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Private Foundation Restructuring and Terminations

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I. OVERVIEW

While private foundations offer certain tax advantages, it isn't always easy to keep them around. Because they are subject to some significant excise taxes under Chapter 42[1], private foundations often need to pay substantial fees to lawyers and accountants to ensure compliance with this excise tax regime. Private foundations are often governed by a small group of individuals with ties to the primary donor—sometimes members of the same family—and over time these relationships may change, raising questions about the purposes and continued viability of the foundation. At other times, they may be controlled by a company that decides to eliminate or change its corporate giving strategy. There are a variety of options for foundations to make a change when the board decides it's time to do so. This outline focuses on the five options of transferring assets to another private foundation by splitting assets or merging with another foundation, winding down and terminating, converting to a private operating foundation, and converting to a public charity. While many of these options implicate state law considerations, they also involve Section 507.

Section 507 distinguishes between voluntary terminations of private foundation status under Section 507(a)(1) and involuntary terminations of private foundation status under Section 507(a)(2) which arise due to willful repeated acts (or failures to act) or a willful and flagrant act (or failure to act). Private foundations terminating on this basis must pay a termination tax under Section 507(c) on the lesser of the aggregate tax benefit or the value of the foundation's net assets. Under Section 507(b)(1), private foundations also can terminate their status by transferring their net assets to certain public charities or operating as public charities, in which case they are not required to pay the termination tax under Section 507(c). This outline addresses the Section 507 implications associated with each of the options for restructuring a private foundation.

II. TRANSFERRING ASSETS TO ANOTHER FOUNDATION: SPLITTING A FOUNDATION AND MERGING FOUNDATIONS

One option for restructuring a private foundation is to transfer its assets to another private foundation by splitting the foundation into two or more separate foundations or merging two foundations. Splitting a foundation often involves the creation of a new legal entity in accordance with the process established under state law followed by the submission of the Form 1023 application for exemption and applications for any relevant state tax exemptions. The process for merging two foundations is also governed by state law and often requires approval by both entities' boards and a merger agreement governing the disposition of

[1] Unless otherwise noted, all Chapter and Section references made herein are to the Internal Revenue Code of 1986, as amended.

assets and governance arrangement following the merger. Either situation may also require approval of the attorney general in the state of incorporation of the transferor foundation.

In both instances, a foundation will need to review Section 507 to determine the implications of transferring assets to another private foundation. Under Section 507(b)(2), "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." Instead, the transferee will be treated as possessing the following attributes and characteristics of the transferor.[2]

First, the transferee succeeds to the aggregate tax benefit of the transferor in an amount equal to the amount of the aggregate tax benefit multiplied by a fraction, the numerator of which is the fair market value of the assets (less encumbrances) transferred to the transferee, and the denominator of which is the fair market value of the assets of the transferor (less encumbrances) immediately before the transfer.[3] Fair market value is determined as of the time of transfer.[4] If the transferee is not "effectively controlled" (within the meaning of Treas. Reg. § 1.482-1(a)(3)), directly or indirectly, by the same person or persons who effectively control the transferor then the transferee shall not succeed to an aggregate tax benefit that exceeds the fair market value of the assets transferred.[5]

The aggregate tax benefit is defined as the sum of:

- the aggregate increases in tax under Chapters 1, 11, and 12 which would have been imposed with respect to all substantial contributors to the foundation if deductions for all contributions made by such contributors to the foundation after February 28, 1913 had been disallowed;[6]

- the aggregate increases in tax under Chapter 1 which would have been imposed with respect to the income of the private foundation for taxable years beginning after December 31, 1912 if (1) it had not been exempt from tax under Section 501(a), and (2) in the case of a trust, deductions under Section 642(c) had been limited to 20 percent of the taxable income of the trust (computed without the benefit of Section 642(c) but with the benefit of Section 170(b)(1)(A));

- the amount succeeded to from transferors under Treas. Reg. § 1.507-3(a) and Section 507(b)(2); and

[2] Treas. Reg. § 1.507-3(a)(1).
[3] Treas. Reg. § 1.507-3(a)(2)(i).
[4] Treas. Reg. § 1.507-3(a)(2)(i).
[5] Treas. Reg. § 1.507-2(a)(2)(ii).
[6] In computing the amount of the aggregate increases, all deductions attributable to a particular contribution are to be included. If the substantial contributor has taken deduction under Sections 170 and 2522 with respect to the same contribution, then the amount of each deduction shall be included.

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