So, You're Splitting Up? What to Know When Dividing a Foundation

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This step-by-step guide will highlight the practical considerations that arise in these (often contentious) situations when a private foundation decides to split into two (or more) foundations and provide the framework for how to plan for such an event.

Occasionally, legal practitioners will come across a private foundation ("PF") that has decided to split into two (or more) PFs. The reason for this decision could be as varied as the pending divorce of the founders, family dissension that impacts productivity, or simply a lack of consensus regarding the PF's philanthropic focus. In these cases, it's not always as simple as dividing the assets into equal parts; rather, several factors should be taken into account to ensure an informed division. This step-by-step guide will highlight the practical considerations that arise in these (often contentious) situations and provide the framework for how to plan for such an event.

TECHNICAL OVERVIEW

Generally, when a PF makes a grant to another PF, the transferor PF is required to exercise special oversight over the transferee PF's spending of the grant funds by following a set of procedures known as "expenditure responsibility" ("ER").[1] These procedures require the transferor PF to conduct due diligence on the transferee PF prior to the transfer, enter into a written grant agreement containing specific terms, obtain annual reports from the transferee PF until the grant funds are fully expended[2], and report the ER grant to the IRS on the transferor's annual 990-PF. Failure to properly exercise ER could result in a violation and a penalty of 20 percent of the grant amount.[3]

A transfer of 25 percent or more of the fair market value of the net assets of a transferor PF (as of the beginning of the transfer year) to one or more transferee PFs is considered a significant disposition of the transferor's assets under IRC Section 507(b)(2) ("Significant Disposition").[4] When a Significant Disposition occurs, certain tax attributes carry over to the transferee, including aggregate tax benefits, any Chapter 42 tax liability, substantial contributors, excess business holdings period, and the basis of property.

However, if all of the transferor PF's assets are distributed in the same taxable year to one or more transferee PFs that are effectively controlled by the same person or persons ("Comprehensive Transfer"), the transferor and transferee PFs are treated as the same entity for tax purposes.[5] In addition to the tax attributes that carry over when there is a Significant Disposition, certain other tax attributes of the transferor PF ("Additional Tax Attributes") carry over and are divided proportionally amongst the transferee PFs in a Comprehensive Transfer.[6] Among these additional tax attributes are the IRC Section 4940 excise tax overpayment credited to the transferor's account and the transferor's excess grants carryover ("EGC"). For the purposes of this article, unless otherwise specified, it is assumed that the transferor PF's assets will be divided into two equal parts.

STEP 1: IDENTIFYING THE CORRECT STRUCTURE FOR A TRANSFER OF ASSETS

When a PF is planning to divide its assets, the first step should be to decide the structure of the anticipated transfer(s), which can be informed by various tax considerations.

To ensure that the Additional Tax Attributes are divided equally amongst the parties, each party would need to form a new PF, and the original PF would need to make a Comprehensive Transfer of all of its assets in equal parts to the new successor PFs (see Structure 1 in Exhibit 1).[7]

However, this approach is typically inefficient because of the need to form and obtain exempt status from the IRS for two (or more) new PFs if they do not already exist. For instance, if the PF were to be divided equally, it would be more economical to form only one PF, transfer half of the assets to it, and have each of the parties assume control over one of the PFs (see Structure 2 in Exhibit 1). Another drawback to structuring the division as a Comprehensive Transfer is that the return preparation for the transferor and transferee PFs can be extremely complex and the instructions to Form 990-PF provide very little guidance on how to report the allocation of the Additional Tax Attributes[8] that carry over only under these very specific circumstances.

The existence of a tax overpayment (one of the Additional Tax Attributes) alone should not justify the cost and effort of pursuing a Comprehensive Transfer because it can be easily accounted for by making an adjustment to the transfer amount. By contrast, the existence of significant EGC, another Additional Tax Attribute, may be grounds for pursuing a Comprehensive Transfer because adjusting the transfer amount to account for this may not be as straightforward as accounting for

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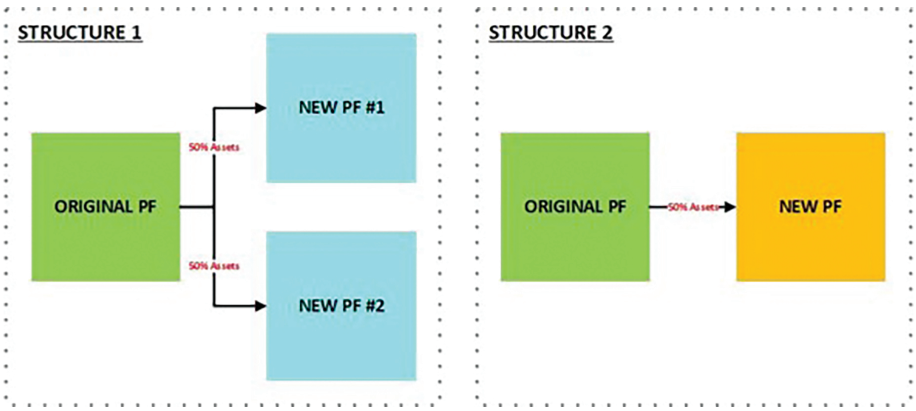
EXHIBIT 1. COMPREHENSIVE TRANSFER OF ASSETS



a tax overpayment. First, unused EGC expires five years after it is created and, second, PFs often are unable to fully utilize them within that time frame.[9]

Because of these limitations, the parties may be unable to settle on a fair adjustment to the transfer amount. Accordingly, in such a case, the parties may consider pursuing a Comprehensive Transfer to ensure a proportional division of the EGC despite the trouble and cost involved. Otherwise, the parties can pursue the more efficient approach of retaining the original PF and transferring assets to another PF. Whether all of the transferor PF's assets are transferred in a Comprehensive Transfer, or such assets are simply divided with another foundation, the transferor won't be able to count the amount transferred toward its own minimum distribution requirement under IRC Section 4942 ("MDR").[10]

In the case of a Comprehensive Transfer, the transferee is treated as if it were the transferor for certain tax purposes, meaning that the transferor is treated as having transferred funds to itself. Accordingly, the transfer won't count towards the transferor PF's MDR and, for the same reason, ER would not be necessary. Similarly, in the case where the transferor PF divides its assets with another PF in a Significant Disposition, the transferor wouldn't typically be able to count the transfer towards its MDR, as doing so would require the transferee to comply with requirements that would defeat the purpose of the transfer. Specifically, the transferee PF would need to spend down all the funds on an accelerated basis,[11] when the purpose of such a transfer usually is to endow the transferee PF. Unlike a Comprehensive Transfer, ER would be necessary when making a Significant Disposition because the transfer would be considered a grant to another PF (as opposed to a transfer from the transferor PF to itself).

If it is determined that a Comprehensive Transfer is appropriate, the next steps would be to establish new PFs (if the parties have not already done so), ensure that the technical requirements for such a transfer are met,[12] and then simply transfer the assets as agreed by the parties. If not, the parties should follow steps 2 through 4 as follows.

STEP 2: DIVIDING ASSETS

There can sometimes be tension between a desire to keep things simple and achieving absolute precision in dividing the assets. On the one hand, board members who get along well but have divergent interests are more likely to be satisfied with a rough, "back of the envelope" division of assets. They wouldn't be likely to get hung up on achieving a perfectly even split. On the other hand, on the heels of a bitter divorce or sibling rivalry, the parties are more likely to concern themselves with a precise asset division to ensure that the other side will not receive a penny more than what they are owed. The authors encountered a case where the parties developed an elaborate six-step formula, carried out to no less than nine decimal places, for dividing the PF's assets. In our experience, the transfer is most commonly framed in terms of a dollar amount, a list of assets, or a percentage of assets.

Although often not practicable, if the parties have an amicable relationship and ample liquid assets on hand, they can simply settle on a dollar amount. If the PF has a combination of cash and non-cash assets, amicable parties can split the assets into portions of roughly equal value as of a set measuring date and define the transfer as the contents of one of those portions. This approach requires a more laidback mindset because if the portions are composed of different assets, the value of each portion can fluctuate after the measuring date, which can result in an uneven division. However, this concern can be mitigated by choosing a measuring date that is close in time to the transfer date. In any event, the parties must be willing to accept that the portions may not be exactly equal in value.

Also, the assets comprising one portion may have different amounts of built-in gain or loss compared to those comprising the other portion, even if such assets are identical.[13] However, the parties may not be concerned about variations in potential tax liability, given the nominal 1.39 percent tax rate on net investment income applicable to PFs. Either way, this can also be accounted for in the form of an adjustment to the transfer amount.

Lastly, for cases where the parties have an acrimonious relationship and insist on a precise division at any cost, they can divide the assets by applying a percentage across the board to ensure that every position (including by tax lot) is split evenly with any fractional shares (or interests that cannot be split) sold and the proceeds divided accordingly.

STEP 3: DECIDING ON ADJUSTMENTS

Assuming that the transferor PF remains in existence, an adjustment to the transfer amount may be desirable. Regardless of how the asset transfer is defined in Step 2 and how well the parties get along, they may wish to consider the follow factors when determining whether and how much of an adjustment should be made:

- **Setup costs for any new PF(s).** Unless an adjustment is made, the party establishing a new PF will bear the entire burden of the associated costs, including attorneys' fees for drafting the charter documents and filing IRS Form 1023 (the application for recognition of exemption), IRS filing fees, corporate state filings (if established as a corporation), and any other related expenses. Since the party retaining the transferor PF won't need to incur any such costs, the parties may agree to split the projected setup costs and adjust the transfer amount accordingly.
- **Outstanding transfer year MDR.** If the transferor PF has not fully satisfied its transfer year MDR by the transfer date, the transferor alone will be responsible for satisfying the outstanding MDR with the remaining funds. As a pre-transfer liability, the parties may agree to make a corresponding adjustment. Without an adjustment, the transferor PF will be left to satisfy an MDR that was calculated when it had twice the amount of assets.
- **Post-transfer year MDR.** Generally, a PF's MDR is calculated based on the prior year's average asset values. Therefore, the transferor PF's MDR for the post-transfer year will be based, in part, on the transferor's average asset values from the beginning of the transfer year through to the transfer date. Unless an adjustment is made, the transferor PF will be left to bear the entire burden of the portion of the post-transfer year's MDR attributable to the average asset values for the portion of the transfer year prior to the transfer date.

For example, suppose the transferor PF's MDR for its tax year ending December 31, 2023 (the transfer year) is satisfied prior to the transfer. Additionally, suppose that on July 1, 2023 (the transfer date), the transferee PF is formed and likewise adopts a December 31 year-end. Suppose further that the transferor PF's asset average for the first half of 2023 is $10 million, the transfer amount is $5 million, and the asset average for the second half of that year is $5 million. Without an adjustment, the transferor PF's MDR for 2024 (the post-transfer year) will be roughly $375,000 ($7.5 million asset average X 5 percent) even though it would be left with only $5 million of assets post-transfer. By contrast, the newly formed transferee PF's MDR for 2024 will be roughly $125,000 ($5 million asset average X 5 percent X 182/365 for a half year[14]), even though it was also left with $5 million of assets post-transfer.

> In the case of a Comprehensive Transfer, the transferee is treated as if it were the transferor for certain tax purposes, meaning that the transferor is treated as having transferred funds to itself.

The transferor PF's asset average for the first half of 2023 is $10 million, so the 2024 MDR attributable to the first half of 2023 would be $250,000 ($10 million X 5 percent X 182/365 for a half year), resulting in a $125,000 adjustment if the parties split the $250,000 equally. In that event, the transferor PF would be out of pocket for $250,000 in the post-transfer year ($375,000 MDR, as calculated using the previous equation - $125,000 adjustment amount retained by the transferor), while the transferee PF will also be out of pocket for $250,000 in such year ($125,000 MDR + $125,000 adjustment amount retained by the transferor).

- **Tax overpayments.** If the transferor PF has an IRC Section 4940 or unrelated business income tax overpayment from the year prior to the transfer year, if the PF made estimated tax payments earlier in the transfer year, or it did both, then the parties may agree to make an adjustment to split any tax overpayment.
- **Excess grants carryover.** When a PF makes qualifying distributions well in excess of its MDR, some or all of the excess may be carried forward for up to five years to satisfy a future year's MDR. If the transferor PF has substantial EGC, the parties may want to adjust the transfer amount to take this into account. In negotiating an adjustment, a five-year-old EGC that is about to expire may warrant less of an adjustment than a recently created EGC that will be available for several years. If the parties can't agree on a fair adjustment amount, they might consider structuring the division as a Comprehensive Transfer from the transferor PF to two (or more) newly formed PFs, in which case they would be able to share the EGC proportionally.[15]
- **Actual pre-transfer tax liability.** To the extent that the transferor PF has realized net capital gain, received payments of investment income, or both during the transfer year, the transferor PF will bear the entire burden of any tax liability incurred with respect to such gain or income. Accordingly, some parties may agree to split the tax liability in half and make a corresponding adjustment to the transfer amount.
- **Latent tax liability for appreciated assets.** Another bargaining point is the allocation of the resulting potential tax liability when each party is allocated property having the same or similar FMV, but one of the parties ends up with high-basis assets and the other party ends up with low-basis assets. For example, suppose that a PF owns Greenacre and Redacre, each of which is worth $10 million. However, suppose that Greenacre's basis is only $500,000, while Redacre's is nearly $10 million. The party receiving Greenacre has a potential tax liability on the transfer date of roughly $132,000 ($10 million value on transfer date - $500,000 basis = $9.5 million potential capital gain X 1.39 percent IRC Section 4940 tax rate = $132,050 potential tax liability). By contrast, the party receiving Redacre has practically zero potential tax liability. The parties might make an adjustment to

the transfer amount to equalize Greenacre's potential tax burden. If the assets are relatively liquid, the parties might consider selling the assets before the transfer and sharing the proceeds and the actual tax liability arising from such sales. For real property, the transferor PF may partition the property prior to the transfer, unless the parties get along well, in which case the PFs can co-own the property.

- **Post-transfer income payments.** Unless an adjustment is made, the transferor PF will be entitled to keep any post-transfer investment income payments that were accrued but not yet received by the transfer date, such as ex-dividend payments. Therefore, it typically won't be worthwhile for the parties to make an adjustment unless significant post-transfer investment income is expected. In the authors' experience, the grant agreement often explicitly provides that any such post-transfer income will remain with the transferor PF.

STEP 4: FINALIZE THE TRANSFER TIMING

As with the previously mentioned steps, the ability of the parties to get along is essential in determining the timing of the transfer. For example, although the parties may determine that the most advantageous time for the transfer for tax purposes is several months away, they may not be willing to remain joined together until that time. However, if the parties are willing to postpone the transfer, here are several key factors to consider when determining the ideal timing:

- If the transferee PF is newly created, the transferor PF may not consider it prudent to make the transfer until the transferee PF has received a favorable determination letter from the IRS, which may take months.
- Planning for a year-end transfer may help the parties more effectively negotiate an adjustment to the transfer amount because the transferor PF's MDR for the transfer year should be known with certainty at that point as the prior year's return determining the transfer year's MDR would have already been filed. Therefore, the transferor can plan to satisfy its MDR by year's end with pre-transfer dollars, thus eliminating the need for an adjustment. Likewise, the transferor PF's cumulative EGC, if any, as of the beginning of the transfer year, would have been determined on the prior year's return, and the transfer amount can be adjusted accordingly. Similarly, the amount of any prior year's tax overpayment, any estimated tax payments made in the transfer year, and any transfer year tax liability arising from net investment income and net capital gains arising prior to the transfer[16] would have been determined on the prior year's return. By the end of the transfer year, the transferor PF should be able to project, with reasonable accuracy, its asset average for the transfer year, enabling it to calculate the following year's MDR and make a corresponding adjustment.
- The other factors listed in Step 3 should not be materially affected by the timing of the transfer.

An escrow account may be useful if there are too many unknowns at the time of the transfer or the parties insist on a precisely equal division of the assets. For example, it may be useful in a case where the parties wish to expedite the transfer, which is expected to occur before the transferor PF's prior year return has been finalized. It might also be useful where there could be significant tax liability (including unrelated business income tax) that will remain unknown until the transferor PF's receipt of K-1s, which may not occur until after the transfer.

When using an escrow account, the transferor PF can place a conservative portion of the assets to be transferred into escrow and transfer the balance to the transferee PF without delay. Once the uncertainties have been resolved, the appropriate portion of the amount that was held in escrow would be transferred to the transferee PF, and any balance would be returned to the transferor PF. This approach eliminates the need for a clawback of funds from the transferee PF.

CONCLUSION

Tax laws aside, human nature and family dynamics will inevitably have a huge impact on PF-to-PF transfers. In cases where the parties are on good terms, they are typically less likely to demand absolute precision when dividing a shared PF's assets. They are also typically patient enough to wait for the ideal time for the transfer and more likely to agree to a simpler transaction. Conversely, the greater the antipathy the parties have toward one another, the more insistent they may be about an exact division of the assets, often leading to a more complex transaction and an unwillingness to put off the transfer despite any advantages that might otherwise result. Regardless of where the parties fall on this spectrum, this article should help them make a more informed decision about how to divide the assets fairly and when to make the transfer.

End Notes

1 IRC Section 4945(h) and Treas. Regs. 53.4945-5.

2 However, if the grant is meant to endow the transferee PF, Treas. Regs. Section 53.4945-5(c)(2) allows the transferee PF to cease reporting after three years. This is of course provided that it is reasonably apparent to the transferor that the funds were not used in a way that would result in a taxable expenditure violation under IRC Section 4945(d).

3 In Hans S. Mannheimer Charitable Trust v. Comm'r, 93 T.C. 35 (1989), the opinion noted that Congress enacted strict and extensive expenditure responsibility rules to prevent certain widespread abusive practices amongst PFs.

4 Although special tax consequences arise from a Significant Disposition, the regulations clarify that the PF will not be considered terminated for purposes of IRC Section 507(a)(1) until it has notified the IRS of its intent to terminate. See Treas. Regs. 1.507-1(a)(1) and -1(b)(6).

5 Treas. Regs. 1.507-3(a)(9)(i) defines "effectively controlled" in reference to Treas. Regs. 1.482-1(a)(3). For purposes of the latter regulation, Treas. Regs. 1.482-1(i)(4) defines "controlled," in pertinent part, to include "...any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose. It is the reality of the control that is decisive, not its form or the mode of its exercise."

6 See Rev. Rul. 2002-28, 2002-1 C.B. 270 for a comprehensive explanation of the tax attributes that are divided in a Comprehensive Transfer.

[7] Per Rev. Rul. 2002-28, the Additional Tax Attributes are divided by following the instructions in Treas. Regs. 1.507-3(a)(9)(i). Such regulation looks at the proportion that the value of the assets each transferee receives bears to the fair market value of the assets held by the transferor immediately before the transfers.

[8] Some return preparers provide a schedule stating that a Comprehensive Transfer occurred and listing the Additional Tax Attributes that carried over because of the transfer. In our experience, even when such a schedule is filed with the return, the IRS does not reliably adjust its records to account for the allocation of the transferor PF's tax overpayment to the transferee PF's account, necessitating coordination with the IRS to correct its accounts.

[9] Contrary to what one might expect, EGC is not applied first to satisfy MDR; rather, EGC may be used to satisfy the MDR only after any current year where qualifying distributions have been applied.

[10] For the purposes of this article, the term "MDR" refers to the amount of qualifying distributions that must be made by the end of the PF's tax year to avoid a penalty under IRC Section 4942, which is technically known as the prior year's undistributed income. For instance, the 2024 MDR represents the 2023 undistributed income.

[11] Generally, per IRC Section 4942(g)(3), when granting to another non-operating PF, the transferor PF may count the grant toward its MDR only if the transferee PF spends down all of the funds it received in a given tax year by the end of its next tax year, does not count its expenditure of the grant funds toward its own MDR, and provides adequate records showing that it has met these requirements.

[12] Haskell and Adams, "Transfers Between Private Foundations," Trusts & Estates 35 (July 2007) (providing a tax compliance and reporting guide for asset transfers between private foundations).

[13] For example, although each portion may have 1,000 shares of the same stock, one portion's shares might have very low basis while the other portion's shares might have very high basis.

[14] Whenever a PF's tax year is less than a full year, such as in the formation year, the applicable percentage used to determine MDR is prorated by multiplying 5 percent by a fraction, where the numerator is the number of days in the short tax year and the denominator is 365.

[15] In PLR 200117042, a Comprehensive Transfer was deemed to occur where a PF transferred its assets to two other PFs, one controlled by each sibling, even though each transferee PF wasn't controlled by a majority of those who controlled the transferor PF.

[16] To the extent that the transferor PF is on a calendar year and has significant investments in partnerships also on a calendar year, the transferor's tax liability attributable to such investments will remain unknown until the K-1s are issued in the following year.