

Office of Chief Counsel
Internal Revenue Service
memorandum

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to: Jason C. Kall
(Manager, Area 4, EO Rulings & Agreements (Tax Exempt & Government Entities))

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subject: Basis of Assets of Former Public Charities for Section 4940 Purposes

This document may not be used or cited as precedent.

ISSUE

For purposes of determining capital gain net income under section 4940 of the Internal Revenue Code (Code),¹ whether the basis of property of a tax-exempt organization described in section 501(c)(3), on the date it ceases to qualify as a public charity under section 509(a)(1), (2), or (3), and becomes a private foundation, is equal to the fair market value of the property on such date or whether it is determined under the rules of Part II of Subchapter O of Chapter 1 of the Code (sections 1011-1023). In other words, is the basis of property held by the organization increased or stepped up to fair market value when it becomes a private foundation?

CONCLUSION

For purposes of determining capital gain net income under section 4940, the basis of property of a tax-exempt organization described in section 501(c)(3) that ceases to qualify as a public charity under section 509(a)(1), (2), or (3), and becomes a private foundation is determined under the rules of Part II of Subchapter O of Chapter 1 of the Code, subject to the provisions of section 4940(c)(3)(B) and without regard to section 362(c).

¹ Except as otherwise indicated, all “section” references are to the Internal Revenue Code of 1986, as amended.

FACTS

An organization exempt from federal income tax under section 501(a) and described in section 501(c)(3), and which is classified as a public charity under section 509(a)(1), (2), or (3), ceases to qualify as a public charity and becomes classified as a private foundation. The organization becomes subject to the excise tax imposed under section 4940(a) and must determine the basis of its property for purposes of determining capital gain or loss from the sale or other disposition of such property.

LAW AND ANALYSIS

Section 4940(a) generally imposes an excise tax on a private foundation, with respect to the carrying on of its activities, equal to 1.39 percent of the foundation's net investment income for the taxable year.

Section 4940(c)(1) defines net investment income as gross investment income plus capital gain net income, less certain deductions. Except to the extent inconsistent with the provisions of section 4940, net investment income is determined under the principles of subtitle A of the Code.

Section 4940(c)(4)(B) provides that the basis for determining capital gain net income in the case of property held by a private foundation on December 31, 1969, and continuously thereafter to the date of its disposition is not less than the fair market value of such property on December 31, 1969.

Treas. Reg. § 53.4940-1(f)(2)(i) provides that for purposes of determining gain from the sale or other disposition of property, the basis is the greater of:

(A) Fair market value on December 31, 1969, plus or minus all adjustments after December 31, 1969, and before the date of disposition under the rules of Part II of Subchapter O of Chapter 1, provided that the property was held by the private foundation on December 31, 1969, and continuously thereafter to the date of disposition, or

(B) Basis as determined under the rules of Part II of Subchapter O of Chapter 1,

subject to the provisions of section 4940(c)(3)(B) (special rules for depreciation and depletion deductions) and without regard to section 362(c) (special rule for certain contributions to capital).

Treas. Reg. § 53.4940-1(f)(2)(ii) provides that for purposes of determining loss from the sale or other disposition of property, basis as determined in Treas. Reg. § 53.4940-1(f)(2)(i)(B) applies.

Rev. Rul. 76-424, 1976-2 CB 367, holds that, for purposes of section 4940(c)(4)(B), stock distributed to a private foundation in 1971 pursuant to the will of an individual who died in 1967, in satisfaction of both a specific bequest and a residuary bequest, will be

considered to have been held by the private foundation on December 31, 1969, even though the stock had not yet been distributed from the individual's estate as of that date. Consequently, the basis of the stock for purposes of computing capital gain includible in the private foundation's net investment income is the fair market value of the stock as of December 31, 1969, under section 4940(c)(4)(B).

Friedman Foundation, Inc. v. Commissioner, 71 TC 40 (1978), held, in part, that in the case of a contribution of stock to a private foundation on November 14, 1973, the private foundation's basis in the stock was the basis of the stock in the hands of the donors under sections 1011 and 1015, rather than, as the private foundation contended, the fair market value of the stock as of either December 31, 1969, or November 14, 1973.

Generally, then, under section 4940, for purposes of determining gain or loss from the sale or other disposition of property, the usual income tax rules of Part II of Subchapter O of Chapter 1 apply in determining basis, subject to the special rules of section 4940(c)(3)(B) and disregarding section 362(c). We find no provision in the law for the basis of an organization's assets to be increased to fair market value on the date the organization becomes classified as a private foundation and thus subject to section 4940(a), except as provided in section 4940(c)(4)(B), which provides for a one-time step-up in basis of property held by private foundations when section 4940 went into effect.² Section 4940(c)(4)(B) is not applicable with respect to property that was not held by or considered held by a private foundation as of December 31, 1969. See *Friedman Foundation, Inc. v. Commissioner*. See also Rev. Rul. 76-424, which applied section 4940(c)(4)(B) to stock distributed to a private foundation in 1971 in satisfaction of a bequest under the will of an individual who died in 1967 on the grounds that the private foundation was considered to hold that property on December 31, 1969.

Consequently, for purposes of determining capital gain net income under section 4940, the basis of property of a tax-exempt organization described in section 501(c)(3) that ceases to qualify as a public charity under section 509(a)(1), (2), or (3), and becomes a private foundation is generally determined under the rules of Part II of Subchapter O of Chapter 1 of the Code.

Please call Ward Thomas at (202) 317-6173 if you have any further questions.

² We are aware a private letter ruling, PLR 9852023, held that, in the case of an organization which ceased to qualify as a public charity described in section 509(a)(3) and became a private foundation, the adjusted basis of property for purposes of determining the capital gain (if any) subject to the excise tax imposed under section 4940(a) should be the fair market value of such property on the date the organization ceases to be a public charity and is classified as a private foundation. We believe PLR 9852023 is incorrect.