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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

200151057

Date: SEP 26 2001

Contact Person:

Identification Number:

Telephone Number:

T:EO:B2

Uniform Issue List: 507.00-00
501.03-02
509.03-00
4940.00-00
4941.04-00
4944.05-00
4945.04-06

Employer Identification Number:

LEGEND:
B =
C =
D =
E =
F =
x =

Dear Sir or Madam:

We have considered your letters dated August 22, 2000, and September 24, 2001, in which you requested certain rulings with respect to a transfer of assets of B to C, D, E, and F.

B is a nonprofit corporation organized in 1953 and currently governed by the Indiana Nonprofit Corporation Act of 1991, as amended. B is exempt under section 501(c)(3) of the Internal Revenue Code (the "Code") and is classified as a private foundation under section 509(a).

B is managed and controlled by directors who are all related by blood or marriage. With the passage of time, the interests of the directors have diverged with respect to the charitable goals and management of B.

B's board of directors believes that B's charitable purposes will be better served by allowing four of its current directors to start and manage their own private foundations (C, D, E, and F) with separate boards that may include their respective spouses, their adult children, and others. Of those four directors, two will continue to serve on B's board of directors.

B proposes to transfer approximately $10x to each of C, D, E, and F. Such transfers will amount to approximately 64.5 percent of B's total assets. The funds transferred to C, D, E, and F will be used for endowment-building purposes, although B will in no way restrict C, D, E, or F from making charitable grants from principal. Neither C, D, E, nor F will provide any consideration to B for the transferred assets. Neither B nor any of its directors will realize any

258

gain from the transfer of assets to C, D, E, or F (the Transfers). None of the directors or officers of B, C, D, E, or F will receive funds or any other benefit, directly or indirectly, from the Transfers.

B presently has several outstanding commitments to provide grant funds to public charities. All such outstanding grant commitments of B will remain B's own responsibility.

B has not notified the Service that it intends to terminate its private foundation status, and it has no plans to do so. Additionally, B has not received notification that its status as a private foundation has been terminated. B has not committed either willful repeated acts (or failures to act) or a willful and flagrant act (or failure to act) giving rise to liability under Chapter 42 of the Code.

The following rulings are requested:

1. The Transfers will not adversely affect B's exemption from federal income tax under section 501(c)(3) of the Code;

2. Each Transfer will constitute a transfer of assets described in section 507(b)(2) of the Code;

3. Because B has not given, and does not plan to give, notice of termination pursuant to section 507(a)(1) of the Code, the Transfers will not constitute a termination of B's status as a private foundation, and the Transfers will not cause B to be subject to the tax imposed by section 507(c);

4. Following the Transfers, C, D, E, and F will possess certain attributes and characteristics of B as described in section 1.507-3(a) of the Income Tax Regulations (the "regulations");

5. The Transfers will not result in the imposition of net investment income tax under section 4940(a) of the Code;

6. The Transfers will not be acts of self-dealing under section 4941 of the Code, and, thus, will not give rise to the tax on self-dealing transactions imposed under section 4941;

7. The Transfers will not trigger the tax on jeopardy investments under section 4944 of the Code;

8. The Transfers will not be taxable expenditures under section 4945 of the Code if B exercises expenditure responsibility under section 4945(h);

9. Because the Transfers constitute grants for endowment as contemplated in section 53.4945-5(c)(2) of the Foundation and Similar Excise Taxes Regulations (the "regulations"), B may satisfy section 4945(h)(3) of the Code by attaching C's, D's, E's, and F's annual grantee reports to its annual information returns (Form 990-PF) for the taxable year in which the

Transfers are made and for the following two taxable years, provided that such reports contain (or are accompanied by) the information set forth in section 53.4945-5(d)(2) of the regulations; and,

10. B's reasonable and necessary legal, accounting, and other administrative expenditures incurred in connection with this ruling request and the Transfers will constitute qualifying distributions under section 4942(g)(1)(A) of the Code, but will not be taxable expenditures under section 4945(d)(5).

Section 501(c)(3) of the Code provides for the exemption from federal income tax of nonprofit organizations that are organized and operated exclusively for charitable and other exempt purposes stated in that section.

Section 509(a) of the Code provides that organizations exempt under section 501(c)(3) will be classified as private foundations, subject to the private foundation provisions of the Code, unless they are described in sections 509(a)(1), (2), (3), or (4).

Section 507(c) of the Code generally imposes a tax on any private foundation that terminates its status under section 507(a). Section 507(a) describes the circumstances under which the status of a private foundation will be terminated, subject to exceptions provided in section 507(b).

Section 507(b)(2) of the Code addresses the transfer of assets by one private foundation to one or more other private foundations pursuant to a liquidation, merger, redemption, recapitalization, or other adjustment, organization, or reorganization, and provides that each transferee private foundation in such a transaction shall not be treated as a newly created organization.

Section 1.507-1(b)(7) of the regulations provides that a significant disposition of a foundation's assets pursuant to section 507(b)(2) of the Code will not constitute a termination of the transferor foundation's status as a private foundation under section 509(a) unless the transferor foundation elects to terminate such status under section 507(a)(1), or unless section 507(a)(2) (regarding willful repeated acts, or one flagrant willful act, giving rise to liability under Chapter 42 of the Code) is applicable.

Section 1.507-3(a)(1) of the regulations 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 other adjustment, organization, or reorganization, the transferee organization shall not be treated as a newly created organization, but shall succeed to the transferor's aggregate tax benefits under section 507(d) of the Code.

Section 1.507-3(a)(4) of the regulations provides that, if a private foundation incurs liability for one or more of the taxes imposed under chapter 42 of the Code (or any penalty resulting therefrom) prior to, or as a result of, making a transfer of assets described in section 507(b)(2) to one or more private foundations, in any case where transferee liability applies, each transferee foundation shall be treated as receiving the transferred assets subject to such liability

to the extent that the transferor foundation does not satisfy such liability.

Section 1.507-3(a)(5) of the regulations provides that a transferor private foundation must make its required amount of qualifying distributions under section 4942 of the Code for any taxable year in which it transfers all or part of its assets to one or more other private foundations pursuant to section 507(b)(2) of the Code.

Section 1.507-3(c)(1) of the regulations provides that a transfer of assets from a private foundation to one or more other private foundations which includes any significant disposition of the transferor private foundation's assets is described in section 507(b)(2) of the Code.

Section 1.507-3(c)(2) of the regulations provides that a "significant disposition" of a foundation's assets generally includes transfers of 25 percent or more of the fair market value of such assets.

Section 1.507-3(d) of the regulations provides that, if a private foundation makes a transfer of assets described in section 507(b)(2) of the Code, the transferor's private foundation status will not be terminated under section 507(a)(1) unless the transferor voluntarily gives notice of termination to the Secretary, provided that the transfer meets the requirements of any pertinent provisions of Chapter 42 of the Code.

Section 1.507-4(b) of the regulations provides that the tax on termination of private foundation status under section 507(c) of the Code generally does not apply to a transfer of assets described in section 507(b)(2) of the Code.

Section 4940 of the Code imposes a tax on the net investment income of a private foundation. Net investment income is defined in section 4940(c)(1) as the amount by which the sum of gross investment income and capital gain net income exceeds certain deductions allowed by section 4940(c)(3). Gross investment income, in turn, is defined generally in section 4940(c)(2) as the gross amount of income from interest, dividends, rents, payments with respect to securities loans, and royalties.

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

Section 4942 of the Code imposes a tax on the undistributed income of a private foundation. Undistributed income, in turn, is defined in section 4942(c) as the excess of a private foundation's distributable amount over its qualifying distributions.

Section 4942(g)(1)(A) of the Code provides that a "qualifying distribution" generally includes any amount paid to accomplish one or more purposes described in section 170(c)(2)(B). It defines qualifying distributions to include reasonable and necessary administrative expenses that are paid to accomplish an exempt purpose, but excludes a

contribution to (i) another organization that is controlled by the transferor or by one or more disqualified persons with respect to the transferor unless the requirements of section 4942(g)(3) are satisfied; or (ii) a private foundation which is not an operating foundation under section 4942(j)(3), except as provided in section 4942(g)(3).

Section 4942(g)(3) of the Code provides that a grant to a section 501(c)(3) organization which is described in sections 4942(g)(1)(A)(i) or (ii) will constitute a qualifying distribution if (A) not later that the close of the first taxable year after its taxable year in which such contribution is received, the transferee organization makes a distribution equal to the amount of such contribution and such distribution is a qualifying distribution which is treated under section 4942(h) as a distribution out of corpus; and (B) the private foundation making the contribution obtains adequate records or other sufficient evidence from such organization showing that the qualifying distribution has been made by the organization.

Section 4945 of the Code imposes a tax on taxable expenditures by private foundations within the meaning of section 4945(d).

Section 4945(d)(4)(B) of the Code provides that a grant to an organization which is not described in section 509(a)(1)-(3) or 4940(d)(2) constitutes a taxable expenditure unless the transferor private foundation exercises expenditure responsibility pursuant to section 4945(h).

Under section 4945(h) of the Code, expenditure responsibility requires a private foundation to exert all reasonable efforts and establish adequate procedures (1) to see that the grant is spent solely for the purpose for which made; (2) to obtain full and complete reports from the grantee on how the funds are spent; and (3) to make full and detailed reports with respect to such expenditures to the Secretary.

Section 53.4945-5(b)(2) of the regulations provides that expenditure responsibility under section 4945(h) of the Code requires a grantor private foundation to make an inquiry of the prospective grantee private foundation before making the grant. Such an inquiry must be complete enough to give a reasonable person assurance that the grantee will use the grant for the proper exempt purposes. The inquiry should concern matters such as the identity, prior history, and experience (if any) of the grantee organization and its managers, and any knowledge which the grantor has (based on prior experience with the grantee or other information which is readily available) concerning the management, activities, and practices of the grantee foundation. The scope of the inquiry may vary from case to case, depending on the size and purpose of the grant, the period of time over which it is to be paid, and the grantor's prior experience with respect to the grantee's capacity to use the grant for proper purposes.

Section 53.4945-5(b)(3) of the regulations provides that in order to exercise expenditure responsibility in connection with a grant pursuant to section 4945(h) of the Code, a grantor private foundation must require that the grant be made subject to a written commitment signed by an appropriate officer, director, or trustee of the grantee organization. The written commitment must include an agreement by the grantee (i) to repay any portion of the amount granted which is not used for the purposes of the grant; (ii) to submit full and complete annual reports on the manner in which the grant funds are spent and the progress made in

accomplishing the purposes of the grant (unless the grant is for endowment or capital purposes); (iii) to maintain records of receipts and expenditures and to make its books and records available to the grantor at reasonable times; and (iv) not to use any of the funds to: carry on propaganda, or otherwise to attempt, to influence legislation within the meaning of section 4945(d)(1); influence the outcome of any specific public election, or carry on, directly or indirectly, any voter registration drive within the meaning of section 4945(d)(2); make any grant which does not comply with the requirements of section 4945(d)(3) or (4); or undertake any activity for any purpose other than one specified in section 170(c)(2)(B). The grant agreement also must specify clearly the purposes of the grant.

Section 53.4945-5(c)(2) of the regulations provides that if a private foundation makes a grant to another private foundation for endowment or other capital purposes, the grantor foundation must require reports from the grantee foundation on the use of the principal and income (if any) from the grant funds. The grantee must make such reports annually for its taxable year in which the grant was made and for the two immediately succeeding taxable years. The grantor may allow the grantee's report to be discontinued only if it is reasonably apparent to the grantor, before the end of the second succeeding taxable year, that neither the principal nor the income from the grant funds has been used for any purpose which would result in liability for tax under section 4945(d) of the Code.

Section 53.4945-5(d)(1) of the regulations provides that a private foundation making a grant for endowment or other capital purposes may satisfy its duty to report to the Secretary under section 4945(h)(3) of the Code by attaching to its annual information return (Form 990-PF) the grantee report required under section 53.4945-5(c)(2) of the regulations during each taxable year in which such a report is required to be collected from the grantee. The report attached to the return must contain, or be accompanied by, the following information: (i) the name and address of the grantee; (ii) the date and amount of the grant; (iii) the purpose of the grant; (iv) the amounts expended by the grantee (based upon the most recent report received from the grantee); (v) whether the grantee has diverted any portion of the funds (or the income therefrom in the case of an endowment grant) from the purpose of the grant (to the knowledge of the grantor); (vi) the dates of any reports received from the grantee; and (vii) the date and results of any verification of the grantee's reports undertaken pursuant to and to the extent required under section 53.4945-5(c)(1) by the grantor or by others at the direction of the grantor.

Section 4945(d)(5) of the Code provides that an expenditure by a private foundation for any purpose other than one specified in section 170(c)(2)(B) constitutes a taxable expenditure.

Section 53.4945-6(b)(1)(v) of the regulations provides that a payment which constitutes a qualifying distribution under section 4942(g) of the Code ordinarily will not be treated as a taxable expenditure under section 4945(d)(5).

Section 4946(a)(1) of the Code defines the term "disqualified person" to include, among others, substantial contributors to a foundation and family members (including children) of such substantial contributors.

Analysis

Your requested rulings are discussed below:

1.

Section 501(c)(3) of the Code provides, among other things, that an organization described therein must be organized and operated exclusively for charitable and other exempt purposes. C, D, E, and F are exempt under section 501(c)(3), and will use the Transfers and the income therefrom to further their exempt purposes. Therefore the Transfers are consistent with B's operation for exclusively exempt purposes and will not jeopardize B's exemption under section 501(c)(3).

2.

Section 507(c) of the Code imposes a termination tax on a private foundation referred to in section 507(a). Pursuant to section 507(a), a private foundation's status as such will be terminated by one of two means (one voluntary and one involuntary) except as provided in section 507(b)(2) which describes the transfer of assets by a private foundation to one or more other private foundations pursuant to a reorganization.

Under section 1.507-3(c)(1) of the regulations, a section 507(b)(2) transfer includes any "significant disposition" of the transferor foundation's assets. Pursuant to sections 1.507-3(c)(1) and (2) of the regulations, a "significant disposition" generally includes a transfer of 25 percent or more of the fair market value of the transferor foundation's assets to one or more other private foundations.

As a result of the Transfers, approximately 64.5 percent of the fair market value of B's assets will be transferred to C, D, E, and F. Pursuant to section 1.507-3(c)(2) of the regulations, therefore, the Transfers constitute a significant disposition of B's assets, and the Transfers are described in section 507(b)(2) of the Code.

3.

Section 507(c) imposes a tax upon organizations whose private foundation status is terminated pursuant to section 507(a). However, section 1.507-3(d) provides that a section 507(b)(2) transfer will not constitute a termination of the transferor's private foundation status under section 507(a)(1) unless the transferor gives voluntary notice of termination. The Transfers in the aggregate constitute a transfer of assets described in section 507(b)(2). Moreover, B has not given, and does not plan to give, voluntary notice of termination of its private foundation status. Accordingly, the Transfers will not result in the termination of B's private foundation status.

Section 1.507-4(b) of the regulations provides that private foundations that make transfers described in section 507(b)(2) of the Code are not subject to the termination tax under section 507(c). Because the Transfers are described in section 507(b)(2), B will not be subject to the

section 507(c) termination tax as a result thereof.

4.

Because the Transfers will constitute a significant disposition of B's assets, section 1.507-3(a)(1) of the regulations provides that C, D, E, and F will not be treated as newly created organizations, but, instead, will possess certain tax attributes and characteristics of B. In particular, C, D, E, and F will take the Transfers subject to any potential liability of B for Chapter 42 taxes incurred prior to, or as a result of, the Transfers (to the extent that B should not satisfy such liability). Should such liability arise, B, C, D, E, and F will agree to share the liability in proportion to their relative assets immediately following the Transfers.

5.

Section 4940(a) of the Code imposes an excise tax on the net investment income of private foundations. "Net investment income" generally is the amount by which the sum of a foundation's gross investment income and capital gain income exceeds certain allowable deductions. "Gross investment income" generally is the gross amount of a foundation's income from interest, dividends, rents, payments with respect to securities loans, and royalties.

The Transfers will be voluntary grants by B to C, D, E, and F. B will not receive any consideration from C, D, E, or F in connection with the Transfers. Additionally, neither B nor any of its directors will realize any gain from the Transfers. Accordingly, B will not have any gross investment income or net investment income as a result of the Transfers, and no tax will be imposed on B, C, D, E, or F under section 4940(a) in connection with the Transfers.

6.

Section 4941 of the Code imposes a tax on any act of self-dealing between a private foundation and a disqualified person. However, organizations described in section 501(c)(3) generally are excluded from the definition of "disqualified person" for purposes of section 4941. C, D, E, and F are organizations described in section 501(c)(3) and, therefore, will not be disqualified persons for purposes of the self-dealing rules. Correspondingly, B is not a disqualified person either of C, D, E, or F. Accordingly, the Transfers are not transactions between a private foundation and one or more disqualified persons, and they will not constitute self-dealing under section 4941.

7.

A private foundation that invests in such a manner as to jeopardize the carrying out of its exempt purposes is subject to an excise tax under section 4944(a)(1) of the Code. Black's Law Dictionary (abr. 7th ed. 2000) defines an investment as "an expenditure to acquire property or assets to produce revenue." B will not receive any consideration or realize any gain in connection with the Transfers. The Transfers are not "expenditure[s] ... to produce revenue." The Transfers are not "investments" as that term is used in section 4944, and the Transfers will not trigger the tax on jeopardy investments under section 4944.

265

8.

Section 4945(a)(1) imposes a tax on each taxable expenditure by a private foundation. The term "taxable expenditure" is defined in section 4945(d) to include a grant by a private foundation to an organization that is not described in section 509(a)(1)-(3) or 4940(d)(2) unless the private foundation exercises expenditure responsibility with respect to the grant.

Expenditure responsibility requires a grantor private foundation to exert all reasonable efforts and to establish adequate procedures: (1) to see that the grant is spent solely for the purpose for which it was made, (2) to obtain full and complete reports from the grantee private foundation on how the funds are spent, and (3) to make full and detailed reports regarding the expenditures to the Secretary.

The regulations provide that a private foundation may satisfy the expenditure responsibility requirements set forth in sections 4945(h)(1)-(2) of the Code by completing a prescribed pre-grant inquiry (the required elements of which are set forth in section 53.4945-5(b)(2) of the regulations), including certain required terms (set forth in section 53.4945-5(b)(3)) in the grant agreement with the grantee foundation, and requiring the grantee organization to submit prescribed reports (the required elements of which are set forth in section 53.4945-5(c)(2)) on the use of the principal and income (if any) from the grant funds. The grantor foundation's obligation to report to the Secretary is subject to a special rule applicable to foundations that make grants for endowment or other capital purposes.

Because they are grants from one private foundation to other private foundations, the Transfers would constitute taxable expenditures if B did not comply with the expenditure responsibility requirements of section 4945(h) of the Code. B will exercise expenditure responsibility as follows: (1) B will complete a pre-grant inquiry pursuant to section 53.4945-5(b)(2) of the regulations; (2) the agreement(s) memorializing the Transfers will contain the terms required by section 53.4945-5(b)(3) of the regulations; (3) B will require C, D, E, and F to submit grantee reports that comply with section 53.4945-5(c) and 53.4945-5(d)(2) of the regulations with respect to their frequency and content; and (4) B will provide reports to the Secretary consistent with the requirements of section 4945(h)(3) of the Code and section 53.4945-5(d) of the regulations.

By taking the preceding steps, B will satisfy the expenditure responsibility requirements of section 4945(h) of the Code. Accordingly, the Transfers will not constitute taxable expenditures under section 4945(d).

9.

Section 53.4945-5(d)(1) of the regulations provides that a grantor foundation that makes a grant for endowment or other capital purposes may satisfy section 4945(h)(3) of the Code by attaching the grantee information reports described in section 53.4945-5(c)(1) of the regulations to the grantor foundation's annual information return for the taxable year of the transfer and the following two years (as required by section 53.4945-5(d)), provided that such reports contain the

266

information set forth in section 53.4945-5(d)(2).

The Transfers constitute grants to establish charitable endowments in C, D, E, and F. B will attach C's, D's, E's, and F's grantee reports to its annual information return (Form 990-PF) for the taxable year of the Transfers and the two years immediately thereafter. C's, D's, E's, and F's reports will contain, or be accompanied by, the information set forth in section 53.4945-5(d)(2) of the regulations. Accordingly, this method of reporting to the Secretary will satisfy B's obligation under section 4945(h)(3) of the Code.

10.

Section 4945(d)(5) of the Code provides that any amount paid or incurred by a private foundation for a noncharitable purpose (i.e., a purpose not specified in section 170(c)(2)(B)) is a taxable expenditure. Pursuant to section 53.4945-6(b)(1)(v) of the regulations, however, any payment that constitutes a qualifying distribution under section 4942(g) ordinarily will not be treated as a taxable expenditure under section 4945(d)(5). Section 4942(g)(1)(A) provides that reasonable and necessary administrative expenses paid to accomplish one or more charitable purposes constitute qualifying distributions.

B's administrative expenses paid in connection with this ruling request and the Transfers, including legal, accounting, and other expenses, constitute qualifying distributions to the extent that such expenses are reasonable and necessary. Accordingly, B's reasonable and necessary legal, accounting, and other administrative expenses paid in connection with this ruling request and the Transfers will not be taxable expenditures under section 4945(d)(5) of the Code.

Conclusion:

Accordingly we rule that:

1. The Transfers will not adversely affect B's exemption from federal income tax under section 501(c)(3) of the Code.

2. The Transfers will constitute a transfer of assets described in section 507(b)(2) of the Code.

3. Because B has not given, and does not plan to give, notice of termination pursuant to section 507(a)(1) of the Code, the Transfers will not constitute a termination of B's status as a private foundation, and the Transfers will not cause B to be subject to the tax imposed by section 507(c).

4. C, D, E, and F will possess the tax attributes and characteristics of B following the Transfers, as described in section 1.507-3(a) of the regulations, and may agree with B to share liability for Chapter 42 taxes incurred prior to, or as a result of, the Transfers (if any) in proportion to the relative assets of the organizations at the time of the Transfers.

5. The Transfers will not result in the imposition of net investment income tax under

section 4940(a) of the Code on B, C, D, E, or F.

6. The Transfers will not be acts of self-dealing under section 4941 of the Code, and, thus, will not give rise to the tax on self-dealing transactions imposed under section 4941.

7. The Transfers will not trigger the tax on jeopardy investments under section 4944 of the Code.

8. The Transfers will not be taxable expenditures under section 4945 of the Code if B exercises expenditure responsibility under section 4945(h).

9. Because the Transfers constitute grants for endowment as contemplated in section 53.4945-5(c)(2) of the regulations, B may satisfy section 4945(h)(3) of the Code by attaching C's, D's, E's, and F's annual grantee reports to its annual information returns (Form 990-PF) for the taxable year in which the Transfers are made and for the following two taxable years, provided that such reports contain (or are accompanied by) the information set forth in section 53.4945-5(d)(2) of the regulations.

10. B's reasonable and necessary legal, accounting, and other administrative expenses incurred in connection with this ruling request and the Transfers will constitute qualifying distributions under section 4942(g)(1)(A) of the Code, but will not be taxable expenditures under section 4945(d)(5).

Because this ruling letter could help to resolve any questions, please keep it in your permanent records.

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

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) Terrell M. Berkovsky

Terrell M. Berkovsky
Manager, Exempt Organizations
Technical Group 2

268