ISSUES

(1) If a private foundation transfers all of its assets to one or more private foundations, is the transferor foundation required to notify the Manager, Exempt Organizations Determinations, Tax Exempt and Government Entities Division (TE/GE), that it plans to terminate its private foundation status pursuant to § 507(a) of the Internal Revenue Code and pay the tax under § 507(c)?

(2) What are a private foundation's tax return filing obligations after it transfers all of its assets to one or more transferee private foundations and:

(a) terminates, or

(b) does not terminate?

(3) If a private foundation transfers all of its assets to one or more private foundations that are effectively controlled (within the meaning of the Income Tax Regulations under § 507), directly or indirectly, by the same person or persons who effectively control the transferor foundation, what are the implications under:

(a) § 4940,

(b) § 4941,

(c) § 4942,

(d) § 4943,

(e) § 4944, and

(f) § 4945?

(4) If a private foundation transfers all of its assets to one or more private foundations that are effectively controlled (within the meaning of the regulations under § 507), directly or indirectly, by the same person or persons who effectively control the transferor foundation, what are the implications for the transferor foundation's aggregate tax benefits under § 507(d)?

FACTS

In each of the following situations: (i) the transferee private foundations are effectively controlled (within the meaning of the regulations under § 507), directly or indirectly, by the same persons who effectively controlled the transferor private foundations; (ii) the private foundations have not committed 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; (iii) the private foundations have not terminated under § 507(a)(2) or (b)(1); (iv) prior to the transactions described below, the transferor private foundations made outstanding grants to organizations not described in § 4945(d)(4)(A), which required the transferor foundations to exercise expenditure responsibility in accordance with § 4945(h); and (v) the private foundations are not operating foundations within the meaning of § 4942(j)(3).

***SITUATION 1***

*P* is recognized as exempt from federal tax under § 501(c)(3) and is classified as a private foundation under § 509(a). *P*'s current directors have divergent charitable objectives.

*X*, *Y*, and *Z* are recognized as exempt from federal tax under § 501(c)(3) and are classified as private foundations under § 509(a). Pursuant to a plan of dissolution, after satisfying all of its outstanding liabilities, *P* distributes all of its remaining assets in equal shares to *X*, *Y*, and *Z*. As part of the plan of dissolution, *X* agrees to exercise expenditure responsibility for all outstanding grants made by *P*. The day after *P* distributes all of its assets, *P* files articles of dissolution with the appropriate state authority.

***SITUATION 2***

*T*, a charitable trust, is recognized as exempt from federal tax under § 501(c)(3) and is classified as a private foundation under § 509(a). The trustees of *T* determine that *T*'s charitable purposes can be more effectively accomplished by operating in corporate form.

The trustees of *T* create *W*, a not-for-profit corporation, for the purpose of carrying on *T*'s activities. *W* is recognized as exempt from federal tax under § 501(c)(3) and is classified as a private foundation under § 509(a). *T* transfers all of its assets and liabilities to *W*.

***SITUATION 3***

*J* and *K* are not-for-profit corporations that are recognized as exempt from federal tax under § 501(c)(3) and are classified as private foundations under § 509(a). *J* and *K* generally confine their grantmaking activities to supporting charitable programs in the city in which both *J* and *K* are located.

*V*, a newly-formed entity, is recognized as exempt from federal tax under § 501(c)(3) and is classified as a private foundation under § 509(a). To eliminate the costs of maintaining two private foundations with identical charitable purposes, *J* and *K* transfer all of their assets and liabilities to *V*.

***LAW***

Section 507(a) provides that, except as provided in § 507(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) with respect to such organization, there have been either willful repeated acts (or failures to act), or a willful and flagrant act (or failure to act), giving rise to a liability for tax under chapter 42, and the Secretary notifies such organization that it is liable for the tax imposed by § 507(c). Under § 507(a)(1) and (2), the organization's private foundation status is terminated when the organization pays the tax imposed by § 507(c) or the entire amount of such tax is abated under § 507(g). The person currently designated to receive the notice of termination described in § 507(a)(1) is Manager, Exempt Organizations Determinations (TE/GE).

Section 507(b)(2) provides that in the case of a transfer of assets of any private foundation to another private foundation pursuant to a liquidation, merger, redemption, recapitalization, or other adjustment, organization or reorganization, the transferee foundation shall not be treated as a newly created organization.

Section 507(c) imposes a tax on each organization whose private foundation status is voluntarily or involuntarily terminated under § 507(a). The tax imposed is equal to the lower of: (1) the amount which the private foundation substantiates by adequate records or other corroborating evidence as the aggregate tax benefit resulting from the § 501(c)(3) status of such foundation, or (2) the value of the net assets of the foundation.

Section 1.507–1(b)(6) of the Income Tax Regulations provides that if a private foundation transfers all or part of its assets to one or more other private foundations pursuant to a transfer described in

§ 507(b)(2) and § 1.507–3(c), such transferor foundation will not have terminated its private foundation status under § 507(a)(1).

Section 1.507–1(b)(7) provides that a transfer of all the assets of a private foundation does not result in a termination of the transferor private foundation under § 507(a), unless the transferor private foundation elects to terminate pursuant to § 507(a)(1), or § 507(a)(2) is applicable.

Section 1.507–3(a)(1) provides that, in a § 507(b)(2) transfer, a transferee organization will not be treated as a newly created organization. The transferee organization is treated as possessing those attributes and characteristics of the transferor organization which are described in § 1.507–3(a)(2), (3) and (4).

Section 1.507–3(a)(2)(i) provides that a transferee organization shall succeed to the aggregate tax benefit of the transferor organization in an amount equal to the amount of such aggregate tax benefit multiplied by a fraction the numerator of which is the fair market value of the assets (less encumbrances) transferred to such transferee and the denominator of which is the fair market value of the assets of the transferor (less encumbrances) immediately before the transfer.

Section 1.507–3(a)(3) provides that, in the event of a transfer of assets under § 507(b)(2), any person who is a substantial contributor with respect to the transferor foundation shall be treated as a substantial contributor with respect to the transferee foundation, regardless of whether such person meets the $5,000 two-percent test with respect to the transferee at any time. If a private foundation makes a transfer described in § 507(b)(2) to two or more transferee private foundations, any person who is a substantial contributor with respect to the transferor foundation prior to such transfer shall be considered a substantial contributor with respect to each transferee.

Section 1.507–3(a)(4) provides that if a private foundation incurs liability for one or more of the taxes imposed under chapter 42 (or any penalty resulting therefrom) prior to, or as a result of, making a transfer of assets described in § 507(b)(2) to one or more private foundations, in any case where transferee liability applies each transferee foundation shall be treated as receiving the transferred assets subject to such liability to the extent that the transferor foundation does not satisfy such liability.

Section 1.507–3(a)(5) provides that, except as provided in § 1.507–3(a)(9), a private foundation is required to meet the distribution requirements of § 4942 for any taxable year in which it makes a § 507(b)(2) transfer of all or part of its net assets to another private foundation.

Section 1.507–3(a)(6) provides that whenever a private foundation makes a § 507(b)(2) transfer of all or part of its net assets to another private foundation, the applicable period of time described in § 4943(c)(4), (5), or (6) shall include both the period during which the transferor foundation held such assets and the period during which the transferee foundation holds such assets.

Section 1.507–3(a)(7) provides that, except as provided in § 1.507–3(a)(9), where the transferor has disposed of all of its assets, during any period in which the transferor has no assets, § 4945(d)(4) and (h) shall not apply to the transferee or the transferor with respect to any expenditure responsibility grants made by the transferor. However, the information reporting requirements under § 4945 will apply for any year in which any such transfer is made.

Section 1.507–3(a)(9)(i) provides that if a private foundation transfers all of its net assets to one or more private foundations that are effectively controlled, directly or indirectly, by the same person or persons that effectively controlled the transferor private foundation, the transferee private foundation will be treated as if it were the transferor private foundation for purposes of §§ 4940 through 4948 and §§ 507 through 509. However, where proportionality is appropriate, such a transferee foundation shall be treated as if it were the transferor in the proportion which the fair market value of the assets (less encumbrances) transferred to such transferee bears to the fair market value of the assets (less encumbrances) of the transferor immediately before the transfer.

Section 1.507–3(a)(9)(ii) provides that § 1.507–3(a)(9)(i) shall not apply to the requirements under § 6033, which must be complied with by the transferor foundation, nor to the requirement under § 6043 that the transferor foundation file a return with respect to its liquidation, dissolution or termination.

Section 1.507–3(a)(9)(iii) (example 2) provides that if the transferees of a § 507(b)(2) transfer are effectively controlled by the same persons who control the transferor, each transferee is required to exercise expenditure responsibility with respect to the transferor's outstanding grants, unless, as part of the transfer, the transferor assigns and one or more transferees assume the transferor's expenditure responsibility, in which case, only the transferees assuming the transferor's expenditure responsibility are required to exercise such expenditure responsibility. Section 1.507–3(a)(9)(iii) (example 2) also provides that because such transferee foundations are treated as the transferor, rather than as recipients of expenditure responsibility grants, there are no expenditure responsibility requirements which must be exercised under § 4945(d)(4) and (h) with respect to the § 507(b)(2) transfer.

Section 1.507–3(a)(10), by reference to § 1.507–1(b)(9), provides that a private foundation that transfers all of its net assets is required to file the annual information return required by § 6033 for the taxable year in which such transfer occurs. However, the foundation will not be required to file such return for any taxable year following the taxable year in which the last of such transfers occurred, provided the foundation does not hold equitable title to any assets or engage in any activity during such subsequent taxable year.

Section 1.507–3(c)(1) provides that for purposes of § 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.

Section 1.507–3(c)(2) provides that the term "significant disposition of assets to one or more private foundations" includes any disposition (or series of related dispositions) by a private foundation to one or more private foundations of 25 percent or more of the fair market value of the net assets of the transferor foundation at the beginning of the taxable year in which the transfers occur.

Section 1.507–3(d) provides that unless a private foundation voluntarily gives notice pursuant to § 507(a)(1), a transfer of assets described in § 507(b)(2) will not constitute a termination of the transferor's private foundation status under § 507(a)(1).

Section 1.507–4(b) provides that private foundations which make transfers described in § 507(b)(2) are not subject to the tax imposed under § 507(c) with respect to such transfers unless the provisions of § 507(a) become applicable.

Section 1.507–7(a) provides that the net value of assets for purposes of § 507(c) shall be 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 it ceases to be a private foundation.

Sections 1.507–7(b)(1) and 1.507–8 provide that in the case of a termination under § 507(a)(1), the date referred to in § 1.507–7(a)(1) shall be the date on which the terminating foundation gives the notification described in § 507(a)(1).

Section 4940(a) generally imposes an excise tax on a private foundation's net investment income for the taxable year.

Section 4940(c)(1) defines net investment income as the amount by which the sum of the gross investment income and the capital gain net income exceeds the deductions allowed under § 4940(c)(3).

Section 4941(a)(1) imposes a tax on each act of self-dealing between a disqualified person and a private foundation. Section 53.4946–1(a)(8) provides that, for purposes of § 4941, the term "disqualified person" shall not include any organization described in § 501(c)(3) (other than an organization described in § 509(a)(4)).

Section 4942(a) generally imposes a tax on the undistributed income of a private foundation (other than an operating foundation under § 4942(j)(3)) for any taxable year, which has not been distributed before the first day of the second (or any succeeding) taxable year following such taxable year.

Section 4942(c) defines "undistributed income" for any taxable year as the amount by which the distributable amount for such taxable year exceeds the qualifying distributions made out of such distributable amount for such taxable year.

Section 4942(d) defines "distributable amount" as the amount equal to the sum of the minimum investment return, plus certain other amounts, reduced by the sum of the taxes imposed on such private foundation for the taxable year under subtitle A and § 4940.

Section 4942(g)(1)(A) defines "qualifying distribution" as any amount (including that portion of reasonable and necessary administrative expenses) paid to accomplish one or more purposes described in § 170(c)(2)(B) other than a contribution to: (i) an organization controlled directly or indirectly by the foundation or by one or more disqualified persons with respect to the foundation, unless certain requirements are satisfied, or (ii) any private foundation which is not an operating foundation under § 4942(j)(3), unless certain requirements are satisfied.

Section 4942(i) provides for a carryover of the amount by which qualifying distributions during the five preceding taxable years (other than amounts required to be distributed out of corpus under § 4942(g)(3)) have exceeded the distributable amounts for such years.

Rev. Rul. 78–387 (1978–2 C.B. 270) holds that when a private foundation transfers all its assets to another private foundation that is controlled by the same persons who controlled the transferor foundation, the transferee foundation may reduce its distributable amount under § 4942(d) by the amount of the transferor's excess qualifying distributions as described in § 4942(i).

Section 4943(a)(1) imposes a tax on the "excess business holdings" (as defined in § 4943(c)) of any private foundation in a business enterprise.

Section 4944(a)(1) imposes a tax on any amount invested by a private foundation in a manner that jeopardizes the carrying out of any of the foundation's exempt purposes.

Section 4945 imposes a tax on any "taxable expenditure" (as defined in § 4945(d)) made by a private foundation.

Section 4945(d)(4) provides that the term "taxable expenditure" includes any amount paid or incurred as a grant to a private non-operating foundation unless the grantor foundation exercises expenditure responsibility with respect to such grant in accordance with § 4945(h).

Section 4945(h) provides that the expenditure responsibility referred to in § 4945(d)(4) means a private foundation is responsible to exert all reasonable efforts and to establish adequate procedures to: (1) see that the grant is spent solely for the purpose for which 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 Secretary.

Section 4946(a)(1) defines a "disqualified person" for purposes of subchapter A of chapter 42.

Section 6033(a)(1) provides that, with certain exceptions, every organization exempt from taxation under § 501(a) shall file an annual return.

Section 6043(b) and § 1.6043–3(a)(1) provide that, with certain exceptions, a private foundation must provide information with respect to a liquidation, dissolution, termination or substantial contraction as required by the instructions accompanying the foundation's annual return.

***ANALYSIS***

SECTION 507

Section 507(b)(2) applies to a significant disposition of assets by one private foundation to one or more private foundations, other than transfers for full and adequate consideration or distributions out of current income. *See* § 1.507–3(c)(1). A transfer of all of a private foundation's assets to one or more private foundations constitutes a significant disposition. *See* § 1.507–3(c)(2). In Situations 1, 2 and 3, each transferor foundation transfers all of its assets to one or more private foundations. The transfers are not for full and adequate consideration and are not distributions out of current income. Thus, the transfers in Situations 1, 2 and 3 are § 507(b)(2) transfers.

A transfer of assets described in § 507(b)(2) does not constitute a termination of the transferor's private foundation status under § 507(a)(1) unless the transferor voluntarily gives notice pursuant to § 507(a)(1). *See* §§ 1.507–1(b)(6) and 1.507–3(d). The transferor foundation is not required to provide such notice. In Situation 1, *P*'s dissolution under state

law has no effect on whether *P* has terminated its private foundation status for federal tax purposes.

In Situations 1, 2, and 3, if the transferor foundation does not give notice to the Manager, Exempt Organizations Determinations (TE/GE), of its intent to terminate, the transferor retains its private foundation status and the § 507(c) tax does not apply. *See* § 507(a)(1) and § 1.507–4(b). The transferor foundation is required to file a Form 990–PF for the taxable year of the transfer(s), but is not required to file a Form 990–PF for subsequent taxable years during which it does not have equitable title to any assets and does not engage in any activity. *See* §§ 6033(a)(1) and 6043(b), and §§ 1.507–1(b)(9) and 1.507–3(a)(10). If, at any time following the transfer(s), the transferor foundation receives additional assets or engages in any activity, the transferor foundation must file a Form 990–PF. Additionally, because the transferor foundation has not terminated its private foundation status, the transferor foundation continues to be treated as a private foundation.

In Situations 1, 2, and 3, if the transferor foundation does give notice to the Manager, Exempt Organizations Determinations (TE/GE), of its intent to terminate, then the § 507(c) tax applies on the date such notice is given. *See* § 1.507–7(a) and (b)(1). Thus, in Situations 1, 2, and 3, if the transferor foundation provides notice at least one day after it transfers all of its assets, the tax imposed by § 507(c) will be zero. The transferor foundation is required to file a Form 990–PF for the taxable year of the transfer(s). *See* §§ 6033(a)(1) and 6043(b).

Regardless of whether the transferor foundation provides notice of its intent to terminate, the transferee foundations are treated as possessing the aggregate tax benefit of the transferor foundations. *See* § 1.507–3(a)(1) and (2)(i). In Situation 1, *X*, *Y*, and *Z* succeed to *P*'s aggregate tax benefit in proportion to the assets transferred to each. *See* § 1.507–3(a)(2)(i).

Moreover, regardless of whether the transferor foundation provides notice of its intent to terminate, where transferee liability applies, each transferee foundation is treated as receiving the transferred assets subject to the transferor foundation's prior excise tax liabilities under chapter 42 (and any penalties resulting therefrom), if any, to the extent the transferor did not previously satisfy those liabilities. *See* § 1.507–3(a)(1) and (4).

SECTION 4940

In Situations 1, 2 and 3, the transfers do not constitute investments of the transferor for purposes of § 4940; therefore, the transfers do not give rise to net investment income subject to tax under § 4940(a).

In Situations 1, 2, and 3, because each transferor foundation transfers all of its assets to one or more private foundations effectively controlled by the same persons that effectively control the transferor, any excess § 4940 tax paid by the transferor may be used by the transferees to offset the transferees' § 4940 tax liability. *See* § 1.507–3(a)(9)(i). In Situation 1, where there are several transferees, proportionality is appropriate, and *X*, *Y*, and *Z* will each succeed to one third of any excess § 4940 tax paid by *P*. *See* § 1.507–3(a)(9)(i).

SECTION 4941

In Situations 1, 2 and 3, the transfers are to § 501(c)(3) organizations, which are not treated as disqualified persons for purposes of § 4941. *See* § 53.4946–1(a)(8). Thus, the transfers do not constitute self-dealing transactions and are not subject to tax under § 4941(a)(1).

SECTION 4942

In Situations 1, 2 and 3, because each transferor foundation transfers all of its assets to one or more private foundations effectively controlled by the same persons that effectively control the transferor, the transferee foundations are treated as though they were the transferor for purposes of § 4942. *See* § 1.507–3(a)(9)(i). Accordingly, the transfers to the transferee foundations are not treated as qualifying distributions of the transferor foundation. In addition, in Situations 2 and 3, each transferee foundation assumes all obligations with respect to the transferor's "undistributed income" within the meaning of § 4942(c), if any, and reduces its own distributable amount under § 4942 by the transferor foundation's excess qualifying distributions under § 4942(i). In Situation 1, where there are several transferee foundations, proportionality is appropriate, and *X*, *Y* and *Z* each becomes responsible for one third of *P*'s undistributed income and succeeds to one third of *P*'s excess qualifying distributions, if any. *See* § 1.507–3(a)(9)(i) and Rev. Rul. 78–387.

SECTION 4943

Whether the transfers cause a transferee foundation to have excess business holdings and be subject to tax under § 4943(a) depends on the facts and circumstances. In Situations 1, 2, and 3, because each transferor foundation transfers all of its assets to one or more private foundations effectively controlled by the same persons that effectively control the transferor, the transferee foundations are treated as though they were the transferor for purposes of §§ 4943 and 4946. *See* § 1.507–3(a)(9)(i). Accordingly, in determining whether a transferee foundation has excess business holdings, the disqualified persons of the transferee foundation are determined in part by treating the transferee as though it were the transferor. For example, both the substantial contributors of the transferee and the substantial contributors of the transferor are treated as a disqualified persons of the transferee in determining whether the transferee has excess business holdings as a result of the transfer. *See* § 4946(a)(1)(A) and § 1.507–3(a)(9)(i); *see also* § 1.507–3(a)(3). In addition, in determining whether a transferee foundation is subject to tax under § 4943, the transferee's holding period in the transferred assets for purposes of § 4943(c)(4), (5), and (6) includes both the period during which the transferor foundation held such assets and the period during which the transferee foundation holds such assets. *See* § 1.507–3(a)(6).

SECTION 4944

In Situations 1, 2, and 3, the transfers do not constitute investments for purposes of § 4944; therefore the transfers do not constitute investments jeopardizing the transferor foundation's exempt purposes and are not subject to tax under § 4944(a)(1).

In Situations 1, 2, and 3, because each transferor foundation transfers all of its assets to one or more private foundations effectively controlled by the same persons that effectively control the transferor, the transferee foundations are treated as though they were the transferor for purposes of § 4945. *See* § 1.507–3(a)(9)(i). Because the transferee foundations are treated as the transferor foundation rather than as recipients of expenditure responsibility grants, there are no expenditure responsibility requirements that must be exercised under § 4945(d)(4) or (h) with respect to the transfers to the transferee foundations. *See* § 1.507–3(a)(9)(i) and (iii)(example 2).

The transferor foundation is required to exercise expenditure responsibility over the transferor's outstanding grants until the transferor disposes of all of its assets. Thereafter, during any period in which the transferor foundation has no assets, the transferor foundation is not required to exercise expenditure responsibility over any outstanding grants. *See* § 1.507–3(a)(7). However, the transferor foundation still must meet the § 4945(h) reporting requirements for the outstanding grants for the year in which the transfers are made. *See* § 1.507–3(a)(7).

The transferee foundations assume expenditure responsibility for all the transferor's outstanding grants. *See* § 1.507–3(a)(9)(i). In Situation 1, because *X* agreed to exercise expenditure responsibility for all of *P*'s outstanding grants, *Y* and *Z* have no expenditure responsibility over *P*'s grants. However, in the absence of such an agreement, *X*, *Y* and *Z* each would be required to exercise expenditure responsibility with respect to all of *P*'s outstanding grants. *See* § 1.507–3(a)(9)(i) and (iii) (example 2).

***HOLDINGS***

(1) A private foundation that transfers all of its assets to one or more private foundations in a transfer described in § 507(b)(2) is not required to notify the Manager, Exempt Organizations Determinations (TE/GE), that it plans to terminate its private foundation status under § 507(a)(1). If the private foundation does not provide notice and does not terminate, the private foundation is not subject to the § 507(c) termination tax. If the private foundation chooses to provide notice, and therefore terminates, it is subject to the § 507(c) tax; however, if the private foundation has no assets on the day it provides notice (*e.g.*, it provides notice at least one day after it transfers all of its assets), the § 507(c) tax will be zero.

(2) (a) A private foundation that has disposed of all of its assets and terminates its private foundation status must file a Form 990–PF for the taxable year of the disposition and must comply with any expenditure responsibility reporting obligations on such return.

(b) A private foundation that has disposed of all of its assets and does not terminate its private foundation status must file a Form 990–PF for the taxable year of the disposition and must comply with any expenditure responsibility reporting obligations on such return, but does not need to file returns in the following taxable years if it has no assets and does not engage in any activities. If, in later taxable years, it receives additional assets or resumes activities, it must resume filing a Form 990–PF for those taxable years in which it has assets or activities.

(3) Where transferee liability applies, each transferee foundation is treated as receiving the transferred assets subject to the transferor foundation's prior excise tax liabilities under chapter 42 (and any penalty resulting therefrom), if any, to the extent the transferor foundation did not previously satisfy those liabilities.

(a) The transfers do not give rise to net investment income and are not subject to tax under § 4940(a). The transferee foundations may use their proportionate share of any excess § 4940 tax paid by the transferor to offset their own § 4940 tax liability.

(b) The transfers do not constitute self-dealing and are not subject to tax under § 4941(a)(1).

(c) The transfers do not constitute qualifying distributions for the transferor foundation under § 4942. The transferee foundations assume their proportionate share of the transferor foundation's undistributed income under § 4942 and reduce their own distributable amount for purposes of § 4942 by their proportionate share of the transferors' excess qualifying distributions under § 4942(i).

(d) Whether the transfers cause a transferee foundation to have excess business holdings and be subject to tax under § 4943(a) depends on the facts and circumstances. In making these determinations, the disqualified persons of a transferee foundation are determined in part by treating the transferee as though it were the transferor. In addition, the transferee's holding period in the transferred assets for purposes of § 4943(c)(4), (5) and (6) includes both the period during which the transferor foundation held such assets and the period during which the transferee foundation holds such assets.

(e) The transfers do not constitute investments jeopardizing the transferor foundation's exempt purposes and are not subject to tax under § 4944(a)(1).

(f) The transferor foundation is not required to exercise expenditure responsibility under § 4945(h) with respect to the transfers. The transferor foundation is required to exercise expenditure responsibility over any outstanding grants until the time it disposes of all of its assets and must satisfy the § 4945(h) reporting requirements for the taxable year in which the transfers were made. Following the transfers and during any period in which the transferor has no assets or activities, the transferor foundation is not required to exercise expenditure responsibility with respect to any of its outstanding grants.

Each transferee foundation must exercise expenditure responsibility with respect to all outstanding grants by the transferor foundation. If, however, the transferor foundation assigns and transferees assume the transferor's expenditure responsibility with respect to a grant, only the transferees assuming the transferor's expenditure responsibility are required to exercise such expenditure responsibility with respect to such grant.

(4) The transferor foundation's aggregate tax benefits under § 507(d) are transferred to the transferee foundations in proportion to the transferor's assets transferred to each transferee.

DRAFTING INFORMATION

The principal author of this revenue ruling is Theodore R. Lieber of the Exempt Organizations, Tax Exempt and Government Entities Division. For further information regarding this revenue ruling, contact Theodore R. Lieber at (202) 283–8999 (not a toll-free call).

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## Section 1092.—Straddles

*26 CFR 1.1092(c)–1: Qualified covered calls.*

## T.D. 8990

## DEPARTMENT OF THE TREASURY
## Internal Revenue Service
## 26 CFR Part 1

## Equity Options With Flexible Terms; Qualified Covered Call Treatment

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulation.

SUMMARY: This document contains final regulations providing guidance on the application of the rules governing qualified covered calls. The new rules address concerns that were created by the introduction of new financial instruments several years after the enactment of the qualified covered call rules. The final regulations provide guidance to taxpayers writing equity call options.

DATES: *Effective Date*: These regulations are effective April 29, 2002.

*Applicability Date*: For dates of applicability, see §§ 1.1092(c)–1(c), 1.1092(c)–2(d), 1.1092(c)–3(c), and 1.1092(c)–4(g).

FOR FURTHER INFORMATION CONTACT: Pamela Lew, (202) 622–3950 or Viva Hammer, (202) 622–0869 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

**Background**

On January 18, 2001, the IRS published in the **Federal Register** proposed regulations (REG–115560–99, 2001–1 C.B. 993 [66 F.R. 4751]) addressing various issues concerning qualified covered call (QCC) options under section 1092(c)(4). No requests to speak at a public hearing were received, and no public hearing was held.

The proposed regulations provide that equity options with flexible terms (FLEX options) may be QCC options as long as they satisfy the general rules for QCC treatment described in section 1092(c)(4), are not for a term of longer than one year, and meet other specified requirements. In addition, an equity option with standardized terms must be outstanding for the underlying equity. For purposes of applying the general rules, the bench marks will be the same as those for an equity option with standardized terms on the same stock having the same applicable stock price.

The proposed regulations also provide that certain over-the-counter (OTC) options may be QCC options so that OTC options that are economically similar to FLEX options may receive the same tax treatment as FLEX options. Specifically, the proposed regulations provide that an OTC option is eligible for QCC treatment if it is entered into with a person registered with the Securities and Exchange Commission (SEC) as a broker-dealer or alternative trading system and meets the same requirements for QCC treatment that apply to FLEX options.

The proposed regulations further provide that equity options with standardized terms with maturities of longer than one year cannot be QCC options.

Comments were requested about the proposed one-year limit for all QCCs, including a discussion of time limitations in general. If a commentator recommended a time limitation greater than one year or recommended that there be no time limitation, a detailed, comprehensive description of possible solutions to the problem of increased risk reduction caused by longer term options was requested. Commentators were also asked to address the administrability of any proposed solutions.

After revisions to take into account several of the comments submitted, the proposed regulations are adopted by this Treasury decision.

**Summary of Principal Comments**

Four commentators responded to the request for comments. Two of the commentators addressed only the proposed 1-year limitation applicable to all QCC options. A third commentator addressed the proposed 1-year limit as well as a number of other issues. The fourth commentator focused on issues other than the proposed 1-year limitation.

*One-year Term Limitation*

A number of commentators object to the proposal to limit QCC treatment to options with a duration of one year or less. These commentators note that the statute does not contain any limitation on the maximum term for QCCs and argue that a one-year limitation would be overly harsh. Among other things, they note that a strict one-year rule would preclude QCC status for even out-of-the-money options. One commentator notes that section 1092(c)(4) does not remove a QCC option completely from the straddle rules. Paragraphs (c)(4)(E) and (f) of section 1092 provide special limitations on QCCs for recognition of loss and suspension of holding period.[1] This commentator suggests that these rules limit the extent to which longer-term QCCs would lead to results inconsistent with the purposes of section 1092.

In response to the request in the preamble to the proposed regulation for alternative regimes to address the

[1] Under section 1092(c)(4)(E), the exception for QCCs does not apply to a covered call that would otherwise qualify for the exception if one leg is disposed of at a loss in one year, gain on the other position is includible for a later year, and less than 30 days has elapsed between these transactions. Under section 1092(f), if a taxpayer grants an in-the-money QCC, then loss on the call is treated as long-term capital loss if gain on the underlying stock would be long-term capital gain. In addition, the holding period is suspended for the period during which the taxpayer is the grantor of the option.