Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Significant Index No.: 9999.9999

Contact Person:

199905029

Telephone Number:

In Reference to: CP:E:EO:T:3

Date: NOV 5 1998

Legend:

X =
Y =
Z =

Dear Sir or Madam:

This is in reference to your August 3, 1998, request for rulings concerning the federal tax consequences of the proposed transactions described below.

The information provided indicates that X is a not-for-profit corporation established in 1945 by Y, a wholly-owned subsidiary of a publicly traded corporation. In 1995, established Z, a not-for-profit corporation. Both X and Z have been recognized as exempt from federal income tax under section 501(a) of the Internal Revenue Code (hereafter "Code") as organizations described in section 501(c)(3) of the Code, and are classified as private foundations under section 509(a) of the Code. X's and Z's boards of directors and officers are identical and all such officers and directors and employees of Y. Both X and Z are dedicated to identical charitable purposes of making gifts to organizations described in section 501(c)(3). Y is a substantial contributor, as that term is defined in section 507(d)(2)(A) of the Code, to both X and Z.

In order to promote administrative convenience and to eliminate duplicate expenses such as auditing and trust management and service fees, the boards of directors have decided to consolidate the activities of X and Z into one entity. In addition, since both X and Z are dedicated to identical charitable purposes, there is no need to have two corporations perform the same mission. Subsequent to the filing of this ruling request, X will submit a Plan of Dissolution and Distribution of Assets (the "Plan") to the appropriate court (the "Court") requesting the Court's approval for X to distribute its net assets to Z, according to the applicable state statutes. Upon receiving such approval, and after receiving a favorable ruling regarding the tax consequences of the transaction from the Internal Revenue Service, X will distribute all of its net assets to Z. After the distribution of net assets is complete, X will

submit an application to the Court requesting permission to dissolve.

Section 509(b) of the Code provides that a private foundation shall continue to be treated as a private foundation unless its status as such is terminated under section 507.

Section 507(a) of the Code provides that, except as provided in section 507(b) [regarding transfers to, or operation as, public charities], an organization's status as a private foundation is terminated only if either (1) the organization notifies the Service of its intent to terminate its status or (2) there have been either willful repeated acts (or failures to act), or a willful and flagrant act (or failure to act), giving rise to liability for tax under Chapter 42, and the Service notifies such organization that it is liable for the termination tax imposed by section 507(c) by reason of such acts, and, in addition to (1) or (2), the tax under section 507(c) is either paid or abated. After the final distribution of all assets by X to Z, X will give notice to the Service under section 507(a)(1) of the Code of its intent to terminate its status as a private foundation.

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 other adjustment, organization, or reorganization, the transferee foundation shall not be treated as a newly created organization.

Section 1.507-3(c)(1) of the Income Tax Regulations (hereafter "regulations") provides that for purposes of section 507(b)(2) the terms "other adjustment, organization or reorganization" shall include the 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" includes any disposition by a private foundation which is 25% or more of the fair market value of the net assets of the distributing foundation at the beginning of the taxable year.

Section 1.507-3(d) of the regulations states that unless a private foundation gives notice pursuant to section 507(a) 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). Such transfer must,

nevertheless, satisfy the requirements of any pertinent provisions of Chapter 42.

Section 1.507-3(a)(1) of the regulations provides that in the case of a significant transfer of assets to one or more private foundations within the meaning of section 1.507-3(c), the transferee shall not be treated as a newly created organization. A transferee is treated as possessing those attributes and characteristics of the transferor described in section 1.507-3(a)(2) [carryover of aggregate tax benefit to the transferee], 1.507-3(a)(3) [carryover of substantial contributors to the transferee], and 1.507-3(a)(4) [carryover of chapter 42 tax liability to the transferee].

Section 1.507-3(a)(2)(i) and (ii) of the regulations provide that a transferee organization to which this paragraph applies shall succeed to the aggregate tax benefit of the transferor organization in an amount determined as follows: Such amount shall be an amount equal to the amount of such aggregate tax benefit multiplied by a fraction 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 value of the assets of the transferor (less encumbrances) immediately before the transfer.

Section 1.507-3(a)(4) of the regulations provides that if a private foundation incurs liability under Chapter 42 (or any penalty resulting therefrom) prior to, or as a result of, making a transfer of assets under 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 except as provided in section 1.507-3(a)(9), the transferor must meet the distribution requirements of section 4942 for any tax year in which it makes a transfer described in section 507(b)(2) of the Code, and the transfer itself counts if it meets the requirements of section 4942(g).

Section 1.507-3(a)(6) of the regulations provides that the holding periods described in section 4943(c)(4), (5), and (6) of the Code include both the period in which the transferor and in which the transferee holds the assets.

Section 1.507-3(a)(7) of the regulations provides that except as provided in section 1.507-3(a)(9), during any period in which the transferor has no assets, section 4945(d)(4) and (h) of

the Code [expenditure responsibility] shall not apply to the transferee or the transferor with respect to any "expenditure responsibility" grants made by the transferor except for information reporting requirements under section 4945 for any year in which the transferor disposes of all its assets.

Section 1.507-3(a)(8)(i) provides that except as provided in section 1.507-3(a)(8)(ii), 1.507-3(a)(6), and 1.507-3(a)(9), a transferee in a section 507(b)(2) transfer:

(a) Will not be treated as being in existence prior to January 1, 1970 with respect to any transferred grants;

(b) Will not be treated as holding the transferred assets prior to January 1, 1970; and,

(c) Will not be treated as having engaged in, or become subject to, any transaction or obligation with respect to the transferred assets prior to January 1, 1970.

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

Section 1.507-3(a)(9)(i) of the regulations provides that if a private foundation transfers all of its net assets to one or more private foundations which are effectively controlled (within the meaning of § 1.482-1(a)(3) [now redesignated as section 1.482-1A(a)(3)]), directly or indirectly, by the same person or persons which effectively controlled the transferor, for purposes of chapter 42 and sections 507 through 509, such a transferee shall be treated as if it were the transferor. However, where proportionality is appropriate, such a transferee shall be treated as if it were the transferor in the proportion which the fair market value of the assets (less encumbrances) transferred to such transferee bears to the fair market value of the assets (less encumbrances) of the transferor immediately before the transfer.

Section 1.482-1A(a)(3) of the regulations provides that the term "controlled" includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not the form or the mode of its exercise.

Section 1.507-3(a)(9)(ii) of the regulations provides that section 1.507-3(a)(9)(i) shall not apply to the requirements under sections 6033, 6056, and 6104 of the Code which must be complied with by the transferor, nor to the requirement under section 6043 that the transferor file a return with respect to its liquidation, dissolution, or termination.

Section 1.507-3(a)(9)(iii) of the regulations provides the following illustration:

Example (2). A and B are the trustees of the P charitable trust, a private foundation, and are the only substantial contributors to P. On July 1, 1973, in order to facilitate accomplishment of diverse charitable purposes, A and B create and control the R Foundation, the S Foundation and the T Foundation and transfer the net assets of P to R, S, and T. As of the end of 1973, P has an outstanding grant to Foundation W and has been required to exercise expenditure responsibility with respect to this grant under sections 4945(d)(4) and (h). Under these circumstances, R, S, and T shall each be treated as if they are P in the proportion the fair market value of the assets transferred to each bears to the fair market value of the assets of P immediately before the transfer. Since R, S, and T are treated as P, absent a specific provision for exercising expenditure responsibility with respect to the grant to W, each of them is required to exercise expenditure responsibility with respect to such grant. If, as a part of the transfer to R, P assigned, and R assumed, P's duties with respect to the expenditure responsibility grant to W, only R would be required to exercise expenditure responsibility with respect to the grant to W. Since R, S, and T are treated as P rather than as recipients of 'expenditure responsibility' grants, there are no expenditure responsibility requirements which must be exercised under sections 4945(d)(4) and (h) with respect to the transfers of assets to R, S, and T.

Section 1.507-3(a)(10) of the regulations provides that section 1.507-1(b)(9) [which requires filing under section 6033 and 6056 of the Code in the year of the transfer] applies where a private foundation has transferred all its net assets.

Section 4940 of the Code imposes a tax on the net investment income of a private foundation for each taxable year it carries on its activities.

Section 4941 of the Code imposes a tax upon any act of self-dealing between a private foundation and a disqualified person. Section 53.4946-1(a)(8) of the regulations provides that, for purposes of section 4941, a transferee is not a disqualified

person if it is an organization described in section 501(c)(3) (unless it is an organization described in section 509(a)(4)).

Section 4942(g)(1)(A) of the Code provides that the term "qualifying distribution" means any amount, including reasonable and necessary administrative expenses, paid to accomplish one or more purposes described in section 170(c)(2)(B) of the Code.

Section 4944 of the Code imposes a tax on amounts invested by a private foundation in such a manner as to jeopardize the carrying out of any of the foundation's exempt purposes.

Section 4945 of the Code imposes a tax on each "taxable expenditure" of a private foundation as defined in section 4945(d). Section 4945(d) defines a taxable expenditure to include, among other things, a grant to another organization, unless such organization is not a private foundation, or unless the donor private foundation exercises "expenditure responsibility" with respect to such grant in accordance with section 4945(h).

Section 4945(h) of the Code provides that expenditure responsibility means 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 or his delegate.

Section 53.4945-5(c)(2) of the Foundation and Similar Excise Taxes Regulations (hereafter also "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 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 two 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 4945(d)(5) of the Code states that a taxable expenditure means any amount paid or incurred by a private foundation for any purpose other than one specified in section

170(c)(2)(B). Section 53.4945-6(c)(3) of the regulations provides that a transfer of assets of a private foundation under section 507(b)(2) will not be considered used exclusively for purposes described in section 170(c)(2)(B) unless such assets are transferred to an organization described in section 501(c)(3) (other than an organization described in section 509(a)(4).

In Rev. Rul. 78-387, 1978-2 C.B. 270, a private foundation that had a carryover of excess qualifying distributions as described in section 4942(i) of the Code transferred all its assets to another private foundation that was controlled by same persons who controlled the first foundation. The Service concluded that the transferee would be treated as if it were the transferor, citing section 1.507-3(a)(9)(i), and allowed the transferee to reduce its distributable amount under section 4942(d) of the Code by such carryover.

While section 507(b)(2) of the Code, on its face, suggests that all tax characteristics of the transferor in a section 507(b)(2) transfer should carry over, proportionately, to the transferee, section 1.507-3(a)(9) of the regulations provides that effective control must exist before the transferee is treated proportionately as the transferor for purposes of Chapter 42 and sections 507-509 of the Code. Even then, the transferor must dispose of <u>all</u> net assets for the transferee to be treated proportionately as the transferor.

Effective control also determines whether there is a carryover of section 4942 excess qualifying distributions, as Rev. Rul. 78-387 indicates. There is no carryover if the transferor still has net assets, or if the transferees are not effectively controlled.

With regard to expenditure responsibility for previous grants, Example 2 of section 1.507-3(a)(9) of the regulations indicates that expenditure responsibility applies to both the transferor and the transferees where they are effectively controlled and the transferor transfers all of its net assets, unless they agree amongst themselves who will assume the expenditure responsibility. If the transfer is of less than all the net assets, then the expenditure responsibility remains with the transferor. If there is a transfer of all the assets to transferees which are not effectively controlled, section 1.507-3(a)(7) provides that neither the transferor nor the transferee need exercise expenditure responsibility (except for information reporting requirements in the year of the transfer) as long as the transferor has no assets. Example (2) also indicates that a section 507(b)(2) transfer is itself a grant to which expenditure

responsibility applies, unless there is effective control of the transferees by the transferor.

The transfer of assets by X to Z will qualify as a section 507(b)(2) transfer because X will transfer more than 25% of its assets to Z, both of which are private foundations. Because the transfer qualifies under section 507(b)(2), Z will not be treated as a newly created organization. Another effect of qualifying under section 507(b)(2) is that Z succeeds to the aggregate tax benefits of X. Because the transfer qualifies under section 507(b)(2), the transfer does not cause a termination of X's status as a private foundation. In addition, because X has not notified the Service of its intent to terminate its private foundation status and because X has not been notified of or committed any acts which could trigger an involuntary termination, the transfer will not cause the imposition of the termination tax under section 507(c) of the Code. If X later terminates its private foundation status, there will be no liability under section 507(c) because X will have no assets.

The transfer of assets by X is a donation to Z. Because it is a donation, and not an investment in Z, the assets received by Y do not constitute net investment income under section 4940(c) of the Code. Accordingly, the transfer of the assets will not be subject to tax under section 4940(a) or section 4944.

Z is exempt from federal income taxation under section 501(c)(3) of the Code. Section 501(c)(3) organizations are specifically excluded from the definition of "disqualified persons" for purposes of section 4941 of the Code. Because Z is not a disqualified person, the transfer of assets by X to Z is not an act of self-dealing. Thus, the transfer of assets is not subject to tax under section 4941.

The issue of whether X must meet its distribution requirements under section 4942 of the Code in the year in which it makes the section 507(b)(2) transfer depends on whether X and Z are effectively controlled by the same persons. Because X and Z are effectively controlled by Y, Z is treated as X for purposes of section 4942. Accordingly, Z will succeed to the distribution requirements of X. Also, the commonality of control means that Z may use any qualifying distribution carryover of X to reduce its distributable amount under section 4942 of the Code.

X will transfer all of its assets to Z, which is exempt from tax under section 501(c)(3). Because Z is a section 501(c)(3) organization, the transfer to Z does not constitute a taxable expenditure under section 4945 of the Code. Further, because X and Z are effectively controlled by the same persons, Z is

treated as X for purposes of section 4945. Consequently, X does not have to exercise expenditure responsibility with respect to the transfer of its assets.

Accordingly, we rule as follows:

1. The proposed transfer of assets is a transfer described in section 507(b)(2) of the Code.

2. The proposed transfer of assets will not adversely affect the tax-exempt status of either X or Z.

3. The proposed transfer of assets will not result in either a voluntary or termination of Z's private foundation status under section 507(a)(1) of the Code or an involuntary termination under section 507(a)(2) of the Code and will not cause the imposition of the termination tax described in section 507(c)(2) of the Code. When, after the transfer of all its assets and liabilities, X notifies the Service of its intent to terminate its status as a private foundation and should the value of X's net assets equal zero at such time as X gives such notice and terminates its private foundation status, then X will not be liable for any termination tax under section 507(c) of the Code.

4. After the proposed transfer of assets, Z will not be treated as a newly created organization for purposes of Code sections 507 and 509.

5. The proposed transfer of assets will not constitute a willful and flagrant act (or failure to act) giving rise to liability to either X or Z for under Chapter 42 of the Code.

6. The proposed transfer of assets will not constitute any act or failure to act under section 507(a)(2) of the Code.

7. The proposed transfer assets will not be treated as either gross investment income or capital gain net income under section 4940 of the Code.

8. The proposed transfer of assets will not constitute an act of self-dealing under section 4941 of the Code.

9. The proposed transfer of assets will not involve the application of section 4943 of the Code concerning excess business holdings, provided that none of the assets transferred places Z in the position of having excess business holdings.

10. The proposed transfer of assets will not be treated as a jeopardy investment under section 4944 of the Code.

11. The proposed transfer of assets will not constitute a grant within the meaning of section 4945(d)(4) of the Code as to which X would be required to exercise expenditure responsibility pursuant to section 4945(h) of the Code.

12. After the transfer of assets, Z will be treated as possessing all the attributes and characteristics of X. Specifically:

a) Z will be treated as if it were X for purposes of Chapter 42 of the Code and Code sections 507 through 509;

b) Z will succeed to the aggregate tax benefit of Z under section 507(d)(2) of the Code;

c) Any person who is a substantial contributor under section 507(d)(2)(A) of the Code with respect to X will be treated as such with respect to Z;

d) Z will take the assets of X subject to any and all liabilities of X imposed by Chapter 42 of the Code;

e) Z will report the net investment income of X for the year of transfer of assets and pay any excise tax imposed under section 4940 of the Code. Z's payment of X's tax liability will not constitute a taxable expenditure under section 4945(d)(5) of the Code;

f) X will not be required to meet the Code section 4942 distribution requirement for its taxable year in which the transfer is made or for the immediately preceding taxable year because X's distributable amount and qualifying distributions in each year are treated as Z's, provided that qualifying distributions from Z after the proposed transfer of assets satisfy X's distribution requirements for periods ending prior to, or on, the date of the transfer;

g) Z may reduce its distributable amount under section 4942(d) of the Code by X's excess qualifying distributions carryover as described in section 4942(i) of the Code;

h) For purposes of section 4940(e) of the Code, for the taxable year in which the proposed transfer of assets occurs, Z's "base period" shall include the five preceding taxable years of X, and the qualifying distributions and assets for each such year and for the year in which the Code section 4940(e) calculation is being made shall be calculated by aggregating the qualifying distributions and assets of X and Z for each year;

i) Z's satisfaction of grants awarded but not yet paid by X prior to the proposed transfer from X to Z shall not, in and of itself, constitute a Code section 4945(d) taxable expenditure by Z;

j) Z will be required to exercise expenditure responsibility under section 4945(h) of the Code with respect to any grants previously made by X that required X to exercise expenditure responsibility at the time the grant was made; X will not be required to exercise expenditure responsibility for any of its grants after the transfer of all its assets to Z;

k) Z may continue to utilize its current fiscal year and will not be required to switch to the calendar year utilized by X prior to the transfer.

These rulings are directed only to the organizations that requested them. Pursuant to section 6110(j)(3) of the Code, these rulings may not be used or cited as precedent.

Sincerely yours,

Edward K. Karcher

Edward K. Karcher
Chief, Exempt Organizations
Technical Branch 3

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