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

200022059

Date: MAR 09 2000

Contact Person:

Uniform Issue List: 507.00-00
509.03-00
4942.05-00
4945.04-06

Contact Number:

Legend:
X =
Y =

Dear Sir or Madam:

This is in reply to your rulings request of September 17, 1998, as modified by your letter of March 3, 2000, requesting rulings on X's transfer of approximately one-third of its assets to Y pursuant to section 507(b)(2) of the Internal Revenue Code.

X is recognized as exempt from federal income tax under section 501(c)(3) of the Code, is a private foundation under section 509(a) of the Code, and is an "operating foundation" under section 4942(j)(3) of the Code.

Y is recognized as exempt from federal income tax under section 501(c)(3) of the Code, is a private foundation under section 509(a) of the Code, but is not an "operating foundation" under section 4942(j)(3) of the Code.

X appoints the governing body of Y and has granted approximately one-third of its assets to Y. Your request focuses on whether X may continue its operating foundation status under section 4942(j)(3) of the Code without regard to its transferee Y, and whether X must exercise expenditure responsibility under section 4945(h) of the Code and section 53.4945-5(c)(2) of the regulations with respect to its transfer of approximately one-third of its assets to Y for Y's capital endowment.

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

Section 509(a) of the Code provides that an organization exempt from federal income tax under section 501(c)(3) of the Code can be a private foundation subject to the private foundation provisions of Chapter 42 of the Code.

Section 507(b)(2) of the Code provides that, in a transfer of assets by one private foundation to another private foundation, the transferee private foundation shall not be treated as a newly created organization.

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Section 507(c) of the Code imposes excise tax on a private foundation that terminates its status as a private foundation pursuant to section 507(a) of the Code.

Section 1.507-3(c)(1) of the Income Tax Regulations provides that a transfer under section 507(b)(2) of the Code includes a transfer of assets from one private foundation to another private foundation pursuant to any reorganization, including a significant disposition of 25% or more of the transferor foundation's assets.

Sections 1.507-1(b)(7) and 1.507-3(d) of the regulations provide that a transferor foundation's transfer of assets pursuant to section 507(b)(2) of the Code will not constitute termination of the transferor foundation's status as a private foundation under section 509(a) of the Code.

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

Section 1.507-3(a)(1) of the regulations indicates that, in a transfer of assets from one private foundation to another private foundation pursuant to a reorganization, because the transferee private foundation is not be treated as a newly created organization, the transferee shall succeed to the transferor's aggregate tax benefits under section 507(d) of the Code.

Section 507(d) of the Code provides, in general, that the aggregate tax benefits of a private foundation refer to the value of its exemption from federal income tax and of the deductions taken by its donors during its existence.

Section 1.507-3(a)(8) of the regulations provides that certain transferor private foundation tax attributes will carry over to a transferee private foundation that receives a transfer of assets under section 507(b)(2) of the Code from a transferor foundation.

Section 1.507-3(a)(9)(i) of the regulations indicates that, if a private foundation transfers assets to another private foundation that is effectively controlled, directly or indirectly, by the same persons who control the transferor foundation, the transferee will be treated as if it were the transferor foundation, for purposes of sections 4940 through 4948 of the Code and sections 507 through 509 of the Code. The transferee is treated as the transferor in the proportion which the fair market value of the transferor's assets that were transferred bears to the fair market value of all of the assets of the transferor immediately before the transfer.

Section 4942 of the Code requires that a private foundation must expend annual qualifying distributions under section 4942(g) for exempt purposes.

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Section 4942(g)(1)(A) of the Code provides that a private foundation does not make a qualifying distribution under section 4942(g) where its distribution is a contribution to: (i) another organization that is controlled by the transferor or by one or more of the transferor's disqualified persons, or (ii) a private foundation that is not an operating foundation under section 4942(j)(3) of the Code.

Section 4942(j)(3) of the Code describes the requirements for a private foundation to be also an "operating foundation" under that section.

Section 4942(j)(3) of the Code provides, in pertinent part, that, to qualify as an "operating foundation" for a specific tax year as provided in section 53.4942(b)-3(a) of the regulations, a private foundation must meet the "income" test of section 4942(j)(3)(A) of the Code and section 53.4942(b)-(1)(a) of the regulations, and the "endowment" test under section 4942(j)(3)(B)(ii) of the Code and section 53.4942(b)-2(b) of the regulations.

Section 4942(j)(3)(A) of the Code and sections 53.4942(b)-1(a) of the Foundation and Similar Excise Taxes Regulations, describing the "income" test, require that an "operating foundation" must make qualifying distributions for the direct active conduct of exempt activities under section 53.4942(b)-1(b) of the regulations in an amount equal to at least "substantially all" (85%) of the lesser of its "adjusted net income" under section 4942(f) and section 53.4942(a)-2(d) or its "minimum investment return" under section 4942(e) and 53.4942(a)-2(c), but, if the qualifying distributions exceed the minimum investment return for the tax year, substantially all of such qualifying distributions must be made directly for the active conduct of exempt activities.

Section 53.4942(b)-3(a) of the regulations provides that an operating foundation must meet the income test and one of the required additional alternative tests on the basis of its preceding four tax years either in the aggregate for all four years or by meeting such tests for any three of the preceding four tax years.

Section 4942(j)(3)(B)(ii) of the Code and section 53.4942(b)-2(b) of the regulations provide that the "endowment" test is met where the qualifying distributions directly for exempt activities are equal to at least two-thirds of the minimum investment return under section 4942(e) of the Code and section 53.4942(a)-2(c) of the regulations.

Section 4945 of the Code imposes excise tax on a private foundation's making of any "taxable expenditure" as defined, in pertinent part, by section 4945(d)(4) of the Code.

Section 4945(d)(4) of the Code requires, in pertinent part, that a grantor private foundation must exercise "expenditure responsibility" under section 4945(h) of the Code on any grant by it to another private foundation in order for its grant not to be a taxable expenditure.

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Section 4945(h) of the Code on expenditure responsibility provides, in part, that the grantor private foundation must obtain proper reports from its grantee private foundation as to the grantee's uses of the grant.

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

Section 53.4945-5(c)(2) of the regulations, on capital endowment grants made to private foundations, provides that, if a private foundation makes a grant to another private foundation for endowment or for other capital purposes, the grantor foundation must require reports from the grantee foundation on the uses of the principal and the income (if any) from the grant funds. The grantee must make such reports annually for its tax year in which the grant was made and for its immediately succeeding two tax years. Only if it is reasonably apparent to the grantor, before the end of such grantee's second succeeding tax 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, may the grantor then allow the grantee's reports to be discontinued.

Section 53.4945-5(b)(3) of the regulations provides, that, in order to exercise expenditure responsibility, the grantor private foundation must require that the grantee organization be made subject to a written commitment, signed by an appropriate officer, director, or trustee of the grantee, to repay any portion of the amount granted which is not used for the purposes of the grant, 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, to maintain records of receipts and expenditures, and to make its books and records available to the grantor at reasonable times, and not to use any of the funds to carry on propaganda or otherwise attempt to influence legislation within section 4945(d)(1) of the Code, or to influence the outcome of any specific public election, or to carry on any voter registration drive within the meaning of section 4945(d)(2), or to make any grant which does not comply with the requirements of section 4945(d)(3) or 4945(d)(4), or to undertake any activity for any purpose other than one specified in section 170(c)(2)(B) of the Code. The agreement must clearly specify the purposes of the grant. Such purposes may include contributing for capital endowment, provided that neither the grants nor the income therefrom may be used for purposes other than those in section 170(c)(2)(B) of the Code.

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Analysis

X has transferred approximately one-third of its assets to Y. Your requested rulings are discussed below:

1.

X does not seek to notify the Service of any voluntary termination of its private foundation status pursuant to section 507(a)(1) of the Code, and an involuntary termination under section 507(a)(2) of the Code is not involved because X's transfer of assets to Y is for Y's exempt purposes under section 501(c)(3) of the Code and there is no willful and flagrant act, or failure to act, resulting in tax under Chapter 42 of the Code and giving rise to involuntary termination under section 507(a)(2) of the Code.

Under section 1.507-3(c)(1) of the regulations, a transfer under section 507(b)(2) of the Code includes a transfer of assets from one private foundation to another private foundations pursuant to any reorganization, including a significant disposition of 25% or more of the transferor foundation's assets. Because X's transfer to Y is approximately one-third of X's assets, X's transfer is a significant disposition of its assets under section 1.507-3(c)(1) of the regulations and, thus, is a transfer under section 507(b)(2) of the Code.

Under sections 1.507-1(b)(7) and 1.507-3(d) of the regulations, X's transfer of its assets to Y pursuant to section 507(b)(2) of the Code will not cause termination under section 507(a) of the Code of X's private foundation status under section 509(a) of the Code.

Under section 507(b)(2) of the Code and section 1.507-3(a)(1) of the regulations, because X's transfer is a transfer of assets from one private foundation to another private foundation pursuant to a significant disposition of X's assets to Y, Y will be a transferee foundation under section 507(b)(2) of the Code and, thus, will not be treated as a newly created organization.

2.

Although X appoints the directors of Y, because X and Y are separate legal entities, X will not include any assets or income of Y in determining X's operating foundation status under section 4942(j)(3) of the Code, and X can continue to be an operating foundation under section 4942(j)(3) of the Code provided that it otherwise continues to meet the requirements for that status under section 4942(j)(3) of the Code and sections 53.4942(b)-2 and 53.4942(b)-3(a) of the regulations..

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3.

Under section 1.507-3(a)(1) of the regulations, in a transfer of assets from one private foundation to another private foundation pursuant to a reorganization, the transferee private foundation will not be treated as a newly created organization, but will succeed to its proportionate share of its transferor's aggregate tax benefits under section 507(d) of the Code. Thus, X's aggregate tax benefits under section 507(d) of the Code will be transferred to Y in proportion to the amount of X's assets transferred to Y.

X must exercise expenditure responsibility under section 4945(h) of the Code and section 53.4945-5(c)(2) of the regulations on its transfer of assets to Y, because the exception under section 1.507-3(a)(7) of the regulations to expenditure responsibility for a transfer of all assets does not apply to X because X's transfer consists of approximately one-third, rather than all, of its assets to Y.

Accordingly, we rule that:

1. The grants by X to Y are transfers under section 507(b)(2) of the Code and do not result in termination under section 507(a)(1) of the Code of X's private foundation status under section 509(a) of the Code. Because Y is a transferee foundation under section 507(b)(2) of the Code, Y will not be treated as a newly created organization.

2. The grants by X to Y will not adversely affect the exemptions of X and Y from federal income tax under section 501(c)(3) of the Code, the status of Y as a private foundation under section 509(a) of the Code, or the status of X as a private operating foundation under section 4942(j)(3) of the Code so long as X otherwise continues to qualify under the tests for operating foundation status under section 4942(j)(3) of the Code and sections 53.4942(b)-2 and 53.4942(b)-3(a) of the regulations.

3. Because X's grants to Y are only part, rather than all, of X's assets and are for Y's capital endowment, X must exercise expenditure responsibility under section 4945(h) of the Code for the tax year of each grant and for the immediately succeeding two tax years as described in section 53.4945-5(c)(2) of the regulations.

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Because this ruling letter could help to resolve any questions about your status, 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 it may not be used or cited as precedent.

Sincerely,

(signed) Garland A. Carter

Garland A. Carter
Manager, Exempt Organizations
Technical Group 2

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