J. IRC 507 TERMINATIONS

1. Introduction

This article is designed to explain the termination provisions under IRC 507 that are applicable to private foundations. While it may not describe "everything you wanted to know", it does try to answer the basics such as: What is a termination?, Is notice to the Service of termination always required?, What rulings are available?, and finally, What problems may be encountered?

As you know, organizations exempt under IRC 501(c)(3) are classified as either public charities or private foundations. Important consequences flow from classification as a private foundation as a result of the Tax Reform Act of 1969, in particular, the imposition of additional operational requirements and the possible imposition of a variety of excise taxes under Chapter 42 of the Code.

For organizations seeking exemption under IRC 501(c)(3), therefore, it is preferable to be classified as a public charity. Such classification may be obtained through an initial ruling or determination, or an advance ruling or determination of a newly created organization upon application for recognition of exemption. Public charity classification is also available to a private foundation after it has properly terminated such status and submitted an exemption application.

For organizations that are not classified as public charities upon application, but which are classified instead as private foundations, or for organizations that either: (1) fail to continue to meet the requirements of public charity status after an initial determination, or (2) which fail to meet the requirements of public charity status after expiration of the advance ruling period, IRC 507 provides the exclusive method of termination of private foundation status.

2. Definition of Termination

The word "termination" as used in IRC 507 is a term of art. A "termination" results when the private foundation ceases to be so classified and becomes a public charity. The term has nothing whatsoever to do with the organization's legal existence (which depending on circumstances may or may not continue) under state law. Thus, a termination under IRC 507 is not a dissolution of the organization.

3. The Statutory Provision

Under IRC 507, there are four basic ways to terminate private foundation status, two of which involve the imposition of tax liability under IRC 507(c) of the Code. These four ways of terminating are: (1) a voluntary termination by notifying the Service of intention to terminate and paying the tax on net assets under IRC 507(c), (2) involuntary termination by repeated violation of the Chapter 42 provisions and becoming subject to the tax under IRC 507(c)--a rare occurrence, (3) transfer of assets to a public charity classified as such under IRC 509(a)(1) of the Code and finally (4) have the organization operate as a public charity under IRC 509(a)(1), (2), or (3) for a period of 60 months after giving appropriate notice.

The statute also encompasses a non-termination provision, where a private foundation may transfer its assets to another private foundation. The transferee private foundation literally steps into the place of the transferor with regard to meeting requirements under Chapter 42 of the Code. This is known as an IRC 507(b)(2) transfer.

4. The Tax under IRC 507(c)

The tax imposed under IRC 507(c) is substantial. The amount imposed is equal to the lower of: (1) the amount of aggregate tax benefit resulting from IRC 501(c)(3) status, which the private foundation has obtained, or (2) the value of the net assets of the foundation. Since the aggregate tax benefit will in almost all cases exceed the net assets of the private foundation, the tax is essentially a tax of the net assets of the private foundation. In Peters v. U.S., 624 F.2d 1020 (Ct. Cl. 1980), application of the termination tax based on the aggregate tax benefit was found by the court to be neither retroactive in application nor confiscatory. IRC 507(g) provides for an abatement of the tax in certain circumstances. Basically, abatement will occur where a private foundation distributes of its net assets to one or more public charities meeting certain requirements.

5. IRC 507(a)(1) - Voluntary Terminations

A. General Rule

Termination under IRC 507(a)(1) is available only if the private foundation is not subject to involuntary termination because of repeated acts (or failures to act) under Chapter 42 of the Code which give rise to taxability. There is a tax imposed under IRC 507(c) for organizations that terminate under this provision. What

triggers a voluntary termination under this provision is the requirement that the organization notify the Service that it intends a voluntary IRC 507(a)(1) termination. Surprisingly, this provision has been widely used, despite the imposition of the tax under IRC 507(c).

As previously noted, IRC 507(c) is a significant tax imposed on the assets of a private foundation. For all intents and purposes the tax would be everything that the foundation owns. What makes the use of the voluntary termination technique popular is that the organization may arrange through grants and satisfaction of liabilities to have no net assets upon which IRC 507(c) can be imposed, by the time the section is invoked.

The following ruling illustrates this technique: **(Please note that G.C.M.s and private letter rulings may not be used or cited as precedent. As reprinted the private letter ruling has been condensed and may contain typographical errors, but these do not change the substance.)**

B. <u>Example</u>

1. Private Letter Ruling 8823050

* * *

> You request a ruling that you will not be subject to any taxes or penalties under section 507 of the Internal Revenue Code nor under Chapter 42 of the Code 42 of the Code as a result of the transfer of your assets to M.
>
> Our records show that you have been recognized as exempt from federal income tax under section 501(c)(3) of the Code. You have been classified as a private foundation under section 509(a). You are organized and operated exclusively for charitable, religious, scientific, literary and educational purposes, including the encouragement of the arts, and the prevention of cruelty to children or animals within the United States or any of its territories or possessions. More specifically, funds have been used for the care of the sick, aged or helpless, to improve living conditions, and to provide recreation for all classes, and for such other charitable purposes as best tend to improve the mental, moral, and physical well-being of persons, regardless of race, color or creed.
>
> As of the end of our 1987 fiscal year, you had assets with a total fair market value of $x. Your current Board of Directors number three and includes, among others, A.

M is a non-profit organization incorporated in January, 1987. It was determined to be exempt from federal income tax as described in section 501(c)(3) of the Code and can reasonably be expected to be a publicly supported organization under section 509(a)(1) and 170(b)(1)(A)(vi) by letter dated May 7, 1987. It is organized and operated exclusively for charitable, religious, scientific, and educational purposes within the meaning of section 501(c)(3) and engages primarily in activities for the benefit of the local community, local county, among others, A. You and M have had no dealings with one another and the only person involved with both organizations is A who is on the Board of Directors for both organizations.

You propose to transfer all of your assets to M. After transferring all of your assets you will remain in existence, but do not plan to receive any further contributions, grant, or assets of any kind. You may request termination as a private foundation under section 507(a)(1) after one year and then dissolve. Your Board or Directors have determined that your tax exempt purposes could be carried out by M and there is no need for you duplicate administrative and other functions. M plans to accept this donation in order to further its exempt purposes and to continue your work. Both you and M agree that the public and community will be better served if all your assets are transferred to it.

Section 507(a) of the Code provides that except as provided in subsection (b), the status of any organization as a private foundation shall be terminated only if (1) such organization notifies the Secretary of its intent to accomplish such termination, or (2) there have been either willful repeated acts (of failure to act), giving rise to liability for tax under chapter 42, and the organization pays the tax imposed by subsection (c).

Section 507(b)(1)(A) of the Code provides that the status as a private foundation of any organization, with respect to which there have not 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, shall be terminated if such organization distribution all of its net assets to one or more organization described in section 170(b)(1)(A) (other than in clauses (vii) and (viii)) each of which has been in existence and so described for a continuous period of at least 60 calendar months immediately preceding such distribution.

Section 1.508-1(b)(7) of the Income Tax Regulations provides that neither a transfer of all of 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) unless the transferor private foundation elects to terminate pursuant

to section 501(a)(1) or section 501(a)(2) is applicable. Thus, if a private foundation transfers all of its assets to one or more persons, but less than all of its net assets to one or more organizations described in section 509(a)(1) which have been in existence and so described for a continuous period of 60 calendar months, for purposes of this paragraph such transferor foundation will not be deemed by reason of such transfer to have terminated its private foundation status under section 507(a) or (b) unless section 507(a)(2) is applicable.

* * *

You have not given notice to the Secretary that you intend to terminate, and you do not intend to terminate for at least one year. Further, you have not operated, nor been determined to have operated, in such a way as to have had willful repeated acts (or failures to act) or a willful and flagrant act giving rise to a liability for tax under Chapter 42. Therefore, you have not terminated under section 507(a) and thus, you will not be subject to the tax imposed under section 507(c). We also note that you have not terminated private foundation status under section 507(b)(1)(A) of the Code, because M, the transferee organization, has not been described in section 509(a)(1) or been in existence for a continuous period of at least sixty months immediately preceding the distribution, as required under section 1.507-1(b)(7).

The transfer of your assets to M is not an act of "self-dealing". As provided in section 53.4946-1(a)(B) of the regulations, M, an organization described in sections 501(c)(3) and 509(a)(1), is not classified as a "disqualified person". Further, although A is a member of both your Board of Directors and M's Board, as a director of M he will not have any powers greater than any other director to allocate, use or distribute the assets which are being transferred. Per section 53.4941(d)-2(f)(2) of the regulations, no act of self-dealing is involved merely because one of the section 509(a)(1) organization's directors is also a foundation manager to the foundation. Also, the transfer of all your assets is to an organization that will further your exempt purposes, and is described in section 509(a)(1), therefore, there is not taxable expenditure as described in section 4945.

Accordingly, based on the information submitted we conclude that the transfer by you of all your assets to M will not subject you to section 507(a) taxes nor will it subject you to excise taxes under Chapter 42. Further, the transfer of all your assets to M will not jeopardize your exempt status.

* * *

C. After Termination

IRC 509(c) provides generally that an organization that terminates its status as a private foundation under IRC 507 shall be treated as an organization created on the day after the date of such termination. After a voluntary termination under IRC 507(a)(1), therefore, an organization wishing to be treated as an exempt organization under IRC 501(c)(3) must apply for recognition of exemption. In accord, Reg. 1.507-1(b)(3). This requirement is of course subject to the same special rules and exceptions for other newly created organizations under section 508(a) and (c) of the Code, with regard to timely notice of application for recognition of exemption.

6. IRC 507(a)(2) Involuntary Terminations

An involuntary termination of private foundation status, with the imposition the IRC 507(c) tax, can result if there have been willful repeated acts (or failures to act), or a willful and flagrant act (or failure to act), committed by the private foundation which gives rise to tax liability under Chapter 42 of the Code. Reg. 1.507-1(c) spells out that in order for this involuntary termination to take place, the Service must give notice to the private foundation of the involuntarily termination. For the purpose of this section the term "willful repeated acts (or failure to act)" means at least TWO acts or failures to act, both of which are voluntary, conscious, and intentional. For the purposes of this section the term "willful and flagrant act (or failure to act)" means one that is voluntarily, consciously, and knowingly committed in violation of any provision of Chapter 42 (other than IRC 4940, and 4948(a)) and which appears to a reasonable man to be a gross violation of any such provision. Further an act or failure to act may take place even if it results in a tax imposed on the private foundation managers rather than upon the private foundation itself. Finally, failure to correct an act(s) or failure(s) to act may themselves be further act(s) or failure(s) to act.

The tough (to meet) standards for an involuntary termination means that few involuntary terminations under IRC 507(a)(2) will take place. In the only court case on record: George F. Harding Museum v. U.S., 674 F. Supp. 1323, (D.N.D. Ill. 1987), imposition of an IRC 507(a)(2) termination was attempted for the purposes of a jeopardy assessment; however, the court decided against such result since the organization had disposed of its entire assets in favor of an unrelated public charity

The following private letter ruling is illustrative of the interplay between the provisions of Chapter 42 which have the potential of being violated and the sanction of IRC 507(a)(2): (Please note that G.C.M.s and private letter rulings may not be used or cited as precedent. As reprinted the private letter ruling has been condensed and may contain typographical errors, but these do not change the substance.)

A. Example

1. Private Letter Ruling 8310002

ISSUES

1. Whether A, B, C and D, who were disqualified persons as to private foundation P, participated in acts of self-dealing under sections 4941(d)(1)(A) and 4941(d)(1)(E) of the Code, where organization N, which was not a private foundation, purchased art objects from A and B with some of the grant funds provided, upon the recommendation of C, by private foundation P, whose manager D was not informed by A, B or C of the possible use of P's funds for the sales that were later determined by state agency O to have been made without an adequate disclosure of the possible conflict of interest of A as to organization N.

2. Whether the acts of self-dealing, if any, were corrected within the meaning of section 4941(e)(3) of the Code during 1978.

3. Whether private foundation P's grants involved in the sales were qualifying distributions under section 4942-(g)(1)(A) of the Code.

4. Whether private foundation P's grants involved in the sales were taxable expenditures under section 4945(d)(5) of the Code.

5. Whether private foundation P's grants involved in the sales are a basis for involuntary termination of the foundation pursuant to section 507(a)(2) of the Code.

* * *

FACTS

A, B, C, and D are disqualified persons, as defined in section 4946 of the Code, as to private foundation P. The governing instrument of private foundation P provides that its settlor C may make suggestions to P's foundation manager D as to the organizations to receive grants from P.

A owned a majority of the stock of commercial corporation B whose actions in this case were controlled by A.

Organizations M and N are each recognized as exempt from federal income tax under section 501(c)(3) of the Code, are not private foundations under section 509, and have as part of their exempt purposes the collection and display of art objects for viewing by the general public.

Grant funds from private foundation P to organizations M and N were used to buy art objects from disqualified person A in 12 sales by A and in one sale by B. A had recommended to settlor C that C recommend the payment of grant funds by private foundation P to organizations M and N for their exempt purposes. A, B and C discussed possible use of some P grant funds for art acquisitions from A and B, but did not inform P's foundation manager D of the possible use of some of P's grant funds to buy art objects from A and B.

* * *

During the time of the last four sales to organization N, A was a member of the governing body of N and of the art acquisition committee of N. After the sales, state agency O, which monitors organization N for purposes of state nonprofit corporation law, issued its report indicating its belief that A, as a member of the governing body of N, had not made adequate disclosure of the possible conflict of interest involved in A's ownership of the art objects bought by N. The report did not deny that fair market value had been paid by N.

In a written settlement with A, state agency O afforded N the opportunity to void the purchases from A and B pursuant to the state law applicable to A's failure to disclose a possible conflict of interest. However, N elected to keep the art objects.

Following the action by state agency O, P's foundation manager D obtained from A, B and C full reimbursement of all of P's grant funds that had been used by M and N to purchase art objects from A and B and also obtained the payment of P's administrative costs of resolving this matter. Financial data obtained by D indicated that there was no income earned on the sales proceeds held by A and B in excess of any increase in value of the art objects held by M and N.

None of P's grants to M and N were earmarked in writing for any use involving A, B, C or D. The initial annual tax returns of P reflected the only information known to P's foundation manager D that grants had been made by P to organizations M and N for their exempt purposes. P's foundation manager D did not learn of the sales concerned until the time

when D sought correction of such transactions as possible acts of self-dealing. The transactions were then described in tax returns that were submitted by private foundation P and that provided information as to the sales and the involvement of A, B and C.

Analysis of the sales data submitted indicates that, during the time period from the first grant to the thirteenth purchase, 55% of the total dollar amount of P's grant funds to the two organizations M and N was used by M and N to purchase art objects from A and B. In regard to the one organization M, during the time period involving grants and sales to M, 85% of the total dollar amount of P's grant funds to M were used by M to purchase art objects from A. In regard to the one organization N, during the time period involving grants and sales to N, 42% of the total dollar amount of P's grants to N was used by N to buy art objects from A and B. In regard to only the time period involving the last four sales to organization N, 25% of the total dollar amount of P's grants to N was used by N to buy art objects from A and B. After the sales, P made grants that were not followed by any sales. Of the 13 sales to M and N, four sales took place in the same month that P's grants were received by the purchasing organization M or N, eight sales occurred in the next month after P's grants were received by the purchasing organization, and one sale was in the second month after a grant was received from P by the purchasing organization.

LAW

* * *

ANALYSES

1. Section 4941(d): Self-Dealing

Under section 4941(d)(1)(A) of the Code, self-dealing includes any indirect sale of property by a disqualified person to a private foundation. Under section 4941(d)(1)(E), self-dealing includes the use of the assets of a private foundation for the benefit of a disqualified person. In this case, it must also be considered whether organization N acted completely independently of disqualified persons A, B or C in deciding to use some of private foundation P's grant funds to purchase art objects from A and B who were disqualified persons as to P. The statute of limitations for tax under section 4941 of the Code has expired with respect to the sales to organization M.

Disqualified person A made it known to organization N that N might be able to acquire the art objects concerned by means of grant funds from private foundation P. A obtained the recommendation of settlor C for

a grant from P to N. However, neither A nor C informed P's foundation manager D of the possible use of some of the grant funds for sales of art objects by A and B.

With regard to all 13 sales to M and N, four sales took place in the same month that grants were received from P, eight sales occurred in the next month after grants were received from P, and one sale was in the second month after a grant was received from P. Each grant was sufficient in amount to cover the respective sale that shortly followed the grant. In regard to the last four sales to N, the last sale was in the same month that N received a grant from P and the three preceding sales were in the next month after N received the respective grants from P. Again each grant was sufficient in amount to cover the sales that followed shortly thereafter. Also, it is noted that, during the time period from the first grant to the thirteenth final sale, 55% of the total dollar amount of the grant funds paid by P to the two organizations M and N were used by M and N to purchase art objects from A and B. In regard solely to organization M during that time period, 85% of the total dollar amount of P's grants to M were used by M to purchase art objects from A. In regard solely to organization N during that time period, 42% of the total dollar amount of P's grants to N were used by N to buy art objects from A and B. In regard to the time period of the last four grants and sales involving N, 25% of the total dollar amount of P's grants to N were used by N to buy art objects from A and B. Further, it is noted that the sales produced profits over the sellers' cost bases in the art objects.

During the time period of the last four sales to organization N, A was a member of the acquisition committee of N and of the governing body of N. State agency O, which monitors compliance with the state nonprofit organization conflict of interest statute applicable to N, made an investigation of sales of art objects at N, including the sales involving A and A's company B. Significantly, the state agency reported its belief that A had not made an adequate disclosure of A's potential conflict of interest in the sales to N, considering that A was on the acquisition committee and on the governing body of N. A entered into a settlement with state agency O under which organization N was afforded full opportunity to rescind the sales to it if it elected to do so.

The circumstances just described lead us to conclude that at least organization N's last four decisions to buy art objects from A and B were not made by N in a fully informed manner completely independently of disqualified person A. Further, these circumstances, particularly the finding of state agency O that A did not make adequate disclosure to N of the possible conflict of interest in the sales, lead us to conclude that at least the last four sales to N, those as to which the statute of limitations for tax under section 4941 of the Code has not expired, were conducted in a

manner using foundation funds that constituted indirect sales of the art objects to private foundation P under section 4941(d)(1)(A) of the Code and a use of the foundation's assets for the benefit of disqualified persons A and B under section 4941(d)(1)(E). Under section 53.4941(a)-1(a)(1) of the regulations, it is immaterial that A, B or C may have had no knowledge that their sales constituted self-dealing under section 4941. Under section 53.4941(a)-1(a)(3), settlor C's significant participation in obtaining the foundation's funds while being aware of the possible use of such funds for the sales, constituted participation in the self-dealing with the other persons A and B, even if C had no knowledge that such action constituted self-dealing under section 4941. Under section 53.4941(a)-1(b)(3)(i), foundation manager D was a foundation manager who, having exercised reasonable care, did not have knowledge of sufficient facts concerning the uses of the grants to know of any self-dealing in this case.

2. Section 4941(e): Correction

Section 4941(e)(3) of the Code and section 53.4941(e)-1(c)(3)(i) of the regulations describe the requirements for correction of an act of self-dealing. In this case, organization N, pursuant to the action of state agency O, was afforded full opportunity for rescission of the sales to it, although it elected to retain the art objects purchased rather than to take rescission in cash. There is no evidence of decline in the fair market value of the art objects from the dates of the sales to the date of the opportunity for rescission of the sales. Also, the facts submitted indicate that any income derived by the disqualified persons from the sales proceeds did not exceed any increase in value derived by the foundation from the art objects. Further, it is observed that the disqualified persons have reimbursed foundation P for all 13 sales and for the administrative costs in resolving this matter. Accordingly, all self-dealing acts involved in this case were corrected within the meaning of section 4941(e)(3) of the Code and section 53.4941(e)-1(c)(3)(i) of the regulations during 1978 when rescission was afforded to N.

3. Section 4942(g)(1)(A): Qualifying Distributions

A private foundation makes a qualifying distribution under section 4942(g)(1)(A) of the Code where it makes a grant to an organization that is exempt under section 501(c)(3) and is not a private foundation to be used for such distributee organization's exempt purposes. Private foundation P's grants to organization N were in fact used to further an exempt purpose of N to improve the size of N's art collection viewed by the general public. N has also affirmed its decision to retain the art objects purchased. The fact that A, B and C were engaged in acts of self-dealing by their roles as disqualified persons in the sales does not negate the relevant fact that, for purposes of section 4942(g)(1)(A), private

foundation P did make grants to N that were used by N in a manner that in fact furthered an exempt purpose of N to increase its art collection. The self-dealing under section 4941 in the sales reflects that the persons involved were disqualified persons as to private foundation P, not that there was any failure by P to distribute its funds to exempt organizations. Therefore, in view of N's use of P's funds, P's grants to N were qualifying distributions by P under section 4942(g)(1)(A).

4. Section 4945(d)(5): Taxable Expenditures

A private foundation makes a taxable expenditure under section 4945(d) (5) of the Code where it expends its funds in a manner that is inconsistent with exempt purposes. Revenue Ruling 77-161 points out that an act of self-dealing is not a taxable expenditure if the expenditure, except for its self-dealing use by a disqualified person, is otherwise an expenditure for an exempt purpose. In this case, private foundation P's grants to organization N were used by N for N's exempt purpose of increasing N's art collection for the benefit of the viewing public, aside from the fact of the self-dealing involved in the sales. Therefore, as in Revenue Ruling 77-161, private foundation P's grants to N were not taxable expenditures under section 4945(d)(5), even with the presence of self-dealing under section 4941(d), because P's grants were in fact used for the furtherance of an exempt purpose of N.

5. Section 507(a)(2): Involuntary Termination

Section 507(a)(2) of the Code provides for the involuntary termination of a private foundation where there have been either willful repeated acts, or a willful and flagrant act, giving rise to liability for tax under Chapter 42 of the Code. In this case, the foundation manager D of private foundation P was not aware, at the time of the grants to organization N, that some of the grant funds were being used by N to purchase art objects from disqualified persons A and B. When foundation manager D learned all of the circumstances involved as a result of information obtained by state agency O, D took prompt action to obtain correction of all the transactions involved by seeking from A, B and C repayment of all P's grant funds used by M and N for the art purchases together with any subsequent appreciation on such funds in excess of the appreciation on the art objects which M and N elected to retain. Foundation manager D also obtained reimbursement of the costs incurred by private foundation P in resolving this matter. The private foundation management has otherwise consistently sought to meet the requirements of Chapter 42 of the Code to the best of its knowledge. The self-dealing acts that occurred have been corrected. There is no indication of future violations of Chapter 42. Accordingly, the facts presented are not a basis

for involuntary termination of private foundation P under section 507(a)(2).

* * *

7. IRC 507(b)(1)(A) Termination of P.F. Status by Transfer of Assets to a Public Charity

Termination under this section results when a private foundation transfers all of its net assets to one or more public charities described in IRC 170(b)(1)(A) (i through vi), and which public charities have been in existence for 60 continuous months before the distribution occurs. Like organizations terminating under IRC 507(a), there can be no willful repeated acts (or failures to act), or willful and flagrant acts (or failures to act) giving rise to liability for tax under Chapter 42. Also, since IRC 507(a) does not apply to such termination, a private foundation which makes such a termination is not required to give the notification described in IRC 507(a)(1). Further, since a private foundation terminating under IRC 507(b)(1)(A) does not incur tax under section 507(c), there is no abatement of such tax required under IRC 507(g).

Rev. Rul. 74-490, 1974-2 C.B. 171, provides that, like termination under IRC 507(a)(1), an organization terminating under section 507(b)(1)(A) surrenders its exempt status. Thereafter, it must re-apply for tax-exempt status and comply with IRC 508(a) and (b), to the extent applicable. The terminating private foundation remains subject to the private foundation rules and Chapter 42 taxes until the actual distribution of assets to the public charity, pursuant to Reg. 1.507-2(a)(4). According to the instructions for Form 990-PF, and pursuant to IRC 6043(b), for a private foundation terminating its status under IRC 507(b)(1)-(A), the private foundation must file Form 990-PF, and indicate in the box on page one thereof, that it is terminating its private foundation status under IRC 507(b)(1)(A).

A private foundation will meet the requirements of IRC 507(b)(1)(A), only if it distributes all of its net assets. Reg. 1.507-2(a)(7) states that a private foundation will distribute all of its net assets only if it transfers all of its right, title, and interest in and to all of its net assets to one or more organizations referred to in IRC 507(b)(1)(A). In effect this means that the transferor may not impose any material restrictions or conditions that prevent the transferee public charity from using the assets and/or the income therefrom in furtherance of its tax-exempt purposes. Whether a material restriction has been imposed is a facts and circumstances determination, however, several factors to be considered are set

forth in Reg. 1.507-2(a)(8). Practically an IRC 507(b)(1)(A) terminating private foundation must (1) satisfy its outstanding liabilities, including any federal taxes such as the IRC 4940 excise tax; and (2) distribute any remaining assets to qualified organizations.

8. IRC 507(b)(1)(B) - Termination of Private Foundation Status by Operation as a Public Charity

A. General Rules

IRC 507(b)(1)(B) is the most common way of terminating private foundation status where the organization will continue in existence. Under IRC 507(b)(1)(B), there are four basic requirements to be met in order for the private foundation to convert itself into a public charity. These four basic steps are: (1) the organization has not been involved in willful repeated acts (or failures to act), or a willful and flagrant act (or failure to act) which gives rise to tax liability under Chapter 42 of the Code, (2) the organization meets the applicable requirements of IRC 509(a)(1), (2), or (3) of the Code for a continuous period of 60 calendar months (a prior transitional period of 12 months is no longer applicable by its own terms), (3) the organization notifies its key District Director (the Secretary's delegate), before the start of the 60-month period that it is terminating its private foundation status, and (4) the organization within 90 days from the end of the applicable 60-month period furnishes the key District Director with information to allow an appropriate determination that the organization has met the requirements of section 509(a)(1), (2), or (3).

The 60-month advance ruling issued under IRC 507(b)(1)(B) to the organization seeking to terminate is discretionary with the Service. The requesting organization may file a consent under IRC 6501(c)(4) to extend the statute of limitations for the collection or assessment of tax under IRC 4940 for all taxable years in the 60-month period. The consent is required to be attached to Form 990-PF. Otherwise, the organization must pay the IRC 4940 tax during the 60-month period. A claim for refund may be filed upon successful completion of the 60-month IRC 507(b)(1)(B) termination.

In order to obtain the discretionary 60-month ruling, the organization must supply certain information. The informational requirements are set forth in Reg. 1.507-2(b)(1)(ii). Essentially these requirements are the same as required of a new organization attempting to obtain an advance ruling as to its public charity status upon initial application, plus the following: (1) notice of its intent to terminate its

private foundation status, (2) whether the 60-month period applies (and it is, therefore, a 60-month termination), and (3) the date its termination period begins.

An organization may have to change its organizational structure, operations (including accounting period), sources of support, or any combination thereof in order to meet the requirements for successful termination under this section. Successful termination occurs only when the final informational requirements are met at the end of the 60-month period.

Assuming that an advance ruling is issued, Reg. 1.507-2(e)(3) provides that grantors and contributors may rely on an advance ruling (with certain exceptions). The organization itself cannot rely on the ruling and must successfully complete the 60-month termination period.

A. Example

The following is an exemplar letter pertaining to a 60-month private foundation termination under IRC 507(b)(1)(B):

Dear Applicant:

This refers to your request for an advance ruling pursuant to section 1.507-2(e)(1) of the Income Tax Regulations pertaining to your proposed termination of private foundation status pursuant to the provisions of section 507(b)(1)(B) of the Internal Revenue Code.

You have filed an appropriate consent under section 6501(c)(4) of the Internal Revenue Code to extend the period of limitation of assessment of tax due under section 4940 of the Code.

You have notified your key District Director that you will begin a 60-month termination of your private foundation status on (date). Beginning on this date, and for a continuous 60-month period thereafter your will operate as a non-private foundation as described in section [170(b)(1)(A)(i through vi), 509(a)(2), 509(a)(3)] of the Internal Revenue Code. To do this you state that you will operate in the manner specified below.

[ADD FACT PARAGRAPHS]

Based upon the information submitted, it is concluded that you can reasonably be expected to terminate your private foundation status and become a [public charity or supporting organization]. However, in order to comply with the requirements under section 507(b)(1)(A)(iii) of the Code, you must file within 90 days after the expiration of the 60-month period such information with the District Director as is necessary to make a final determination as to your status under section [170(b)(1)(A)(i through vi), 509(a)(2), 509(a)(3)] of the Internal Revenue Code.

Pursuant to section 1.507-2(e)(3) of the Income Tax Regulations, for the purposes of sections 170, 545(b)(2), 556(b)(2), 642(c), 4942, 4945, 2055, 2106(a), and 2522, grants or contributions to you, as an organization which has obtained this ruling, will be treated as made to an organization described in section 509(a)(1), (2), or (3), as the case may be until notice that such advance ruling is being revoked is made to the public (such as publication in the Internal Revenue Bulletin). The preceding sentence shall not apply, however, if the grantor or contributor was responsible for, or aware of, the act or failure to act that resulted in your failure to meet the requirements of section [170(b)(1)(A)(i through vi), 509(a)(2), 509(a)(3)] of the Internal Revenue Code, or acquired knowledge that the Internal Revenue Service had given notice to you that your advance ruling would be revoked.

Please be advised that prior to making any grant or contribution which allegedly will not result in the grantee's failure to meet the requirements of section 509(a)(1), (2), or (3), you, the potential grantee organization, may request a ruling whether such grant or contribution may be made without failure. You may file such request with your key District Director and the grantor may rely upon such favorable ruling, if issued, for the purposes of sections 170, 545(b)(2), 556(b)(2), 642(c), 4942, 4945, 2055, 2106(a), and 2522. The issuance of such a ruling will be at the sole discretion of the Commissioner.

Pursuant to the provisions of section 1.507-2(e)(4) of the Income Tax Regulations, you cannot rely on this ruling. Consequently if you do not pay the tax imposed by section 4940 of the Code for any taxable year or years during the 60-month period, and it is subsequently determined that such tax is due for such year or years

(because you did not in fact complete a successful termination pursuant to section 507(b)(1)(B) and were not treated as an organization described in section [170(b)(1)(A)(i through vi), 509(a)(2), 509(a)(3)] of the Internal Revenue Code, for such year or years, you are liable for interest in accordance with section 6601 for any amount of tax under section 4040 which has not been paid on or before the last date prescribed for payment. However, since any failure to pay such tax during the 60-month period (or period prior to the revocation of this ruling) is due to reasonable cause, the penalty under section 6651 with respect to the tax imposed by section 4040 shall not apply.

Even though you are treated as a non-private foundation for some purposes, pursuant to sections 6033 and 6056 of the Internal Revenue Code you are still required to file annual return 990-PF. Page 1 of Form 990-PF has a block to indicate that you are in the process of terminating your private foundation status. You should attach a copy of this ruling to each 990-PF you file during the 60-month period of your termination.

In the event you supply your key District Director within 90 days from the end of your termination period with information that shows the termination was effective, then you should file Form 990 for the final year of the termination period. This applies even if the key District Director has not yet affirmed that you have appropriately terminated your private foundation status by the time the return for the final year of termination is due.

B. Procedures

Either the District Office or the National Office may issue such a letter. <u>Notification however, must be made at the key District level in order to comply with the statutory notice requirement</u> (Reg. 1.507-2(b)(1)(ii). On the other hand, some types of transactions related to the termination would be proposed transactions handled only by the National Office. Regardless of where the letter is issued, the key District should maintain a follow-up file in order to make sure the information required at the end of the 60-month period is supplied and the organization has had an opportunity to successfully terminate its private foundation status through operation as a public charity.

A private foundation wishing to begin a 60-month termination immediately need not wait until the end of its taxable year but may change its accounting period in order to start a 60-month period. See Rev. Rul. 77-113, 1977-1 C.B. 151.

In determining whether the organization has met the requirements for a successful "60-month" termination, as a public charity, its aggregate sources of support are considered. Failure to meet the requirements on an aggregate basis means that the organization retains its private foundation status. In the event it did fail to successfully terminate, for those years individually within the 60-month period for which it met the applicable requirements for public charity status, the private foundation would be considered a public charity.

Public charity status as a supporting organization under IRC 509(a)(3) is also possible under this provision. In such cases a 60-month "advance" IRC 509(a)(3) ruling may be issued. See Rev. Rul. 78-386, 1978-2 C.B. 179.

During the 60-month termination period, the terminating private foundation must complete Form 990-PF indicating thereon on page one that it is terminating its private foundation status. See: IRC 6033(c)(1) and IRC 6043(b). In the final year, assuming it has furnished information which indicates it has successfully completed the 60-month termination, Form 990 may be filed for the type of Non-private foundation it has become.

9. IRC 507(b)(2) Transfers from Private Foundation to Private Foundation

IRC 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.

Thus, by its terms, IRC 507(b)(2) of the Internal Revenue Code deals with a transfer of assets from one private foundation to a second private foundation and the treatment and characteristics of those assets in the hands of the transferee private foundation. Basically, where a valid IRC 507(b)(2) transfer has occurred, the tax attributes and characteristics of those assets carry over to the transferee.

The IRC 507(b)(2) transfer does NOT constitute a termination of the transferor organization's private foundation status. It is included in our discussion

here, however, because it is considered part of the statutory scheme of IRC 507 of the Code.

The terminology "other adjustment, organization, or reorganization" includes any partial liquidation or any other significant disposition of assets of the transferor private foundation to one or more private foundations, other than transfers for full and adequate consideration or distributions out of current income. Two examples of this are: (1) where a private foundation disposes of a substantial portion of its assets to another private foundation in order to effectuate separation of family interests or activities, or (2) where a private foundation reincorporates in a another state (Rev. Rul. 67-390, 1967-2 C.B. 179).

The term "significant disposition" must also be defined. Reg. 1.507-3(c)(2) provides a definition. A "significant disposition" has occurred where a transaction or series of related transactions has taken place with one or more transferee private foundations, over one or more taxable years, which transactions have resulted in the transfer of more than 25% of the fair market value of the net assets of the transferor private foundation. Further, the determination of whether a "significant disposition" has occurred through a series of related distributions will be made on the basis of the facts and circumstances of the particular case.

The IRC 507(b)(2) transfer is specifically not a voluntary relinquishment of private foundation status under IRC 507(a)(1) of the Code, unless notice of intent to terminate is given. Reg. 1.507-3(d). Conceivably, however, the transfer could be an act or failure to act giving rise to involuntary termination under IRC 507(a)(2) of the Code.

The transfer of assets pursuant to IRC 507(b)(1)(A) may result in a IRC 507(b)(2) transfer, if the transferee organizations lose their public charity status. Reg. 1.507-3(e). Otherwise, if public charity status is maintained (as a result of successful termination), transfers during the "60-month advance ruling period" shall not be treated as IRC 507(b)(2) transfers. Reg. 1.507-3(f).

Assuming a successful IRC 507(b)(2) transfer, the transferee private foundation(s) will, pursuant to Reg. 1.507-3(a)(2), and (c), succeed to all of the "aggregate tax benefit" of the transferor private foundation.

A question remains as to what extent the transferor private foundation must exercise "expenditure responsibility". Expenditure responsibility is defined in IRC 4945(h). Generally, in the context of IRC 507, the provision requires that the

transferor private foundation assure that the "grant" to the transferee private foundation be used for the purpose for which made and that reports be obtained showing how the funds were spent. The issue is a significant one. The tax imposed by failure to exercise expenditure responsibility is very harsh. See: Gladney v. Commissioner, 745 F.2d 955 (Fifth Cir. 1984), cert. den. 474 U.S. 923 (1985).

A. Examples

Two ruling letters set forth the kinds of rulings available under IRC 507(b)(2) and exemplify the apparent conflicts in the area: **(Please note that G.C.M.s and private letter rulings may not be used or cited as precedent. As reprinted the private letter ruling have been condensed and may contain typographical errors, but these do not change their substance.**

(1) Private Letter Ruling 8817045

* * *

> This is in reference to your ruling request of October 8, 1987, with respect to the proposed transfer of assets of X to a proposed new not-for-profit corporation, upon its recognition of exemption from federal income tax under section 501(c)(3) and classification as a private foundation.
>
> X has been recognized as exempt from federal income tax under section 501(c)(3) of the Code and is classified as a private foundation.
>
> Y is a member of the Board of Directors and is the person primarily responsible for the funding of the foundation in past years; Z, the former spouse of Y, was until recently also a Director of X. In recent years Y and Z have experienced significant differences of opinions concerning the foundation's management and future activities, in particular, the contribution policy.
>
> Pursuant to an agreement in settlement of a suit brought by Z against X the parties agreed that Z would resign as a director and create a new foundation of which she will be a director. The new entity will promptly apply for recognition of exemption under section 501(c)(3) of the Code. Thereafter, X will transfer a sum which will not constitute less than 25% of X's net assets as of the date of the transfer. The completion of the transfer is subject to receipt of favorable rulings from the Internal Revenue Service and the appropriate State authorities.

* * *

The proposed transaction involves a transfer of at least 25% of the assets of X. Thus, the transaction will result in a significant disposition of assets within the meaning of section 1.507-3(c)(1) of the Income Tax Regulations. Accordingly, consistent with section 507(b)(2) and the regulations promulgated thereunder, the proposed transaction will not result in a change in X's tax status. Since no termination has taken place the tax imposed by Code Section 507(c) does not apply. You have agreed with our determination that the proposed transfer will not be a taxable expenditure under section 4945(d)(4) of the code provided that X exercises expenditure responsibility to the extent required by section 53.4945-5(c)(2) of the foundation and other excise tax regulations. Furthermore, since the transaction constitutes an "adjustment, organization, or reorganization" within the meaning of sections 1.507-3(c)(1) and (2), the new entity shall not be treated as a newly created organization.

Accordingly, the transfer will not result in the imposition of additional tax under section 4940 or result in the imposition of tax under section 4944. Furthermore, since the proposed transaction is a transfer of assets from X to the new entity, neither of which is a disqualified person with respect to the other, the proposed transaction does not constitute an act of self-dealing. Finally, the payment of reasonable expenses with respect to this ruling request and implementation of the transfer is a reasonable expense consistent with your purposes and does not constitute a taxable expenditure.

Based on the information provided and assuming that X and the entity to be created continue to be recognized as exempt and are classified as private foundations, we conclude that:

a) The proposed transaction will not result in a termination of the transferor foundation status pursuant to Section 507 and is a transfer described in 507(b)(2).

b) The proposed transfer will not result in X being subject to any tax under Section 507(c).

c) The proposed transfer will not constitute any act of self dealing under Section 4941 with respect to X, the new entities and their respective disqualified persons (including Y and Z).

d) The proposed transfer will not give rise to net investment income for either X or the new entity and will not result in the imposition of additional tax under Section 4940.

e) The proposed transfer will not constitute a jeopardy investment under Section 4944.

f) The proposed transaction will not be a taxable expenditure under Section 4945(d)(4) of the Code provided that the transfer or exercise expenditure responsibility to the extent required by Section 53.4945-5(c)(2) of the foundation and other excise tax regulations.

g) The legal, accounting and other expenses incurred by the Foundation in obtaining this ruling request will not constitute taxable expenditures pursuant to Section 4945 and will be considered qualifying distributions under Section 4942.

* * *

A second ruling reaches a different result, however:

(2) Private Letter Ruling 8813073

* * *

This is in response to your letter of August 20, 1987, requesting certain rulings with respect to the proposed transfer of all the net assets of M to N and O.

M is a charitable trust which was established by seven identified individuals on November 19, 1959. The Trustee is P, a bank located in the same city in which M is domiciled. M has been recognized by the IRS as exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code and as a private foundation under Code section 509(a).

N was incorporated under the nonprofit statute of the state of Q on September 19, 1986. N has been determined by the IRS to be tax exempt under section 501(c)(3) of the Code and a private foundation under section 509(a).

O was incorporated under the nonprofit statute of the state of Q on October 13, 1986. O has also been recognized by the IRS as tax exempt under Code section 501(c)(3) and as a private foundation under section 509(a).

The Trustee, P, desires to transfer all of the assets of M to N and O for several reasons. One reason is that Q law, by which M, N, and O are

all governed, clearly defines the rules concerning officers' and directors' duties and internal governance of corporations by statute. In contrast, Q statutes governing trust administration are less comprehensive and the case law less developed. You maintain that, "conducting the exempt functions of the organization in corporate form would thus allow for greater certainty of proper administration."

In addition, you inform us that under Q law, the charter and bylaws which govern the internal affairs of a corporation are more easily amended than an irrevocable trust agreement, which can be amended by the trustees only to the extent that such a right is conferred by the instrument. Otherwise, amendment of even administrative provisions requires court approval. Also, under Q law, a charitable corporation need not file reports with the court clerk, "whereas the better interpretation of the relevant (Q) statute seems to require such reports on the part of a trust, and it is clear that the Clerk could insist that a trust file such reports."

The Trust Indenture gives the Trustee, P, the authority to manage and administer trust assets; however, distributions are to be made pursuant to the directions of the Advisory Committee of M. Both N and O have entered into custodianship agreements which provide that P will receive and hold assets, collect and remit income, furnish periodic accountings, prepare tax returns and act according to the entity's instructions. After the distribution of M's assets to N and O, P will be responsible for managing the assets of two organizations, instead of three, thereby lowering administrative expenses and reducing duplication of effort.

The final reason given for the proposed transfer of assets is that in view of possible differences in the long-term charitable goals of the individual donors of the Trust, the distribution of M's assets to separate foundations (N and O) will facilitate the achievement of the charitable goals of each of the major donors to M.

M, N and O have all been formed to operate exclusively for charitable, educational, religious and scientific purposes within the meaning of section 501(c)(3) of the Code. All three entities are grant-making foundations which provide financial support to public charities selected by their governing bodies. M is managed and administered by P, but the distribution of its assets is made pursuant to the directions of the three-person, self-perpetuating Advisory Committee, presently consisting of A, B, and C.

N is governed by a self-perpetuating Board of Directors. The current Directors are A, B, and D. The Bylaws of N require that the number of Directors shall be no less than three and no more than five.

The affairs of O are managed by a self-perpetuating Board of Directors currently consisting of A, B, and C. The Bylaws of O provide that the number of Directors must be at least three but no more than five during the lifetime of A, but that upon his death the number of Directors shall be at least five and no more than eleven. The Bylaws require that at all times at least one lineal descendant of A must be serving as a Director of O.

The Trustee, P, has the authority to encroach upon the corpus of the trust property at any time to carry out the charitable purpose of M, even to the extent of complete exhaustion of Trust corpus. M will terminate fifteen (15) years after the date of the last contribution to it. Upon termination, the Trust instrument suggests a preference on the part of the original donors that any remaining trust assets be distributed to R, a College in O. However, any section 501(c)(3) organization is a permissible distributee of M, even upon its termination.

Both N and O have a perpetual existence, but may be terminated by their Directors. In the event of termination, the charters of both foundations assure that remaining assets shall be distributed to further exempt purposes under section 501(c)(3) of the Code. The Charter of O provides that if the Directors fail to select a distributee of the assets, then remaining assets shall be distributed to R, assuming it is still tax exempt under section 501(c)(3). Otherwise, the assets shall be distributed to federal, state and local governments to be used exclusively for public purposes.

A appears to be a substantial contributor to M. He is also the only substantial contributor to O. B and D are substantial contributors to N.

M currently holds assets with an approximate net value of $ 230x. M also had an excess distribution carryover of approximately $ 27x as of December 31, 1986. M proposes to transfer 50% of its net assets to N and the remaining 50% of its net assets to O. After the proposed transfer, M will not accept further charitable contributions or engage in further activities. At least one day after the transfer of its assets, M will undergo a voluntary termination by notifying IRS, in the prescribed time and manner, that M intends to terminate its private foundation status under Code section 507(a)(1). At the time such notification of termination is made, the value of the net assets of M will be zero.

The transfer of assets from M to N and O will be without consideration. N and O will assume all of the liabilities and obligations of M at the time of transfer. Both foundations will continue to carry on the tax exempt purposes and activities of M. You contend that the continuation of the purposes of M "through operation in corporate form

will allow for greater efficiency, flexibility, and convenience in achieving the Trust's charitable goals."

At the time of the proposed transfer of its assets, M will have committed no willful repeated acts or failure to act which would give rise to liability for tax under Chapter 42.

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.

The meaning of the terms "liquidation, merger, reorganization, redemption, and recapitalization" is determined by the law of the State in which the private foundation was incorporated or otherwise formed.

Section 1.507-3(c)(1) of the Income Tax Regulations provides in part that "for purposes of section 507(b)(2), 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. For purposes of this paragraph, a distribution out of current income shall include any distribution described in section 4942(h)(1)(A) and (B)."

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

Inasmuch as M proposes to transfer 100% of its assets to two private foundations, a significant disposition of assets will clearly occur and the transfer will qualify as an "other adjustment" under Code section 507(b)(2).

Section 507(a) of the Code provides that, except as provided in section 507(b), a private foundation can terminate its private foundation status only if it notifies the Service of its intent to terminate (voluntary termination) or it commits willful repeated acts (or failures to act) or a willful and flagrant act (or failure to act) giving rise to liability under Chapter 42 and is notified that it is liable for the termination tax imposed under section 507(c) and the foundation pays the tax imposed by section 507(c) or such tax is abated.

Section 1.507-3(d) of the regulations states that unless a private foundation gives notice pursuant to section 507(a)(1), 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). Such transfer must, nevertheless, satisfy the requirements of any pertinent provisions of Chapter 42.

The tax imposed under section 507(c) of the Code is only applicable to terminations of private foundation status as described in sections 507(a)(1) and 507(a)(2).

Because the proposed transfer by M is a section 507(b)(2) transfer, no voluntary termination of the private foundation will be deemed to have occurred. Further, at the time of the proposed transfer, M will have committed no willful repeated acts of failures to act or a willful and flagrant act giving rise to liability under Chapter 42 of the Code. Accordingly, the termination tax under Code section 507(c) is not herein applicable.

Section 1.507-3(a)(1) of the regulations provides that a section 507(b)(2) transfer results in a carryover of certain tax attributes and characteristics of the transferor organization to the transferee foundation.

Section 1.507-3(a)(2) provides that a transferee private foundation succeeds to that part of the transferor's "aggregate tax benefit" (defined in section 1.507-5) that is attributable to the assets transferred, based on the transferor's assets held just before the transfer. However, the fair market value of assets held and transferred is determined at the time of transfer.

Under section 1.507-3(a)(3), a substantial contributor to the transferor foundation shall also be treated as a substantial contributor with respect to all transferee foundations regardless of whether such a person meets the $ 5,000-2% test with respect to any of the transferee foundations at any time. Thus, a transferee foundation that has acquired a "substantial contributor" by reason of a section 507(b)(2) transfer will be affected by the rules under section 4941 (self-dealing), section 4942 (income distributions), and section 4943 (excess business holdings) that relate to a private foundation and its "disqualified persons".

Under section 1.507-3(a)(4), a transferor foundation cannot prevent the use of its assets for the payment of Chapter 42 tax liabilities by transferring such assets to another private foundation. In such a case the assets are subject to, in the hands of the transferee, any liability incurred by the transferor either prior to or as a result of the transfer, to the extent that the transferor foundation does not satisfy the liability.

Section 1.507-3(a)(9) 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 section 1.482-1(a)(3)), directly or indirectly, by the same person or persons which effectively controlled the transferor private foundation, then for purposes of Chapter 42 (section 4940 et seq.) and part II of subchapter F of Chapter 1 of the Code (sections 507 through 509), such a transferee private foundation shall be treated as if it were the transferor. Further, when there is a transfer to more than one foundation, there is to be proportionality based upon the net value of the assets transferred to each. Thus, the transferee foundations will share proportionately in the benefits or advantages previously held by the transferor foundation and will assume proportionately the obligations and responsibilities of the transferor.

Inasmuch as O is effectively controlled by a three-member board consisting of the same three individuals who compose M's Advisory Committee, and because the governing boards of M and O can control the selection of future board members, both organizations are effectively controlled by the same persons. Two of the three individuals who are members of M's Advisory Committee are also members of the three-member Board of Directors of N. In similar situations, the Service has ruled that effective control exists between two organizations.

Because M and the two foundations, N and O, are effectively controlled by the same individuals, each foundation should succeed to its pro rata share of the aggregate tax benefit of M (without any limitation as to the fair market value of the assets).

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 (other than public charities described in sections 509(a)(1), (2), (3)) unless the private foundation exercises expenditure responsibility with respect to such grant in accordance with section 4945(h). The exercise of expenditure responsibility requires that the foundation which makes the transfer keep detailed records of the way the payment is spent by the recipient foundation. An exception is found in section 1.507-3(a)(9) of the regulations, cited above, relating to a transfer of all net assets between private foundations effectively controlled by the same persons. In this situation, each transferee foundation, for purposes of section 4945, will be treated as if it were the transferor in the proportion which the fair market value of the assets transferred to such transferee bears to the fair market value of the assets of the transferor immediately before the transfer.

With respect to the present ruling request, each transferee foundation will be treated as the transferor would have been treated with

respect to all of the assets transferred to it. There will be no deemed "receipt" of the transferred assets and thus, no expenditure responsibility requirements must be met by M with respect to the transfer.

Section 1.507-3(a)(7) of the regulations states that a private foundation that has disposed of all of its assets need not comply with the "expenditure responsibility" rules of Code sections 4945(d)(4) and (h) while it has no assets. The exception does not apply to information reporting requirements imposed by section 4945 and the regulations thereunder for the year in which the transfer is made.

N and O will be treated as if they were the transferors (M) with respect to any previous grants by M, and the foundations, rather than M, will be obligated to exercise expenditure responsibility as to any outstanding grants based on the proportionate fair market value of assets received.

Section 1.507-3(a)(5) of the regulations states that except as provided in subparagraph (9), a private foundation is required to meet the distribution requirements of section 4942 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. A private foundation will not have to satisfy the distribution requirements if the transfer qualifies under section 1.507-3(a)(9) as a transfer of all of its net assets to one or more private foundations effectively controlled by the same persons. As indicated above, the transfer of assets from M to N and O comes within the criteria of section 1.507-3(a)(9).

Under Code section 4942(i), an excess qualifying distribution is a distribution of either undistributed income or corpus with respect to a taxable year beginning after December 31, 1969, that exceeds the distributable amount for that taxable year. Section 4942(i) and section 53.4942(a)-3(e) of the regulations further provide that if a private foundation makes excess qualifying distributions in any taxable year in which it is subject to the initial tax under Code section 4942(a), then the excess distribution may be used to reduce distributable amounts in any taxable year of the adjustment period - the five taxable years immediately following the taxable years in which the excess distribution occurred.

In Rev. Rul. 78-387, 1978-2 C.B. 270, a private foundation that had a carryover of excess qualifying distributions as described in Code section 4942(i) transferred all its assets to another private foundation that was controlled by the same persons who controlled the first foundation. Held, the transferee foundation may reduce its distributable amount under section 4942(d) by such carryover. The holding is based on the provisions of section 1.507-3(a)(9) of the regulations.

When a transferor private foundation transfers all of its assets to more than one transferee, each transferee may, for purposes of determining its respective distribution requirement under section 4942, reduce its respective distributable amount by its pro rata share of the transferor's excess qualifying distribution carryover, if any, determined as of the end of the taxable year immediately preceding the taxable year of the transferee.

Section 4941 imposes an excise tax on each act of self-dealing between a disqualified person and a private foundation. Code section 4946(a)(1) defines the term "disqualified person" to include, with respect to a private foundation, a person who is a substantial contributor or who is a foundation manager (defined in section 4946(b) as an officer, director, or trustee). Section 4941(d)(1)(E) of the Code provides that the term "self-dealing" includes 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 53.4941(d)-2(f)(2) of the regulations states that the fact that a disqualified person receives an incidental or tenuous benefit from the use by a foundation of its income or assets will not, by itself, make such use an act of self-dealing. Thus, the public recognition a person may receive, arising from the charitable activities of a private foundation to which such person is a substantial contributor, does not in itself result in an act of self-dealing since generally the benefit is incidental and tenuous. For example, a grant by a private foundation to a section 509(a)(1), (2), or (3) organization will not be an act of self-dealing merely because one of the recipient organization's officers, directors, or trustees is also a manager of or a substantial contributor to the foundation.

Pursuant to the above cited regulations, the mere fact that A or others may be substantial contributors to M, N, and O should not mean that the transfer will constitute self-dealing. Similarly, the fact that three members of M's Advisory Committee are also members of the Board of Directors of one or both foundations does not mean that the transfer should be considered self-dealing under Code section 4941.

A section 507(b)(2) transfer of assets will not constitute a section 507(a)(1) voluntary termination unless the private foundation voluntarily gives notice of termination. If M gives proper notice of termination at least one day after all of the net assets of M are transferred to foundations N and O, a section 507(a) termination will occur. Section 507(c) imposes a tax on any organization terminated under section 507(a). The tax is equal to the lower of the aggregate tax benefit or the value of the net assets of the organization which terminates its private foundation status. Section 507(e) defines "the value of the net assets" as the value determined at whichever time such value is higher: (1) the first day on which action is

taken by the organization which culminates in its ceasing to be a private foundation, or (2) the date on which the organization ceases to be a private foundation. Pursuant to section 1.507-7(b)(1) of the regulations, the date referred to under (1) above shall be the date on which M gives notice of termination under section 507(a)(1).

If M has no assets on the date it gives notice of termination and on the date it ceases to be a private foundation, then the net value of the assets will equal zero. In such instance, the amount of the termination tax to be imposed will also equal zero. See Code sections 507(c) and 507(e) above.

Based on the application of the above principles to the facts presented in your ruling request, we rule as follows:

(1) The transfer of all the net assets of M to N and O will constitute an adjustment described in section 507(b)(2) of the Code; therefore, N and O will not be treated as newly created organizations.

(2) The proposed transfer of all the net assets of M to N and O will not terminate the status of M as a private foundation under section 507(a) of the Code, and therefore will not result in the imposition of the termination tax under section 507(c).

(3) The proposed transfer will not constitute a willful and flagrant act (or failure to act) giving rise to liability for tax under Chapter 42 of the Code.

(4) N and O are effectively controlled (within the meaning of section 1.482-1(a)(3) of the regulations) by the same persons who effectively control M; thus, for purposes of Chapter 42 and part II of subchapter F of Chapter 1 of the Code, each transferee foundation will be treated as if it were the transferor (M).

(5) The proposed transfer of assets to N and O will not be a taxable expenditure of M under section 4945 of the Code and M will not be required to exercise expenditure responsibility or to comply with the information reporting requirements of section 4945, either in the year of the transfer or in any subsequent year, with respect to the transfer to N and O. These foundations will have expenditure responsibility for previously made outstanding grants of M.

(6) M will not be required for any taxable year subsequent to any termination of its private foundation status under section 507(a)(1) of the Code to comply with the periodic reporting, return and notice provisions of sections 6033 and 6104(b).

(7) Code section 4942 applies to N and O in the year of the transfer as if they were M and, therefore, the foundations will succeed to M's distribution requirements for the taxable year of the transfer. Each foundation's distributable amount for the taxable year in which the transfer occurs will be increased by the foundation's pro rata share of M's distributable amount for the year of transfer and all qualifying distributions made by M in the year of the transfer will be treated on a pro rata basis as having been made by the foundations. Each foundation will be responsible for reporting its respective pro rata share of all undistributed income determined under section 4942 for the year of the transfer.

(8) The foundations, N and O, may, for purposes of determining their respective distribution requirements under section 4942, reduce their respective distributable amounts by their ratable shares of M's excess qualifying distribution carryover, if any, determined as of the end of the taxable year immediately preceding the taxable year of the transfer.

(9) The transfer of M's assets to N and O will not give rise to net investment income for M or for either foundation and, therefore, will not result in the imposition of additional tax under Code section 4940 on M or the foundations.

(10) The transfer will not constitute an act of self-dealing with respect to M or to either of the foundations under Code section 4941.

(11) Should M properly notify the Service, at least one day after all of the net assets of M are transferred to the foundations, that M intends to terminate its private foundation status, then such notice will be effective to terminate the private foundation status of M under section 507(a)(1).

(12) Should the value of the net assets of M equal zero at such time as M gives the above notice and terminates its private foundation status, then M will not be liable for any termination tax under Code section 507(c).

* * *

C. Discussion

Reg. 1.507-3(a)(7) would seem to suggest that where the transferor private foundation has disposed of all of its assets then neither it nor its transferee needs to exercise expenditure responsibility for the amounts transferred. In fact, where there is a complete disposition of assets by the transferor private foundation, then

expenditure responsibility need not be exercised by the transferor foundation, except with regard to information (reporting) requirements in the year of transfer. The transferee private foundation is, of course, subject to the normal rules of expenditure responsibility under IRC 4945(h) of the Code. The complete transfer of assets situation is set forth in PLR 8813073, shown above.

For the partial transfer of assets situation, there is a different result. In the partial transfer of assets situation, the transferor private foundation must exercise expenditure responsibility for all periods in which any portion of the transferred assets remain. The partial transfer of assets situation is set forth in PLR 8817045, shown above. Where the transferor private foundation later goes out of existence, with one or many transferee private foundations still in possession of transferred assets, the result is less clear, but from a practical standpoint, if the transferor private foundation has properly terminated, then no expenditure responsibility can be exercised.

10. Conclusion

The rules permit a terminating private foundation to make a disposition of its assets in several ways without incurring tax liability; however, they are precisely drawn so that assets are not lost to charity and the Internal Revenue Service can monitor events.