 20150050 (not precedent).

In determining whether the LLC in Ltr. Rul. 201907004 was controlled by the CLAT, the IRS only addressed the first test of control under Reg. § 53.4941(d)-1(b)(5), because the second test of control would only apply if the disqualified persons were in a position of control only by virtue of aggregating their votes or positions of authority with that of the CLAT. Because the CLAT had no votes or position of authority with respect to the LLC, the second test of control under the regulation was not applicable.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Richard L. Fox

Jonathan G. Blattmachr

CITE AS:

LISI Charitable Planning Newsletter #289 (December 2, 2019) at http://www.leimbergservices.com

CITES:

Ltr. Rul. 201907004; IRC § 4941; Reg. § 53.4941(d)-1(b)(5); Reg. § 53.4941(d)-2(c)(1); Ltr. Rul. 201510050; Rev. Rul. 76-158, 1976-1 CB 354; IRC § 4947(a)(2).