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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

200151053

UIL Numbers: 507.01-01
4940.00-00
4941.00-00
4946.02-00

Date: SEP 24 2001

Contact Person:

Identification Number:

Telephone Number:

T:EO:B3

Employer Identification Number:

Legends:

Foundation I =
Foundation II =
A =
B =
X =

Dear Sir or Madam:

This is in reference to your ruling request dated April 2, 2001 concerning the federal income and excise tax consequences of the proposed transfer of X% of the net assets of Foundation I to Foundation II.

Both Foundation I and II have received determination letters stating they are tax-exempt under section 501(c)(3) of the Internal Revenue Code ("Code") as a section 509(a) private foundation. Six individuals manage both Foundation I and II. All six individuals are members of either A's or B's family. The managers have developed a plan whereby the assets of both Foundations would be equalized and the control of Foundation I and Foundation II would later be transferred to members of A's family and B's family respectively. The proposed plan would place members of the family in equal standing with respect to both Foundations' net assets. The same persons control both Foundations because the members, officers and directors of each foundation are the same individuals. The distribution would enable the family members to pursue separate charitable goals.

You propose to distribute approximately X% of Foundation I's net assets to Foundation II to equalize the assets held by each foundation. You represent that subsequent to the transfer of X% of Foundation I's net assets to Foundation II, Foundation I and Foundation II will continue to operate and maintain their tax-exempt status as private foundations under section 509(a) of the Code.

231

You have requested the following rulings:

1. The transfer of X% of Foundation I's net assets to Foundation II qualifies as a section 507(b)(2) of the Code transfer and will not terminate Foundation I's status as a private foundation nor subject it to a termination tax under section 507(a).

2. The transfer to Foundation II will not generate gross investment income or capital gains or losses, as defined in section 4940(c) of the Code; therefore, Foundation I will not be subject to tax under section 4940(a).

3. The transfer will not be an act of self-dealing as defined in section 4941(d) of the Code by Foundation I, Foundation II, or any foundation manager as defined in section 4946(b); therefore, no tax will be imposed under section 4941(a).

4. Foundation I and Foundation II will not be subject to tax under section 4943 of the Code because the transfer will not generate excess business holdings nor will Foundation II receive excess business holdings in the transfer.

5. The transfer will not constitute an investment, which may jeopardize Foundation I's exempt purposes; therefore, Foundation I will not be subject to tax under section 4944 of the Code.

6. The transfer will not be a taxable expenditure by Foundation I provided Foundation I exercises the capital endowment grant expenditure responsibility required by section 4945(h) of the Code and section 53.4945-5(c)(2) of the Foundation and Similar Excise Taxes Regulations ("foundation regulations"); therefore, Foundation I will not be subject to tax under section 4945.

7. Foundation II will succeed to X% of the aggregate tax benefit of Foundation I as determined under section 1.507-3(a)(2) of the Income Tax Regulations ("regulations").

8. Foundation II will be treated as if it were Foundation I for purposes of sections 507-509 of the Code and Chapter 42 because both foundations are effectively controlled, within the meaning of section 1.482-1(a)(3) of the regulations, directly or indirectly, by the same persons and because Foundation I will have transferred X% of its net assets to Foundation II. Foundation II shall be treated as if it were Foundation I in the proportion which the fair market value of the assets (less encumbrances) transferred to Foundation II bears to the fair market value of the assets (less encumbrances) of Foundation I immediately before the transfer.

9. Foundation II may reduce its distributable amount as defined in section 4942(d) of the Code by Foundation I's excess distribution carryovers, if any, permitted by section 4942(i) to the extent Foundation II is treated as Foundation I under section 1.507-3(a)(9) of the regulations.

232

10. Any person who is a substantial contributor as defined in section 507(d)(2) of the Code, with respect to Foundation I shall also be considered a substantial contributor with respect to Foundation II pursuant to section 1.507-3(a)(3) of the regulations.

11. The transitional rules and savings provisions of section 1.507-3(a)(8)(i)-(ii) of the regulations will apply to Foundation II.

12. The merger and transfer of X% of Foundation I's net assets will not adversely affect the section 501(c)(3) of the Code tax-exempt status of Foundation I or Foundation II.

13. Pursuant to section 53.4945-6(b)(2) of the foundation regulations, the legal, accounting and other expenses, if reasonable in amount, incurred by Foundation I and Foundation II in connection with the merger transaction and submission of this letter ruling request will not constitute taxable expenditures under section 4945 of the Code.

Section 507(a) of the Code states that, except as provided in section 507(b), an exempt organization which is a private foundation can terminate its private foundation status only if it notifies the Service of its intent to terminate or if it commits acts or failures to act giving rise to tax under Chapter 42 and if it pays the termination tax imposed by section 507(c) or has the tax abated.

Section 507(b)(2) of the Code provides that in the case of a transfer of assets of any private foundation to another private foundation pursuant to any liquidation, merger, redemption, recapitalization, or the adjustment, organization or reorganization, the transferee foundation shall not be treated as a newly created organization.

Section 507(c) of the Code imposes an excise tax on each terminating private foundation equal to the lower of the aggregate tax benefit resulting from such termination or the value of its net assets.

Section 507(e) of the Code provides that, for purposes of section 507(c), the value of the net assets shall be determined at whichever time such value is higher: (1) the first day on which action is taken which culminates in its ceasing to be a private foundation or (2) the date on which it ceases to be a private foundation.

Chapter 42 imposes excise taxes on private foundations for net investment income under section 4940(a) of the Code, acts of self-dealing under section 4941, undistributed income under 4942(a), excess business holdings under section 4943(a), jeopardy investments under section 4944(a) and taxable expenditures under section 4945(a).

Section 4940 of the Code provides for the imposition of a tax on the net investment income of private foundations.

Section 4941 of the Code provides for the imposition of tax on each act of self-dealing between a disqualified person and a private foundation.

Section 4941(d)(1)(E) of the Code states that the term "self dealing" means any direct or indirect transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation.

Section 4944(a) of the Code imposes a tax on a private foundation if it invests any amount in a manner as to jeopardize the carrying out of any of its exempt purposes.

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

Section 4945(d)(4) of the Code provides that the term "taxable expenditure" means any amount paid or incurred by a private foundation as a grant to an organization unless such organization is described in paragraph (1), (2), or (3) of section 509(a) or is an exempt operating foundation, or the private foundation exercises expenditure responsibility with respect to such grant.

Section 4945(d)(5) of the Code provides that the term "taxable expenditure" does not include amounts paid or incurred by a private foundation as a grant to another organization for purposes specified in section 170(c)(2)(B).

Section 4945(h) of the Code provides that the expenditure responsibility referred to in subsection (d)(4) means that the private foundation is responsible to exert all reasonable efforts and to establish adequate procedures to see that the grant is spent solely for the purpose for which made, to obtain full and complete reports from the grantee on how the funds are spent, and to make full and detailed reports with respect to such expenditures to the Secretary.

Section 4946(a)(1) of the Code provides, in part, that the term "disqualified person" shall not include any organization, which is described in section 501(c)(3) (other than an organization described in section 509(a)(4)).

Section 4946(a)(1)(B) of the Code defines a disqualified person to include with respect to a private foundation a foundation manager.

Section 4946(b)(1) of the Code states that the term foundation manager includes a trustee of a foundation having the authority or responsibility over the activities of the foundation.

Section 1.507-1(b)(6) of the regulations provides that a transfer of all or part of a private foundation's assets to one or more private foundations pursuant to a transfer described in section 507(b)(2) of the Code and section 1.507-3(c), such transferor foundation will not have terminated its private foundation status under section 507(a)(1).

Section 1.507-1(b)(7) of the regulations provides that neither a transfer of all the assets of a private foundation nor a significant disposition of assets by a private foundation shall be deemed to result in a termination of the transferor private foundation under section 507(a) of the Code unless the transferor private foundation elects to terminate pursuant to section 507(a)(1) or section 507(a)(2) is applicable.

Section 1.507-3(c)(1) of the regulations provides that for purposes of section 507(b)(2) of the Code, the terms "other adjustment, organization or reorganization" shall include any partial liquidation or any other significant disposition of assets to one or more private foundations, other than transfers for full and adequate consideration or distributions out of current income.

Section 1.507-3(c)(2) of the regulations provides that the term "significant disposition of assets to one or more private foundations" shall include any disposition for a taxable year where the aggregate of the dispositions to one or more private foundations for the taxable year, is 25 percent or more of the fair market value of the net assets of the foundation at the beginning of the taxable year.

Section 1.507-3(a)(1) of the regulations provides that in the case of a significant disposition of assets to one or more private foundations within the meaning of paragraph (c) of this section, the transferee organization shall not be treated as a newly created organization. A transferee organization to which this paragraph applies shall be treated as possessing those attributes and characteristics of the transferor organization.

Section 1.507-3(a)(2)(i) of the regulations provides that a transferee organization to which section 507(b)(2) of the Code applies shall succeed to the aggregate tax benefit of the transferor organization in an amount equal to the amount of the aggregate tax benefit multiplied by a fraction of the numerator of which is the fair market value of the assets (less encumbrances) transferred to such transferee and the denominator of which is the fair market of the assets of the transferor (less encumbrances) immediately before the transfer. Fair market value shall be determined as of the time of the transfer.

Section 1.507-3(a)(5) of the regulations provides that except as provided in subparagraph (9) of section 1.507-3(a), a private foundation is required to meet the distribution requirements of section 4942 of the Code for any taxable year in which it makes a section 507(b)(2) transfer of all or part of its net assets to another private foundation.

Section 1.507-3(a)(8)(ii) of the regulations provides that the provisions enumerated in subparagraphs (a) through (g) of this subdivision shall apply to the transferee private foundation with respect to the assets transferred to the same extent and in the same manner that they would have applied to the transferor private foundation had the transfer described in section 507(b)(2) not been effected.

Section 1.507-3(a)(9)(i) of the regulations provides that if a private foundation transfers all or part of its net assets to one or more private foundations which are effectively controlled (within the meaning of section 1.482-1(a)(3)), directly or indirectly by the same persons which

235

effectively controlled the transferor private foundation, for purposes of chapter 42 and sections 507-509 of the Code, such a transferee private foundation shall be treated as if it were the transferor. Where only part of the transferor foundation's net assets are transferred, the transferee foundation shall be treated as if it were the transferor foundation in the proportion which the fair market value of the assets (less encumbrances) transferred to the transferee foundation bears to the fair market value of the assets (less encumbrances) of the transferor foundation immediately before the transfer.

Section 1.507-3(d) of the regulations provides that unless a private foundation gives notice pursuant to section 507(a)(1) of the Code, a transfer of assets described in section 507(b)(2) will not constitute a termination of the transferor's private foundation status under section 507(a)(1).

Section 1.507-4(b) of the regulations provides that private foundations that make transfers described in section 507(b)(1)(A) or (2) of the Code are not subject to the termination tax imposed under section 507(c) with respect to such transfers.

Section 53.4945-5(c)(2) of the foundation regulations provides that if a private foundation makes a grant described in section 4945(d)(4) to a private foundation which is exempt from taxation under section 501(a) for endowment, for the purchase of capital equipment, or for other capital purposes, the grantor foundation shall require reports from the grantee on the use of the principal and the income (if any) from the grant funds. The grantee shall make such reports annually for its taxable year in which the grant was made and the immediately succeeding 2 taxable years. Only if it is reasonably apparent to the grantor that, before the end of such second succeeding taxable year, neither the principal, the income from the grant funds, nor the equipment purchased with the grant funds has been used for any purpose, which would result in liability for tax under section 4945(d), the grantor may then allow such reports to be discontinued.

Section 53.4946-1(a)(8) of the foundation regulations provides that for purposes of section 4941 of the Code only, the term "disqualified person" does not include any organization described in section 501(c)(3) (other than an organization described in section 509(a)(4)).

Rev. Rul. 78-387, 1978-2 C.B. 270, holds that when a transferee foundation is treated as the transferor under section 1.507-3(a)(9) of the regulations, the transferee is entitled to reduce its distributable amount under section 4942 of the Code by the amount of the transferor's excess qualifying distribution carryover.

A transfer of X% of Foundation I's net assets to Foundation II does not terminate Foundation I's private foundation status and thus does not subject it to the termination tax under section 507(c) of the Code. Transfers qualifying as section 507(b)(2) transfers do not terminate private foundation status under section 507(a)(1). Additionally, transferee foundations are not considered newly created organizations under section 507(b)(2).

Subsequent to a section 507(b)(2) of the Code transfer, an organization's status as a private foundation is not terminated unless the private foundation voluntarily gives notice to that effect under section 507(a)(1) or 507(b)(1). Section 507(b)(2) transfers include those in which a

private foundation transfers all or part of its assets to another private foundation "pursuant to any liquidation, merger, redemption, recapitalization, or other adjustment." Section 1.507-3(c)(1) of the regulations provides that section 507(b)(2) transfers include any significant dispositions of assets, defined as 25% or more of the fair market value of a private foundation's net assets.

Foundation I and Foundation II are private foundations within the definition of section 509(a) of the Code. The transaction proposed is an adjustment by means of a capital grant to equalize the assets held by each foundation. Foundation I will transfer X% of its net assets to Foundation II in a section 507(b)(2) transfer. Foundation I's private foundation status does not terminate. Additionally, Foundation II is not considered a newly created organization.

The transfer does not result in the imposition of tax on investment income under section 4940 of the Code. Section 4940 imposes an excise tax on investment income received by private foundations. Investment income includes capital gains from the sale or other disposition of property. The transfer of assets by Foundation I is not considered "a sale or other disposition of property" and so does not generate capital gain which would be subject to the section 4940 excise tax.

The transfer also does not result in the imposition of tax as an act of self-dealing under section 4941 of the Code. The excise tax on self-dealing is imposed where a private foundation and a disqualified person engage in prohibited transactions such as the sale or exchange of property. An organization described in section 501(c)(3) is not a disqualified person for purposes of section 4941. The transfer is not an act of self-dealing because Foundation II has received a determination letter stating that it is a tax-exempt organization under section 501(c)(3).

Also, the transfer does not subject the foundations to the tax on excess business holdings imposed by section 4943 of the Code. Private foundations are taxed if they hold an excessive amount of a business enterprise in corporate or partnership form. Foundation I has represented that it does not currently hold excess business holdings and therefore will not be transferring such to Foundation II.

The transfer does not result in the imposition of tax for a jeopardy investment under section 4944 of the Code. Section 4944 imposes a tax on investments by private foundations which jeopardize their charitable purposes. The transfer pursuant to section 507(b)(2) is not considered an investment for purposes of section 4944.

The transfer does not result in the imposition of tax for a taxable expenditure under section 4945 of the Code because Foundation I will exercise the capital endowment grant expenditure responsibility required by section 4945(h) of the Code and section 53.4945-5(c)(2) of the regulations.

Regarding taxes imposed on private foundations in chapter 42 of the Code, a section 507(b)(2) transfer results in Foundation II succeeding to a proportionate share of the tax attributes of Foundation I where both foundations are effectively controlled by the same

persons. Effective control is defined under section 482 and means "any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised,...it is the reality of the control that is decisive and not its form." If the transferee foundation receives less than 100% of the net assets of the transferor foundation in a section 507(b)(2) transfer the transferee foundation is treated as if it were the transferor foundation for purposes of chapter 42 and sections 507-509 in the proportion which the fair market value of the assets (less encumbrances) transferred to the transferee foundation bear to the fair market value of the assets (less encumbrances) of the transferor foundation immediately before the transfer. Foundation I and Foundation II are effectively controlled by the same persons because the members, officers and directors of each foundation are the same individuals. Further, Foundation I will have transferred X% of its net assets to Foundation II. Foundation II should therefore be treated as if it were Foundation I for purposes of chapter 42 and sections 507-509 to the extent provided in section 1.507-3(a)(9) of the regulations.

Foundation II's minimum distribution requirements under section 4942 of the Code should be increased with respect to the assets received in the section 507(b)(2) transfer as if the assets were held by Foundation II for the full tax year. Additionally, pursuant to Rev. Rul. 78-387, 1978-2 C.B. 270, Foundation II should reduce its distributable amount by any carryover excess qualifying distributions of Foundation I to the extent Foundation II is treated as Foundation I under section 1.507-3(a)(9) of the regulations. Neither foundation should be subject to tax under section 4942 because both have represented that they will adhere to the special rules regarding minimum distributions.

Foundation II also will succeed to a proportionate amount of the aggregate tax benefit of Foundation I as defined in section 1.507-3(a)(2) of the regulations. Foundation I's substantial contributors, as defined in section 4946 of the Code, continue to be classified as substantial contributors of Foundation II.

The transfer does not adversely affect the tax-exempt status of either foundation. The tax-exempt status of these foundations is not adversely affected because the transfer qualifies under section 507(b)(2) of the Code and is made to a section 501(c)(3) organization.

Finally, the Foundations have represented that the legal, accounting, and other expenses incurred by the foundations in connection with this ruling request in implementing the proposed transfer will be reasonable and necessary expenses paid to accomplish one or more purposes described in section 170(c)(2)(B) of the Code. Therefore, such expenses will not constitute taxable expenditures under section 4945.

Therefore we rule that:

1. The transfer of X% of Foundation I's net assets to Foundation II qualifies as a section 507(b)(2) of the Code transfer and will not terminate Foundation I's status as a private foundation nor subject it to a termination tax under section 507(a).

2. The transfer to Foundation II will not generate gross investment income or capital gains or losses, as defined in section 4940(c) of the Code; therefore, Foundation I will not be subject to tax under section 4940(a).

3. The transfer will not be an act of self-dealing as defined in section 4941(d) of the Code by Foundation I, Foundation II, or any foundation manager as defined in section 4946(b); therefore, no tax will be imposed by section 4941(a).

4. Foundation I and Foundation II will not be subject to tax under section 4943 of the Code because the transfer will not generate excess business holdings nor will Foundation II receive excess business holdings in the transfer.

5. The transfer will not constitute an investment, which may jeopardize Foundation I's exempt purposes; therefore, Foundation I will not be subject to tax under section 4944 of the Code.

6. The transfer will not be a taxable expenditure by Foundation I provided Foundation I exercises the capital endowment grant expenditure responsibility required by section 4945(h) of the Code and section 53.4945-5(c)(2) of the foundation regulations; therefore, Foundation I will not be subject to tax under section 4945.

7. Foundation II will succeed to X% of the aggregate tax benefit of Foundation I as determined under section 1.507-3(a)(2) of the regulations.

8. Foundation II will be treated as if it were Foundation I for purposes of sections 507-509 of the Code and Chapter 42 because both foundations are effectively controlled, within the meaning of section 1.482-1(a)(3) of the regulations, directly or indirectly, by the same persons and because Foundation I will have transferred X% of its net assets to Foundation II. Foundation II shall be treated as if it were Foundation I in the proportion which the fair market value of the assets (less encumbrances) transferred to Foundation II bears to the fair market value of the assets (less encumbrances) of Foundation I immediately before the transfer.

9. Foundation II may reduce its distributable amount as defined in section 4942(d) of the Code by Foundation I's excess distribution carryovers, if any, permitted by section 4942(i) to the extent Foundation II is treated as Foundation I under section 1.507-3(a)(9) of the regulations.

10. Any person who is a substantial contributor as defined in section 507(d)(2) of the Code, with respect to Foundation I shall also be considered a substantial contributor with respect to Foundation II pursuant to section 1.507-3(a)(3) of the regulations.

11. The transitional rules and savings provisions of section 1.507-3(a)(8)(i)-(ii) of the regulations will apply to Foundation II.

12. The merger and transfer of X% of Foundation I's net assets will not adversely affect the section 501(c)(3) of the Code tax-exempt status of Foundation I or Foundation II.

13. Pursuant to section 53.4945-6(b)(2) of the foundation regulations, the legal, accounting and other expenses, if reasonable in amount, incurred by Foundation I and Foundation II in connection with the merger transaction and submission of this letter ruling request will not constitute taxable expenditures under section 4945 of the Code.

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

This ruling is limited to the applicability of the provisions of the sections of the Code as noted above. This ruling is based on the understanding that there will be no material changes in the facts upon which it is based.

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,

(signed) Robert C Harper, Jr.

Robert C. Harper, Jr.
Manager, Exempt Organizations
Technical Group 3