



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

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SE:T:EO:RA:T1

Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

UIL 4942.03-05

Legend:

B =

C =

D =

E =

F =

G =

H =

I =

J =

K =

L =

M =

year x =

year y =

Dear _____ :

This is in response to your request for a ruling regarding the proposed transfer of property from B to C.

FACTS:

B is exempt as an organization described in section 501(c)(3) of the Internal Revenue Code, and classified as a private non-operating foundation within the meaning of section 509(a). B's primary activity is grantmaking for the support and implementation of research programs and conservation activities.

C is exempt as an organization described in section 501(c)(3) of the Code, and classified as a private non-operating foundation within the meaning of section 509(a). C's principal activities involve maintaining and operating botanical gardens with over 700 cactus species as a "living library" for scientists, botanists, and students who study the plants for educational and research purposes. C does not charge any fees for such services.

B's and C's directors were identical prior to the death of D. The directors were D, D's widow, E, and D's children, F and G. D died in year x. Upon the death of D, a successor director was not named, so the remaining directors of both B and C were E, F, and G. In year y, H was appointed as a new director of C. H is not related to any of the other C directors. The B board plans to appoint I as a new director. I is a son of E.

The J trust ("Trust"), which D created during his lifetime, holds title to acres of property ("Property") and a vacant residential lot ("Lot"), both located near C's botanical gardens. The non-charitable beneficiaries of the Property and Lot under the Trust have disclaimed their interest in the Property and Lot. B is the sole charitable beneficiary.

B and C represent that they have taken and will take the following actions:

B, as the Trust's sole charitable beneficiary, will receive both the Property and Lot. Once B receives the Property and Lot, it will transfer both to C for no consideration (the "Proposed Transfers"). C will then use the Property in support of its botanical gardens and related activities, in furtherance of C's exempt purposes. C will either sell the Lot or use it in support of its botanical gardens and related activities.

B and C represent that, consistent with section 4942(g)(3) of the Code, C will make a qualifying distribution, of an amount equal to the value of the Property and Lot at the time of the transfer to C, not later than the end of the first taxable year after the taxable year in which C receives the Property and Lot. To make this qualifying distribution, C will, during the taxable year following the year of B's transfer of the Property and Lot, elect under section 53.4942(a)-3(c)(2)(iv) of the Foundation and Similar Excise Taxes Regulations to treat as a current distribution out of corpus an amount distributed by C in a prior taxable year that C treated as a distribution out of corpus that year.

C has made distributions of approximately \$K in the past five years which it has treated as distributions out of corpus under section 53.4942(a)-3(d)(1)(iii) of the regulations. Such corpus distributions have not been availed of for any other purpose. C will not use such distributions for any purpose other than to elect, under section 53.4942(a)-3(c)(2)(iv), to treat them as current distributions out of corpus in the year following the year of B's transfer of the Property and Lot to C. These distributions out of corpus currently exceed the fair market value of the Property and Lot, which are estimated to be \$L and \$M, respectively.

B and C also represent that C will provide B adequate records demonstrating that C has made the qualifying distribution described above. For instance, C will provide B with its tax return that includes C's section 53.4942(a)-3(c)(2)(iv) election statement.

B represents that it will exercise expenditure responsibility over the Property and Lot as required by section 4945(h) of the Code. For instance, B and C will enter into a pre-grant agreement that meets the requirements of section 53.4945-5(b)(3) of the regulations. C will provide annual reports stating that the Property and Lot continue to be used to further the purpose of the Proposed Transfers and the exempt purposes of C or, if either property is sold, that the proceeds will be used to further the exempt purposes of the Proposed Transfers and of C. C will be required to make such reports in the year in which the Proposed Transfers are made, and for at least the two successive years thereafter, until it is reasonably apparent to B that C

has not used the Property and Lot for any purpose which would result in liability for tax under section 4945(d) of the Code. B will make full and detailed reports to the IRS with respect to C's use of the Property and Lot.

You have requested the following rulings:

1. The Proposed Transfers will not result in "net investment income," and therefore will not result in a liability for tax under section 4940 of the Code.
2. The Proposed Transfers will not constitute acts of "self-dealing," and therefore will not result in a liability for tax under section 4941 of the Code.
3. The Proposed Transfers will constitute "qualifying distributions" under section 4942 of the Code for B.
4. The Proposed Transfers will not constitute "taxable expenditures" under section 4945 of the Code.

APPLICABLE LAW:

Section 4940(a) of the Code imposes a tax upon a private foundation's "net investment income."

Section 4940(c)(1) of the Code defines the term, "net investment income" to mean the amount by which the sum of the gross investment income and the capital gain net income exceeds the deductions allowed by section 4940(c)(3).

Section 4940(c)(4)(1)(a) of the Code provides that, for purposes of determining capital gain net income, there shall be taken into account only gains and losses from the sale or other disposition of property used for the production of interest, dividends, rents, and royalties, and from property used for production of unrelated business taxable income.

Section 4941(a) of the Code imposes certain excise taxes on direct and indirect acts of self-dealing between a disqualified person and a private foundation.

Section 4946(a)(1)(H) of the Code provides, in relevant part, that a private foundation may be a "disqualified person" in certain circumstances with respect to another private foundation, but only for purposes of the excess business holding rules under section 4943.

Section 53.4946-1(a)(8) of the regulations provides that for purposes of section 4941 of the Code, the term "disqualified person" shall not include any organization described in section 501(c)(3).

Section 4942(a) of the Code imposes a tax on a private foundation's failure to make required charitable distributions. Amounts expended and property transferred by a private foundation to meet this mandatory payout requirement must be in the form of qualifying distributions.

Section 4942(g)(1)(A) of the Code defines a "qualifying distribution" as, except as provided in section 4942(g)(3), any amount paid by a private foundation to accomplish one or more

purposes described in section 170(c)(2)(B), other than any contribution to (i) an organization controlled by the foundation or one or more disqualified persons or (ii) a private foundation which is not an operating foundation.

Section 4942(g)(3) of the Code and section 53.4942(a)-3(c)(1)(i) of the regulations provide a limited exception with respect to the general rule of section 4942(g)(1)(A) of the Code. They provide that a contribution by a private foundation either to an organization controlled by the foundation or one or more disqualified persons or to a non-operating private foundation will be treated as a qualifying distribution if (a) the recipient makes a qualifying distribution of an amount equal to the value of the grant not later than the end of the recipient's first taxable year after the taxable year in which the grant is received; and (b) the grant-making foundation obtains adequate records or other sufficient evidence which shows that the redistribution has been made by the recipient organization.

Section 53.4942(a)-3(c)(2)(iv) of the regulations provides that to satisfy the section 4942(g)(3) distribution requirements, a donee organization may elect (by attaching an election statement to the organization's tax return for the taxable year for which the election is to apply) to treat as a current distribution out of corpus any amount distributed by the organization in a prior taxable year which was treated as a distribution out of corpus. To be available for treatment as a current distribution out of corpus, the prior distribution:

- (a) Must have been treated by the organization as a distribution out of corpus under section 53.4942(a)-3(d)(1)(iii) of the regulations;
- (b) Must not have been availed of for any other purpose; for example, to reduce the organization's distributable amount in a prior tax year under section 53.4942(a)-3(e) of the regulations;
- (c) Must have occurred within the preceding five years; and
- (d) May not be later availed of for any other purpose.

Section 4945 of the Code imposes an excise tax on any private foundation's making of a taxable expenditure under section 4945(d).

Section 4945(d) of the Code provides that a "taxable expenditure" is any amount paid or incurred by a private foundation to carry on propaganda or attempt to influence legislation; to influence the outcome of any public election or to carry on any voter registration drive; to an individual for study, travel, or similar purposes; for any other purpose other than the exempt purposes specified in section 170(c)(2)(B); and to an organization that is neither a public charity described in sections 509(a)(1) through (3) nor an exempt operating foundation described in section 4940(d)(2), unless the private foundation exercises expenditure responsibility under section 4945(h).

Section 4940(d)(2) of the Code defines an "exempt operating foundation" as a private foundation that is an operating foundation, has been publicly supported for at least 10 taxable years, does not have an officer who is a disqualified individual under section 4940(d)(3)(B), and has a governing board that is broadly representative of the general public and consists of individuals at least 75% of whom are not disqualified individuals.

Section 4940(d)(3)(B) of the Code defines "disqualified individual" as an individual who is, with

respect to a private foundation, a (1) substantial contributor to the foundation, (2) an owner of more than 20% of the voting power, profits interest, or beneficial interest of the foundation, or (3) a member of the family of any individual described in (1) or (2).

Section 4945(h) of the Code provides that the expenditure responsibility referred to in section 4945(d) means that the private foundation is responsible to exert all reasonable efforts to establish adequate procedures to (1) see that the grant is spent solely for the purpose for which it was made; (2) obtain full and complete reports from the grantee on how the funds are spent; and (3) make full and detailed reports with respect to such expenditures to the IRS.

Section 53.4945-5(b)(3) of the regulations provides that, in order to exercise expenditure responsibility, the grantor private foundation must require that the grantee organization make a written commitment to (1) repay any portion of the amount granted which is not used for the purposes of the grant, (2) submit full and complete annual reports on the manner in which the grant funds are spent and the progress made in accomplishing the purposes of the grant, (3) maintain records of receipts and expenditures, (4) make its books and records available to the grantor at reasonable times, and (5) not use any of the funds to (i) carry on propaganda or otherwise attempt to influence legislation, (ii) influence the outcome of any specific public election or carry on any voter registration drive, (iii) make any grant which does not comply with the requirements of sections 4945(d)(3) or 4945(d)(4) of the Code, or (iv) undertake any activity for any purpose other than one specified in section 170(c)(2)(B) of the Code. The agreement must clearly specify the purposes of the grant.

Section 53.4945-5(c)(2) of the regulations provides, in part, that if a private foundation makes a grant described in section 4945(d)(4) of the Code to another private foundation for endowment or other capital purposes, then the grantor foundation must require annual reports from the grantee on the uses of the principal (and income, if any) from the grant for the 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, nor any equipment purchased with grant funds has been used for any purpose which would result in liability for tax under section 4945(d) of the Code, may the grantor allow such reports to be discontinued.

ANALYSIS:

Section 4940

Section 4940(a) of the Code imposes a tax on a private foundation's net investment income for a taxable year. Investment income includes capital gains from the sale or other disposition of property used for the production of interest, dividends, rents, royalties, and unrelated business taxable income. See section 4940(c)(4)(1)(A). B will receive no consideration for the Proposed Transfers to C. Accordingly, B's Proposed Transfers will be considered a contribution to C, rather than a sale or other disposition of property that could generate a capital gain to B under section 4940(c)(4)(1)(A). Therefore, the Proposed Transfers will not constitute net investment income to B under section 4940(c)(1), and B will not be subject to the section 4940 tax.

The Proposed Transfers will not involve any sale or other disposition of property by C that could generate income to C under section 4940(c)(4)(1)(A) of the Code. Therefore, the Proposed

Transfers will not result in net investment income to C under section 4940, and C will not be subject to the section 4940 tax.

Section 4941

Section 4941(a) of the Code imposes certain excise taxes on direct and indirect acts of self-dealing between a disqualified person and a private foundation. A private foundation may be a disqualified person with respect to another private foundation solely for purposes of section 4943 of the Code. See section 4946(a)(1)(H). For purposes of section 4941, however, the term “disqualified person” does not include a section 501(c)(3) organization such as C. See section 53.4946-1(a)(8) of the regulations. Therefore, B and C are not disqualified persons with respect to one another. Accordingly, the Proposed Transfers of the Property and Lot from B to C will not constitute an act of self-dealing under section 4941 of the Code.

Section 4942

Section 4942(g)(1) of the Code provides, in pertinent part, that except as provided in section 4942(g)(3), a qualifying distribution does not include an amount paid to a private foundation controlled by a disqualified person or to a non-operating private foundation. However, section 4942(g)(3) and section 53.4942(a)-3(c) of the regulations provide that if the requirements of these provisions, as explained above, are met, a payment to such a foundation would constitute a qualifying distribution.

Because C and B have identical boards of directors, C is controlled by one or more disqualified persons with respect to B for purposes of section 4942(g)(1)(A) of the Code. Therefore, the requirements of sections 4942(g)(3) of the Code and section 53.4942(a)-3(c) of the regulations must be satisfied for the Proposed Transfers from B to C to be a qualifying distribution under section 4942(g)(1)(A).

Based on B's and C's representations that they have taken and will take certain actions needed to qualify the Proposed Transfers as qualifying distributions, as described above, we conclude that B and C have met and likely will meet each of the requirements of section 4942(g)(3) of the Code and section 53.4942(a)-3(c) of the regulations. Therefore, the Proposed Transfers by B to C would constitute a qualifying distribution for purposes of section 4942 of the Code.

Section 4945

Section 4945 of the Code provides, in part, that a taxable expenditure is any amount paid or incurred by a private foundation to an organization that is neither a public charity nor an exempt operating foundation, unless the private foundation exercises expenditure responsibility under section 4945(h). Section 4945(h) of the Code and sections 53.4945-5(b)(3) and 53.4945-5(c)(2) of the regulations provide that if the requirements of these provisions, as explained above, are met, a private foundation would satisfy the requirement to exercise expenditure responsibility with respect to a transfer that it makes.

Because C is neither a public charity nor an exempt operating foundation, B must exercise expenditure responsibility over its Proposed Transfers of the Property and Lot to C, pursuant to sections 4945(d)(4)(B) and 4945(h), to avoid liability for the tax imposed under section 4945.

Based on B's and C's representations that they have taken and will take certain actions, as described above, we conclude that B and C have met and will likely meet the requirements of section 4942(h) of the Code and sections 53.4945-5(b)(3) and 53.4945-5(c)(2) of the regulations. Therefore, B will exercise expenditure responsibility with respect to the Proposed Transfers. As a result, the Proposed Transfers would not constitute a taxable expenditure under section 4945 of the Code.

CONCLUSIONS:

Accordingly, we rule as follows:

1. The Proposed Transfers will not result in "net investment income," and therefore will not result in a liability for tax under section 4940 of the Code.
2. The Proposed Transfers will not constitute acts of "self-dealing," and therefore will not result in a liability for tax under section 4941 of the Code.
3. The Proposed Transfers will constitute "qualifying distributions" under section 4942 of the Code for B.
4. The Proposed Transfers will not constitute "taxable expenditures" under section 4945 of the Code.

This ruling is based on the understanding that there will be no material change in the facts upon which it is based.

This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described.

This ruling will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, *Notice of Intention to Disclose*. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

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

If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

In accordance with the Power of Attorney currently on file with the Internal Revenue Service, we are sending a copy of this letter to your authorized representative.

Sincerely,

Steven Grodnitzky
Manager, Exempt Organizations
Technical Group 1

Enclosure: Notice 437