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Tax Information for Private Foundations and Foundation Managers



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Introduction

A private foundation is any domestic or foreign organization described in section 501(c)(3) of the Internal Revenue Code except for an organization referred to in section 509(a)(1), (2), (3), or (4) of the Code. In effect, the definition divides organizations described in section 501(c)(3) into two classes, namely private foundations and public charities.

Organizations that are not private foundations are generally those which have broad public support or actively function in a supporting relationship to those organizations.

An excise tax is imposed on the net investment income of most domestic private foundations. This is discussed in Chapter IV of this publication.

The Code contains five provisions that impose two–tier excise taxes on private foundations, foundation managers, or other disqualified persons that engage in certain prohibited acts. These five provisions are discussed in Chapters VI through X of this publication. Foundation managers and disqualified persons are defined in Chapter V.

The first–tier tax (initial tax) is automatically imposed if the foundation engages in a prohibited act. For prohibited Acts occurring after 1984, the initial tax may be abated (set aside) if it is established that the prohibited act was due to reasonable cause and not to willful neglect, and that the act was corrected within the correction period. If the prohibited act is not corrected by the end of the taxable period, the second-tier tax (additional tax) is imposed. Generally, the taxable period ends on the earlier of:

1) The date a notice of deficiency for the initial tax is mailed, or
2) The date the initial tax is assessed.

If the prohibited act is corrected during the correction period, the additional tax will not be assessed. If the tax has been assessed, it will be abated. If the tax has been collected, it will be credited or refunded as an overpayment.

The correction period begins on the date the prohibited act occurs and ends 90 days after a notice of deficiency for the additional tax is mailed, extended by any period the Internal Revenue Service determines is reasonable and necessary to correct the prohibited act. If a petition is filed with the United States Tax Court to redetermine the tax, the correction period ends when the Court's decision is final. If the Court determines that the additional tax was properly imposed, it may determine whether the act that gave rise to the tax was timely corrected.

In addition, a private foundation may contest the imposition of the additional tax in the United States District Court or in the United States Court of Claims as long as the full amount of the ***initial tax*** is paid. The additional tax does not have to be paid.

Other publications that may be of general interest are Publication 526, *Charitable Contributions,* Publication 557, *Tax–Exempt Status for Your Organization,* and Publication 598, *Tax on Unrelated Business Income of Exempt Organizations.*

Chapter I

Determination of Status

Every organization that qualifies for tax exemption as an organization described in this publication is a private foundation unless it falls into one of the categories specifically excluded from the definition of that term. Organizations that fall into the excluded categories, discussed later, are generally those that either have broad public support or actively function to support those organizations. Organizations that test for public safety also are excluded.

An organization is not a private foundation if it is:

1) A church or a convention or association of churches,
2) A school,
3) An organization operated for the benefit of certain state and municipal colleges and universities,
4) A hospital,
5) A medical research organization (operated in conjunction with a hospital),
6) A governmental unit,
7) A publicly supported organization,
8) An organization that normally receives no more than one-third of its support from gross investment income and income after tax from unrelated business taxable income, and receives more than one-third of its support from contributions, membership fees, and gross receipts from activities relating to its exempt function—subject to certain exceptions,
9) An organization operated, supervised, or controlled by or in connection with one or more of the organizations described in items (1) through (8), but not controlled (directly or indirectly) by disqualified persons other than foundation managers,
10) An organization operated solely for the benefit of one or more organizations that are exempt as civic leagues or social welfare organizations, local associations of employees, labor, agricultural, or horticultural organizations, and business leagues, chambers of commerce, real estate boards, boards of

trade, or professional football leagues (However, the exempt organization benefited must meet the support tests described in item (8), and the organization operated to benefit such organization must meet the control tests of item (9) and must not be controlled by disqualified persons other than foundation managers.), or

11) An organization organized and operated to test for public safety.

A more detailed description of the types of organizations excluded from the definition of private foundation may be found in Publication 557.

Even if an organization falls within one of the categories excluded from the definition of private foundation, it will be presumed to be a private foundation, with some exceptions, unless it gives timely notice to the Internal Revenue Service that it is not a private foundation. The presumption of private foundation status is rebuttable. The notification requirement applies to an organization regardless of when it was organized. The only exceptions to this requirement are those organizations that are excepted from the requirement of filing Form 1023, *Application for Recognition of Exemption.* Nonexempt charitable trusts described in section 4947(a)(1) also are excepted.

If an organization is required to file the notice, it must do so within 15 months from the end of the month in which it was organized.

Private Foundation Status

If your organization was a private foundation on October 9, 1969, or becomes a private foundation on any later date, it will be treated as a private foundation for all periods after that time unless its status is terminated under section 507 (see Chapter III). Therefore, if an organization was described in section 501(c)(3) and was a private foundation within the meaning of section 509(a) on October 9, 1969, it will be treated as a private foundation for all periods thereafter, even though it may also satisfy the requirements of an organization described in some other paragraph of section 501(c).

For example, if on October 9, 1969, an organization was described in section 501(c)(3), but because of its activities, it could also have qualified as an organization described in section 501(c)(4), the organization will continue to be treated as a private foundation if it was a private foundation on October 9, 1969.

Taxable private foundations. If an organization is an exempt private foundation on or after October 9, 1969, but it is later determined that it is no longer exempt as an organization described in section 501(c)(3) as of any date after October 9, 1969, the organization, even though it may operate thereafter as a taxable entity, will continue to be treated as a taxable private foundation unless its status as such is terminated under section 507.

For example, X organization was an exempt private foundation on October 9, 1969. It was later determined that, as of July 1, 1972, X was no longer exempt as an organization described in section 501(c)(3) because it did not conform its governing instrument under section 508(e). X will continue to be treated as a private foundation after July 1, 1972, unless its status as such is terminated under section 507.

Note. If an organization was not exempt on October 9, 1969, it will not be treated as a private foundation because of section 509(b), unless it becomes a private foundation on a later date.

Status of organization after termination of private foundation status. An organization whose status as a private foundation is terminated under section 507 will be treated as an organization created on the day after the day of the termination. An organization whose private foundation status has been terminated under the provisions of section 507(a) will, if it continues to operate, be treated as a new organization and must, if it wants to be classified under section 501(c)(3), apply for recognition of section 501(c)(3) status.

If the private foundation status of an organization has been terminated under section 507(b)(1)(B) and the regulations thereunder, and

1) The organization does not continue at all times thereafter to meet the requirements of section 509(a)(1), (2), or (3) (and is, therefore, no longer excluded from the definition of a private foundation), and
2) The status of the organization as a private foundation is thereafter terminated under section 507(a), then for determining the tax imposed under section 507(c)(1), the combined tax benefit resulting from section 501(c)(3) status will be figured only from the date on which the organization again becomes a private foundation under item (1).

The tax imposed on termination of private foundation status is imposed on the organization and is equal to the lesser of:

1) The amount the private foundation can verify by adequate records or other evidence as the total tax benefit resulting from the section 501(c)(3) status of the foundation, or
2) The value of the net assets of the foundation.

Private Operating Foundations

A private foundation may qualify for treatment as a private operating foundation. These foundations generally are still subject to the tax on net investment income (Chapter IV), and to the other requirements and restrictions that generally apply to private foundation activity. However, operating foundations are not subject to the excise tax on failure to distribute income (Chapter VII). Also, contributions to private operating foundations described in section 4942(j)(3) are deductible by the donors to the extent of 50% of the donor's adjusted gross income, whereas contributions to all other private foundations (except those discussed later in this chapter under *Private Nonoperating Foundation Distributing All Contributions Received*) are generally limited to 30% of the donor's adjusted gross income. In addition, a private operating foundation may receive qualifying distributions from a private foundation if the private foundation does not control it.

A private operating foundation is any private foundation that spends at least 85% of its adjusted net income or its minimum investment return, whichever is less, directly for the active conduct of its exempt activities (the income test), and that, in addition, meets one of the following tests: the assets test, the endowment test, or the support test.

Certain private foundations that provide long-term care facilities are treated as operating foundations ***only*** for the purposes of the excise tax on failure to distribute income. These foundations are discussed in greater detail in Chapter VII of this publication.

Income test. To qualify as an operating foundation, the organization must make qualifying distributions directly for the active conduct of its exempt activities equal to substantially all (at least 85%) of the lesser of its:

1) Adjusted net income, or
2) Minimum investment return.

If a private foundation's qualifying distributions exceed its minimum investment return for the tax year, but are less than its adjusted net income, substantially all of the total qualified distributions must be made directly for the active conduct of the foundation's exempt activities. However, if the foundation's minimum investment return is less than its adjusted net income and its qualified distributions equal or exceed the adjusted net income, only that part of the qualified distributions equal to substantially all of the foundation's adjusted net income must be made directly for the active conduct of the foundation's exempt activities.

Qualifying distributions and minimum investment return are defined in Chapter VII.

Adjusted net income is the excess of gross income for the tax year (including gross income from any unrelated trade or business) determined with certain modifications (described later) over the total deductions (including deductions directly connected with carrying on any unrelated trade or business) that would be allowed a taxable corporation determined with certain deduction modifications (described later).

Gross income does not include gifts, grants, or contributions received by the private operating foundation but does include income from a functionally-related business. Gross income and the total deductions allowable from that income will be figured as they are normally figured for income tax purposes except as otherwise provided. For figuring adjusted net income, there will be no exclusions, deductions, or credits unless provided under *Income modifications* and *Deduction modifications.*

Amounts received by the foundation in tax years beginning after 1969 representing repayment of principal on loans made in tax years before 1970 are not includible in gross income. However, payments of interest on those loans are includible in gross income.

Income modifications:

1) Interest on government obligations normally excluded under section 103 of the Code is included in gross income.
2) When reporting capital gains and losses from the sale or other disposition of property, only net short-term capital gains are included in gross income. Long-term capital gains or losses are not included. Neither are net section 1231 gains included. But net section 1231 losses may be included in the computation if the losses are otherwise deductible under these rules. Any net short-term capital loss may not be deducted for the year in which it occurs. This loss may not be carried back or carried over to earlier or later tax years regardless of whether the foundation is a corporation or a trust. Capital gain dividends received from a regulated investment company are excluded from the foundation's adjusted net income.
3) Gross income includes:
   a) Amounts received or accrued as repayments of amounts taken into account as qualifying distributions for any tax year,
   b) Amounts received or accrued from the sale or other disposition of property to the extent that the acquisition of the property was considered a qualifying distribution for any tax year, and
   c) Any amount set aside for a specific project (see *Set-asides,* in Chapter VII) to the extent the amount set aside was not necessary for the purposes for which it was set aside.
4) The excess of fair market value on the date of distribution over adjusted basis of property distributed to a state, a U.S. possession, or any political subdivision thereof, the United States, or the District of Columbia for public purposes, or to a charitable trust or corporation, will not be included in gross income.
5) The income received from an estate during the administration period will not be included in the operating foundation's gross income. However, if the estate is considered terminated for income tax purposes because of a prolonged administration period, the income will be included in gross income.

For purposes of item 2, in determining gain from the sale or other disposition of property, adjusted basis will be the greater of:

1) The fair market value of the property on December 31, 1969, plus or minus all adjustments to basis after 1969, using straight line depreciation and cost depletion, if the foundation held the property on December 31, 1969, and continuously thereafter to the date of sale or disposition, or
2) Adjusted basis as normally determined using straight line depreciation or cost depletion.

For determining loss from a sale or other disposition of property, the adjusted basis as normally determined using straight-line depreciation or cost depletion will apply.

Example. The Morgan Foundation bought unimproved land in January 1969, for $102,000. On December 31, 1969, the fair market value of the property was $110,000 and the adjusted basis was still $102,000. The property was sold on January 2, 1983, for $105,000. Because the fair market value on December 31, 1969, was greater than the adjusted basis, the fair market value is the adjusted basis used to determine gain. However, because the adjusted basis for determining gain, $110,000, was greater than the sale price, there was no gain. Moreover, because the adjusted basis for determining loss, $102,000, was less than the sale price, there was no loss.

Deduction modifications. Deductions generally are limited to ordinary and necessary expenses paid or incurred for the production or collection of gross income, or for the management, conservation, or maintenance of property held for the production of income. These expenses include the part of a private foundation's operating expenses paid or incurred for the production or collection of gross income. Operating expenses include compensation of officers, other salaries and wages of employees, interest, rent, and taxes.

When only part of the property is income producing or held for the production of income subject to the provisions of section 4942 and the remainder is used for exempt purposes, the allowable deductions must be divided between exempt and nonexempt uses.

If the expenses for property used for exempt purposes are more than the income received from the property, the excess may not be deducted.

Allowances for straight line depreciation and depletion (other than percentage depletion) are deductible. Deductions will be allowed for expenses and interest paid or incurred to carry tax-exempt obligations. However, no deduction will be allowed for amounts not paid or incurred for purposes described earlier. For example, there will be no deduction for:

1) Charitable contributions,
2) Net operating losses, and
3) The special deductions for corporations.

Directly for the active conduct of exempt activities means qualifying distributions a foundation makes that are used to conduct exempt activities by the foundation itself, rather than by or through one or more grantee organizations that receive the qualifying distributions directly or indirectly from the foundation.

Grants made to other organizations to assist them in conducting their activities are considered an indirect, rather than direct, means of carrying out an exempt purpose of the private foundation, even though the activities of the grantee organization may further the exempt activities of the grantor foundation.

Amounts paid to buy or maintain assets used directly in the conduct of the foundation's exempt activities, such as the operating assets of a museum, public park, or historic site, are direct expenditures for the active conduct of the foundation's exempt activities. Likewise, administrative expenses (such as staff salaries and traveling expenses) and other operating costs necessary to conduct the foundation's exempt activities (regardless of whether they are directly for the active conduct of exempt activities) are treated as qualifying distributions expended directly for the active conduct of exempt activities if the expenses and costs are reasonable in amount.

However, administrative expenses and operating costs that are not for exempt activities, such as expenses in connection with the production of investment income, are not treated as qualifying distributions. Expenses for both exempt and nonexempt activities will be allocated to each activity on a reasonable and consistently applied basis.

Any amount set aside by a foundation for a specific project, for example to buy and restore or build additional buildings or facilities that are to be used by the foundation directly for the active conduct of the foundation's exempt activities, will be treated as qualifying distributions expended directly for the active conduct of the foundation's exempt activities if the set-aside meets the requirements described in Chapter VII.

Payments to individuals. If a foundation makes or awards grants, scholarships, or other payments to individual beneficiaries (including program-related investments as described in Chapter IX) to support active programs to carry out the foundation's exempt purpose, the payments will be treated as qualifying distributions made directly for the active conduct of exempt activities only if the foundation maintains some ***significant involvement*** in the active programs in support of which it makes the payments.

A foundation will be considered as maintaining a ***significant involvement*** in grant-making if—

1) The foundation operates as follows:
   a) An exempt purpose of the foundation is the relief of poverty or human distress, and its exempt activities are designed to improve conditions among the poor or distressed or in an area subject to poverty or national disaster (such as providing food or clothing to indigents or residents in a disaster area),
   b) The grants or other payments for the exempt purpose are made directly by the foundation without the help of an intervening organization or agency, and
   c) The foundation has a salaried or voluntary staff of administrators, researchers, or other personnel who supervise and direct the exempt activities on a continuing basis, ***or***
2) The foundation has developed some specialized skills, expertise, or is involved in a particular discipline (such as scientific or medical research, social work, education, or the social sciences). It has a salaried staff of administrators, researchers, or other personnel who supervise or conduct programs or activities that support the foundation's work in its particular area of interest. As part of these programs or activities the foundation makes grants, scholarships, or other payments to individuals to encourage their involvement in the foundation's area of interest and in some segment of the activities carried on by the foundation (such as grants under which the recipients, in addition to independent study, attend classes, seminars, or conferences sponsored or conducted by the foundation, or grants to engage in social work or scientific research projects under the general direction and supervision of the foundation).

Whether making or awarding grants, scholarships, or other payments constitutes qualifying distributions made directly for the active conduct of the foundation's exempt activities is determined by the facts and circumstances of each particular case. The test applied is a qualitative one. If the foundation maintains a significant involvement (as defined earlier), it will not fail to qualify solely because more of its funds are devoted to grants, scholarships, or other payments than to the active programs that such grants, scholarships, or other payments support.

However, if a foundation does no more than select, screen, and investigate applicants for grants or scholarships, under which the recipients perform their work or studies alone or exclusively under the direction of some other organization, the grants or scholarships will not be treated as qualifying distributions made directly for the active conduct of the foundation's exempt activities. The administrative expenses of screening and investigating (as opposed to the grants or scholarships themselves) may be treated as qualifying distributions made directly for the active conduct of the foundation's exempt activities.

Only private operating foundations may treat the ***payment of the tax on net investment income*** (see Chapter IV) as a qualifying distribution made directly for the active conduct of activities constituting the foundation's exempt purpose.

Assets test. A private foundation will meet the assets test if 65% or more of its assets:

1) Are devoted directly to the active conduct of its exempt activity, or to a functionally related business (as defined in Chapter X), or a combination of the two,
2) Consist of stock of a corporation that is controlled by the foundation (by ownership of at least 80% of the total voting power of all classes of stock entitled to vote and at least 80% of the total shares of all other classes of stock) and at least 85% of the assets of which are so devoted, or
3) Are any combination of (1) and (2).

Qualifying assets. An asset is devoted directly to the foundation's exempt purpose only if it is used by the foundation in actually carrying on the charitable, educational, or other similar function that gives rise to the exempt status of the foundation. Assets such as real property, physical facilities or objects (such as museum assets, classroom fixtures, and research equipment) and intangible assets (such as patents, copyrights, and trademarks) are directly devoted to the extent they are used by the foundation in directly carrying on its exempt activities or program. However, assets (for example, stock, bonds, or rental property) including endowment funds, when held primarily for the production of income, for investment, or for some similar use, are not devoted directly to the active conduct of the foundation's exempt function, even though income from the assets is used to carry on the foundation's exempt function.

Whether an asset is held for the production of income, for investment, or for some similar use, rather than being used for the active conduct of the foundation's exempt activities, is a question of fact.

For example, an office building used to provide offices for employees engaged in the management of endowment funds of the foundation is not devoted to the active conduct of the foundation's exempt activities.

However, for property used both for exempt and other purposes, if the exempt use of the property represents at least 95% of the total use, the property will be considered to be used exclusively for an exempt purpose. Property acquired by a foundation to be used in carrying out its exempt purpose may be considered devoted directly to the active conduct of that purpose even though the property, in whole or in part, is leased for a limited and reasonable period of time during which arrangements are made for its conversion to the use for which it was acquired. Generally, one year is considered a reasonable period of time. Similarly, when property is leased by a foundation in carrying out its exempt purpose and when the rental income received from the property by the foundation is less than the amount that would be required to be charged to recover the cost of purchase and maintenance of the property, the property will be considered devoted directly to the active conduct of the foundation's exempt activities.

Fair market value must be used in determining whether 65% or more of the assets are devoted directly to exempt purposes. However, in the case of assets that are unique and for which no ready market or standard valuation method exists, such as historical objects, buildings, certain works of art, and botanical gardens, the historical cost (unadjusted for depreciation) will be considered fair market value, unless the foundation can show that fair market value is other than cost. If the foundation can show that fair market value is other than cost, this substituted valuation may be used for the tax year for which the new valuation is shown and for each of the following 4 tax years.

See Chapter VII for a discussion of valuations.

Assets maintained for extending credit or making funds available to members of a charitable class are not considered assets devoted directly to the active conduct of exempt activities. For example, assets set aside in special reserve accounts to guarantee student loans made by lending institutions will not be considered qualifying assets. Even though amounts set aside for specific projects may qualify (as explained earlier) as distributions expended directly for the active conduct of exempt activities for the income test, they do not qualify under the assets test as assets devoted directly to the active conduct of the foundation's exempt activities.

Assets held for less than a full tax year. In applying the assets test, assets held for only part of the tax year are taken into account for the year by multiplying the fair market value of each asset by a fraction. The numerator of the fraction is the number of days during the year that the foundation held the asset, and the denominator is the total number of days in the year.

Endowment test. A foundation will meet the endowment test if it normally makes qualifying distributions (defined in Chapter VII) directly for the active conduct of its exempt activities of at least two-thirds of its minimum investment return. The term "directly for the active conduct of its exempt activities" means the same as it does for the income test discussed earlier.

The minimum investment return for any private foundation is 5% of the excess of the combined fair market value of all assets of the foundation (other than those used or held for use directly in the active conduct of its exempt purpose) over the amount of indebtedness incurred to buy those assets.

In determining whether the amount of qualifying distributions is at least two-thirds of the organization's minimum investment return, the organization is not required to trace the source of the expenditures to determine whether they were received from investment income or from contributions.

Example. X foundation, created after May 26, 1969, has $400,000 of endowment funds and other assets not directly used for its exempt purpose. X makes qualifying distributions of $20,000 during the year directly for the active conduct of its exempt function. Two-thirds of X's minimum investment return is $13,333.33 (5% × $400,000 = $20,000; ⅔ × $20,000 = $13,333.33). Since the $20,000 distribution is greater than $13,333.33, X meets the endowment test.

Support test. A private foundation will meet the support test if:

1) At least 85% of its support (other than gross investment income) is normally received from the general public and 5 or more unrelated exempt organizations,
2) Not more than 25% of its support (other than gross investment income) is normally received from any one exempt organization, and
3) Not more than 50% of its support is normally received from gross investment income.

Here the term ***support*** means gifts, grants, contributions, membership fees, the value of services or facilities furnished by a governmental unit without charge, net income from unrelated business activities, and gross receipts from admissions, sales of merchandise, performance of services, or providing facilities in any activity that is not an unrelated trade or business.

The support received from any one exempt organization may be counted toward satisfying the 85% support test only if the foundation receives support from at least five exempt organizations.

For example, a foundation that normally receives 20% of its support (other than gross investment income) from each of five unrelated exempt organizations will meet the support test even though it receives no support from the general public. However, if a foundation normally receives 50% of its support (other than gross investment income) from three foundations and the balance of the support comes from sources other than exempt organizations, the foundation will not meet the 85% test.

Support from the general public includes support received from an individual, trust, corporation, or governmental unit to the extent that the total amount received from any one individual, trust, or corporation does not exceed 1% of the foundation's total support (other than gross investment income) for the period. In applying the 1% limit, all support received from any donor and any person related to the donor is treated as received from one person. Support received from a governmental unit is not subject to the 1% limit.

Determination of compliance with operating foundation tests. The determination of whether the income test and one of the three remaining tests are met depends on whether the tests are met in the normal and regular operation of a foundation over a period of years, rather than on a given day during the year or on a year-by-year basis. A foundation may qualify as an operating foundation if it meets the income test and either the assets, endowment, or support test for any 3 years during a 4–year period, or on the basis of a combination of all pertinent amounts of income or assets held, received, or distributed during the 4–year period. The 4–year period consists of the tax year in question and the 3 years immediately before the year in question. A foundation may not use one method for satisfying the income test and the other method for satisfying one of the other tests.

For example, if the income test is satisfied on the 3-out-of-4–year basis, you may not use the 4–year combination method to satisfy one of the other tests. However, the fact that the foundation uses one method to satisfy the tests in a particular year will not prevent it from using the other method to satisfy the tests in a later year. If a foundation fails to satisfy the income test and either the assets, endowment, or support test for a particular tax year under ***either*** the 3-out-of-4–year method or the combination method, it will be treated as a nonoperating foundation for the tax year and for all later tax years until it satisfies the tests.

New organizations. A newly organized foundation generally will be treated as an operating foundation only if it has satisfied the income test and one of the three other tests for its first tax year of existence. If so, it will be treated as an operating foundation from the beginning of its first year. This status will continue for its second and third tax years of existence only if it satisfies the tests by the combination method for all tax years of existence.

Before the end of its first tax year, a foundation may be treated as an operating foundation if it has made a good faith determination that it is likely to meet the tests for its first year. A good faith determination may be based on an affidavit or opinion of counsel, giving enough facts concerning the operations and support of the organization to enable the Internal Revenue Service to determine that the requirements are likely to be met. If a foundation is treated as an operating foundation for its first year, but actually fails to qualify for the first year, it will be treated as a nonoperating foundation as of the first day of its second year. However, such a foundation may establish to the satisfaction of the Service that it is likely to qualify as an operating foundation on the basis of its 2nd, 3rd, and 4th tax years. If so, it will be treated as an operating foundation until the first day of a tax year in which it fails to qualify. Status as a private foundation that is not an operating foundation will continue until the organization is able to satisfy these tests by either the 3-out-of-4–year method or the combination method.

The deductibility of grants or contributions to an operating foundation will not be affected until notice of a change in the status of such an organization is made to the public (such as by publication in the *Internal Revenue Bulletin*) ***unless:***

1) The contribution was made after the contributor acquired knowledge that the organization would be deleted by the Service from classification as an operating foundation, or
2) The contribution was made after an act or failure to act which caused the inability to satisfy the tests for qualification as an operating foundation, and the contributor was responsible for, or was aware of, the act or failure to act. A contributor will not be considered responsible for, or aware of, the act or failure to act if the contributor made the contribution relying on a written statement by the foundation that the contribution would not result in the inability to qualify as an operating foundation. This statement must be signed by a foundation manager and must give enough facts concerning the operations and support of the organization to assure a reasonably prudent person that a contribution would not result in disqualification as an operating foundation.

Exempt Operating Foundations

Effective for tax years beginning after 1984, certain private operating foundations, known as ***exempt operating foundations,*** are not subject to the tax on net investment income (Chapter IV).

To qualify as an exempt operating foundation for a tax year, a private foundation must meet all the following requirements:

1) It must be a private foundation (see above discussion),
2) It has been ***publicly supported*** for at least 10 tax years or was a private operating foundation on January 1, 1983, or for its last tax year ending before January 1, 1983.
3) Its governing body, at all times during the tax year, consists of individuals less than 25% of whom are disqualified individuals, and is broadly representative of the general public, and
4) It has no officer who is a disqualified individual at any time during the tax year.

Publicly supported means that the organization normally receives:

1) A substantial part of its support (other than income from its exempt function) from governmental units or from direct or indirect contributions from the general public, ***or***
2) More than a third of its support from governmental units, certain publicly supported charities (listed as items (1) through (7) under *An organization is not a private foundation* at the beginning of this chapter), and persons other than disqualified persons (see Chapter V), in any combination of gifts, grants, contributions, membership fees, and gross receipts from activities that are not an unrelated trade or business (but only including such gross receipts from any one person, or bureau or similar agency of a governmental unit, that are not more than the greater of $5,000 or 1% of the foundation's support for the tax year), ***and***

does not normally receive more than a third of its support from gross investment income (see Chapter IV) plus any excess of unrelated business taxable income over the tax on unrelated business income.

A "substantial part" of the foundation's support, for purposes of (1) above, generally is a third of its total support, figured on a combined basis for the 4 tax years immediately preceding the tax year in question. However, if the foundation does not meet this one-third support test, it may still qualify as deriving a substantial part of its support from governmental units and from the general public if it:

1) Normally receives at least 10% of its support from these sources,
2) Satisfies the "attraction of public support" requirement by being organized and operated to attract new and additional public or governmental support on a continuous basis, and
3) Satisfies some or all of 5 public support factors.

Substantial public support is discussed in detail in Publication 557, *Tax-Exempt Status for Your Organization.*

Disqualified individual, for purposes of the requirements regarding composition of the governing body and officers of the foundation, means any of the following:

1) A substantial contributor, as defined in Chapter V,
2) An owner of more than 20% of—
   a) The total combined voting power of a corporation,
   b) The profits interest of a partnership, or
   c) The beneficial interest of a trust or unincorporated enterprise, which is a substantial contributor to the foundation, or
3) A member of the family (defined in Chapter V) of any individual described in (1) or (2).

Indirect ownership of stock in a corporation, profits interest in a partnership, or beneficial interest in a trust or unincorporated enterprise is taken into account for determining a disqualified individual under (2) above, according to the rules explained under *Attribution of ownership* in Chapter V.

Ruling letter required. A foundation wanting recognition of "exempt operating foundation" status must obtain a ruling letter from the Internal Revenue Service determining that it has met the specific requirements of this special status. To claim exemption from the tax on net investment income, the foundation should attach a copy of this ruling letter to its annual returns, Forms 990–PF, for tax years beginning after 1984 for which the claim for exemption is made.

To obtain the ruling letter, the foundation should submit its request to Internal Revenue Service, Assistant Commissioner (Employee Plans and Exempt Organizations), 1111 Constitution Avenue, Washington, DC 20224. Supporting documents and materials with the ruling request must demonstrate that requirements (1) through (4) listed at the beginning of this discussion are met. Specifically, for purposes of requirements (3) and (4), the foundation must list all its officers and members of its governing body for the current year and identify any that are disqualified individuals.

Special Rules for Certain Foundations and Trusts

Private Nonoperating Foundation Distributing All Contributions Received

Contributions to a private nonoperating foundation may qualify for the benefit of the 50% contribution deduction limit, and donors may deduct the full value of appreciated property, if the private nonoperating foundation:

1) Distributes an amount equal in value to 100% of all contributions received in the tax year by the 15th day of the 3rd month after the close of its tax year,
2) Has no remaining undistributed income for the year, and
3) Distributes only qualifying distributions that are treated as distributions out of corpus.

Qualifying distributions cannot be made to:

1) An organization controlled directly or indirectly by the foundation or by one or more disqualified persons, or
2) A private foundation that is not an operating foundation.

To qualify for the 50% contribution deduction, the organization must distribute all contributions received in any year, whether of cash or property. Distributions will be treated as made first out of contributions of property and second out of cash contributions received by the foundation during the year, to qualify for the deduction of the full value of appreciated property. A private foundation is not required to trace specific contributions of property, or amounts into which those contributions are converted, to specific distributions. A private foundation may choose to treat part or all of one or more distributions, made by the 15th day of the 3rd month after the close of the year, as made out of corpus. The choice is discussed in Chapter VII under *Treatment of qualifying distributions.*

The fair market value of contributed property, determined on the date of the contribution, generally must be used to determine whether an amount equal to 100% of the contributions received has been distributed. If the property is sold, the foundation may reduce the property's fair market value by any reasonable selling expenses incurred. The foundation must distribute the balance of the fair market value of the property that was sold to meet the 100% distribution requirement. However, if within 30 days after receiving the contributed property, the foundation sells the property or distributes the property to a public charity, the foundation may choose to treat either—

1) The gross amount received on the sale, minus reasonable selling expenses incurred, or
2) The fair market value of the contributed property at the date of its distribution to the public charity as the fair market value for purposes of the 100% distribution requirement.

A taxpayer claiming a deduction for a charitable contribution to a private nonoperating foundation must get adequate records or other sufficient evidence from the foundation showing that the foundation made the required qualifying distributions in the time prescribed. Records or other evidence must be attached to the taxpayer's return for the tax year the charitable contribution deduction is claimed.

Private Foundation Maintaining a Common Fund

Designation by substantial contributors. Donors to a private foundation that pools all contributions received in a common fund are also eligible for the 50% contribution deduction limit, and may deduct the full value of appreciated property (see above discussion under *Private Nonoperating Foundation Distributing All Contributions Received*), if the foundation meets certain requirements. The foundation must be described as a supporting organization of a public charity (as defined in section 509(a)(3) of the Internal Revenue Code) except for the fact that any donor (or donor's spouse) who is a substantial contributor has the right to designate annually the public charities that are to receive the income from the donor's contribution to the fund and to direct (by deed or by will) the payment to public charities of the corpus in the common fund from the donor's contribution.

Distribution requirements. To qualify, the private foundation must be required by its governing instrument to distribute, and it must actually distribute (including administrative expenses):

1) All of the adjusted net income of the common fund to one or more public charities by the 15th day of the 3rd month after the close of the tax year in which the income is realized by the fund, and
2) All the corpus from any donor's contribution to the fund to one or more public charities not later than one year after the donor's death or after the death of the donor's surviving spouse if the surviving spouse has the right to designate the recipients of the corpus.

Failure to designate. A private foundation will not fail to qualify if a substantial contributor or spouse fails to exercise the right to designate the recipients of income or corpus of the fund, as long as the income and corpus from the contribution are distributed as required.

Nonexempt Trusts

Section 4947 generally subjects trusts that are not exempt from tax to the same requirements and restrictions that apply to private foundations if the trusts have any unexpired interests devoted to charitable purposes. The aim of section 4947 is to prevent a trust of this nature from being used to avoid the requirements and restrictions that apply to private foundations.

In this connection, a charitable purpose includes a religious, educational, charitable, scientific, or literary purpose, a purpose to foster national or international sports competition (but only if there is no provision of athletic facilities or equipment), a purpose to prevent cruelty to children or animals, or a gift to or for the use of a state, a possession of the United States, or any political subdivision of the same, the United States, or the District of Columbia, when the gift is to be used exclusively for public purposes.

Charitable trusts. A charitable trust described in section 4947(a)(1) is a trust that is not tax exempt, all of the unexpired interests of which are devoted to one or more charitable purposes, and for which a charitable contribution deduction was allowed under a specific section of the Internal Revenue Code. A charitable trust is treated as a private foundation unless it meets the requirements for one of the exclusions that classifies it as a public charity. Thus, it is subject to the private foundation excise tax provisions described in this publication and the other provisions that apply to exempt private foundations, including termination requirements and governing instrument requirements. However, a charitable trust is not treated as a charitable organization for purposes of exemption from tax. Accordingly, the trust is subject to the excise tax on its investment income under the rules that apply to taxable foundations rather than those that apply to tax-exempt foundations.

For purposes of the organizational test, when a charitable trust seeks exemption from tax as a charitable organization, the trust is considered organized on the day it first becomes subject to section 4947(a)(1). Generally, for purposes of the special and transitional rules for excise taxes discussed in this publication, a charitable trust will be considered organized on the first day it has amounts in trust for which a deduction was allowed under the Internal Revenue Code. Under this rule, a trust may be treated as a private foundation in existence on a date governing one of the applicable special and transitional rules even though the trust did not otherwise become subject to the provisions that apply to private foundations until a later date.

Scope of provisions regarding charitable trusts. These provisions apply to nonexempt trusts in which all unexpired interests are charitable.

An estate from which the executor or administrator is required to distribute all of the net assets in trust to charitable beneficiaries will not be considered a charitable trust during the period of estate administration or settlement except for the conditions discussed in the next paragraph. A charitable trust created by a will is considered a charitable trust as of the date of death of the decedent-grantor. However, a revocable trust that becomes irrevocable upon the death of the decedent-grantor, or a trust created by will from which the trustee is required to distribute all of the net assets for, or free of trust to, charitable beneficiaries, is not considered a charitable trust for a reasonable period of settlement (defined later) after becoming irrevocable. After that period, the trust is considered a charitable trust.

Estates. When an estate from which the executor or administrator is required to distribute all of the net assets in trust for charitable beneficiaries, or free of trust to those beneficiaries, is considered terminated for federal income tax purposes, the estate will then be treated as a charitable trust between that date and the date the final distribution of all the net assets is made to or for the benefit of the charitable beneficiaries. These provisions do not affect the determination of the tax liability of the beneficiaries of the estate.

Example. Malcolm Thorn bequeaths his entire estate, including 100% of the stock of a wholly-owned corporation, to M, an organization described in section 501(c)(3), under a will that gives his executor authority to hold the stock and manage the corporation for a period of up to 10 years for the benefit of M before its ultimate disposition. A deduction for the charitable bequest was allowed to Malcolm's estate. The executor is vested with a full range of powers, including the power of sale. Upon Malcolm's death, his executor distributes Malcolm's assets to M except for the stock of the corporation, which he holds for 5 years before its disposition. Because the executor held the stock of the corporation beyond a reasonable time for performing all the ordinary duties of administration, the estate is considered terminated for federal income tax purposes and is subject to the provisions of section 4947(a)(1) from the date of this termination to the date of final disposition of the stock of the corporation.

Certain split-interest trusts that wind up. A split-interest trust (defined later) in which all of the unexpired interests are charitable remainder interests and in which the charitable beneficiaries have become entitled to distributions of corpus in trust or free of trust will continue to be treated as a split-interest trust until the date final distribution of all the net assets is made. However, if after the expiration of any intervening interests, the trust is considered terminated for federal income tax purposes, the trust will then be treated as a charitable trust rather than a split-interest trust between the date on which the trust is considered terminated and the date final distribution of all the net assets is made. These provisions do not affect the determination of the tax liability of the beneficiaries of the trusts.

Split-interest trusts that become charitable trusts. A split-interest trust in which all of the unexpired interests are charitable remainder interests and in which some or all of the charitable beneficiaries are not entitled to distributions of corpus will continue to be treated as a split-interest trust for a reasonable period of settlement after the expiration of the noncharitable interest. A split-interest trust that under its terms is to continue to hold assets for charitable beneficiaries after the expiration of the noncharitable interest rather than distributing them is allowed a reasonable period of time for settlement before being treated as a charitable trust.

Reasonable period of settlement is that period reasonably required (or if shorter, actually required) by the trustee to perform the ordinary duties of administration necessary for the settlement of the trust. For example, these duties include the collection of assets, the payment of debts, taxes, and distributions, and the determination of the rights of the subsequent beneficiaries.

Example. On January 15, 1983, Cyril Elmwood created a charitable remainder annuity trust under which the trustees were required to distribute $10,000 a year to Betty, Cyril's wife, for life and to hold the remainder in trust for the use of M, an organization described in section 501(c)(3). Cyril was allowed a deduction for the amount of the charitable interest, and the trust was treated as a split-interest trust from the date of its creation. Betty died on February 10, 1988. On April 15, 1988, the trustees completed the ordinary duties of administration necessary for the settlement of the trust brought about by Betty's death. These duties include, for example, an accounting for and payment to Betty's estate of amounts accrued by Betty while alive during 1988. However, the trustees did not distribute the corpus to M by April 15, 1988. The trust would continue to be treated as a split-interest trust until April 15, 1988. After April 15, 1988, the trust would be treated as a charitable trust.

Revocable trusts that become charitable trusts. A revocable trust that becomes irrevocable upon the death of the decedent-grantor in which all of the unexpired interests are charitable and whose governing instrument provides that the trustee is required to hold some or all of the net assets in trust (after becoming irrevocable) solely for charitable beneficiaries, is not considered a charitable trust for a reasonable period of settlement after becoming irrevocable, except that certain rules concerning self-dealing apply. After that period, the trust is considered a charitable trust.

Trust devoted to qualified charitable contribution purposes. A trust in which all of the unexpired interests are devoted to war veterans' organizations or certain cemetery companies as well as the types of organizations listed earlier under *Scope of provisions regarding charitable trusts* will be considered a charitable trust. Payments made to veterans' organizations and certain cemetery companies will be considered qualifying distributions under these circumstances.

Example. Hugo Briar creates an inter vivos trust whose governing instrument provides that M, a war veterans' organization, and N, an organization described in section 501(c)(3), are each to receive 50% of the income for a period of 10 years. At the end of the 10–year period, the corpus is to be distributed to O, an organization also described in section 501(c)(3). Hugo is allowed an income tax deduction for the value of all interests placed in trust. The payments to M are qualifying distributions. Accordingly, the trust will be considered a charitable trust.

Charitable trusts that support public charities. Charitable trusts that qualify under section 509(a)(3) (as supporting organizations of public charities) are not treated as private foundations and, thus, are not subject to the taxes and restrictions that apply to private foundations. In determining whether it qualifies under section 509(a)(3), a charitable trust will be treated as if organized on the day it first becomes subject to section 4947(a)(1). The previous relationship between the charitable trust and the organizations it benefits or supports may be considered. The charitable trust may obtain recognition of its status as a section 509(a)(3) organization by requesting a ruling from the Internal Revenue Service.

Split-interest trusts. A split-interest trust is a trust:

1) That is not exempt from tax,
2) Not all of the unexpired interests of which are devoted to religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals, and
3) That has amounts in trust for which a charitable contribution deduction has been allowed.

Also included under these provisions is a split-interest trust that is not treated as a charitable trust during a reasonable period of settlement or while it is in the process of winding up. See the earlier discussion under *Certain split-interest trusts that wind up* or *Split-interest trusts that become charitable trusts.*

A split-interest trust is subject to the following provisions discussed in this publication in the same manner as is a private foundation:

1) Terminations, Chapter III,
2) Governing instruments, Chapter II,
3) Tax on self-dealing, Chapter VIII,
4) Tax on excess business holdings, Chapter X,
5) Tax on investments that jeopardize charitable purpose, Chapter IX, and
6) Tax on taxable expenditures, Chapter VI.

These provisions do not apply to amounts transferred in trust before May 27, 1969.

Also, the provisions do not apply to any amounts payable under the terms of a split-interest trust to income beneficiaries, unless a charitable contribution deduction was allowed with respect to the income interest of the beneficiary. For example, Hyram Jones created a split-interest trust that is required annually to pay Melanie Jones 5% of the net fair market value of the trust assets, valued annually, for her life; and to pay the remainder to Y, a section 501(c)(3) organization. A charitable contribution deduction was allowed for the remainder interest. Each annual amount payable to Melanie for her life is not subject to the provisions listed earlier. These payments are not acts of self-dealing or taxable expenditures. However, with the exception of the income interest so paid, the trust is subject to the provisions in the same manner as if the trust were a private foundation.

Exception for certain segregated amounts. These provisions will not apply to assets held in trust (including income and capital gains received from these assets), other than assets for which a charitable contribution deduction has been allowed, if these assets are segregated from the other assets held in trust.

Segregation of amounts. Amounts generally will be considered segregated if:

1) The assets for which no deduction was allowed are separately accounted for from assets for which a deduction was allowed for any income or remainder interest, and
2) Because there is a separate accounting, the trust can be treated as two separate trusts, one devoted exclusively to noncharitable income and remainder interests and the other as a charitable trust or a split-interest trust.

Under these circumstances, only the trust that is devoted exclusively to noncharitable income and remainder interests will be considered a segregated amount which is not subject to the restrictions described above for split-interest trusts.

Exclusively charitable amounts. If an amount held in trust that is devoted exclusively to noncharitable income and remainder interests is segregated from an amount held in trust that is devoted exclusively to charitable income and remainder interests, then the latter amount will be treated as a charitable trust.

Charitable and noncharitable amounts. If an amount held in trust that is devoted exclusively to noncharitable income and remainder interests is segregated from an amount held in trust that is devoted to both charitable income or remainder interests and noncharitable income or remainder

interests, then that latter amount will be treated as a split-interest trust.

Accounting for segregated amounts. A trust that has segregated amounts must separately account for the income, deductions, and other items attributable to each segregated amount in the books of account and separately account to each of the beneficiaries of the trust.

Separate accounting will be made according to the method ***regularly employed*** by the trust, if the method is reasonable. In all other cases, it will be made in a manner that, in the opinion of the Internal Revenue Service, is reasonable.

A method of separate accounting will be considered ***regularly employed*** by a trust when the method has been consistently followed in earlier tax years or when a trust that has never before kept segregated amounts begins a reasonable method of separate accounting for its segregated amounts and consistently follows such method in the future. The trust will keep permanent records and other data relating to the segregated amounts as are necessary to enable the IRS to determine the correctness of the methods used to segregate these amounts.

Scope of provisions regarding split-interest trusts. The provisions generally apply to trusts in which some but not all unexpired interests are charitable. An estate from which the executor or administrator is required to distribute all of the net assets in trust or free of trust to both charitable and noncharitable beneficiaries will not be considered a split-interest trust during the period of estate administration or settlement with the exception of the provisions discussed under *Estates* in the next paragraph. A split-interest trust created by a will is considered a split-interest trust as of the date of death of the decedent-grantor except for the exceptions discussed under *Certain revocable and testamentary trusts that wind up* later in this chapter.

Estates. When an estate, from which the executor or administrator is required to distribute all of the net assets in trust or free of trust to both charitable and noncharitable beneficiaries, is considered terminated for federal income tax purposes, then the estate will be treated as a split-interest trust or charitable trust (if applicable) between the date on which the estate is considered terminated and the date on which final distribution of the net assets to the last remaining charitable beneficiary is made. This does not affect the determination of the tax liability of either charitable or noncharitable beneficiaries of the estates.

Example. Henry Post died on January 15, 1983, and bequeathed $10,000 to M, an organization described in section 501(c)(3), and the remainder of his estate to Wilma, his wife. A deduction for the charitable bequest was allowed to Henry's estate. Substantially all of Henry's estate consisted of 100% of the stock of a wholly owned corporation, certain liquid assets such as marketable stocks and securities and bank accounts, and Henry's home, automobile, and other personal property. Henry's will gave his executor a full range of powers, including the power to sell the stock. After Henry's death, his executor continued to manage the wholly owned corporation while attempting to sell the stock of the corporation. During this period, the executor made no distributions to M. On May 24, 1988, the Internal Revenue Service determined that the administration of the estate has been unnecessarily prolonged and the estate is considered terminated as of that date for federal income tax purposes. Henry's estate will be treated as a split-interest trust between May 24, 1988, and the date on which the $10,000 bequest to M is satisfied. Henry's estate will be subject to the private foundation provisions that apply during that period. For example, a sale of the house by the estate to any disqualified person would be an act of self-dealing.

Revocable trusts that become split-interest trusts. A revocable trust that becomes irrevocable upon the death of the decedent-grantor and whose governing instrument provides that the trustee is required to hold some or all of its net assets in trust for both charitable and noncharitable beneficiaries after becoming irrevocable is not considered a split-interest trust for a reasonable period of settlement after becoming irrevocable, except that the tax on self-dealing may apply.

After that period, the trust is considered a split-interest trust.

For a definition of "reasonable period," see the previous discussion of *Split-interest trusts that become charitable trusts.*

Certain revocable and testamentary trusts that wind up. A revocable trust that becomes irrevocable upon the death of the decedent-grantor, or a trust created by will, from which the trustee is required to distribute all of the net assets in trust or free of trust to both charitable and noncharitable beneficiaries is not considered a split-interest trust for a reasonable period of settlement after becoming irrevocable. After that period, the trust is considered a split-interest trust or a charitable trust, whichever applies.

Governing instrument requirements, charitable deduction limitations, denial of deductions, and other provisions that apply to exempt private foundations also apply to charitable remainder trusts.

Application of the rules relating to termination of private foundation status. The termination rules discussed in Chapter III do not apply to a charitable or split-interest trust by reason of any payment to a beneficiary that is directed by the terms of the governing instrument of the trust and is not discretionary with the trustee or, in the case of a discretionary payment, because of, or following, the expiration of the last remaining charitable interest in the trust.

Example. H creates a nonexempt charitable trust under which the income is to be paid for 15 years to R, a section 501(c)(3) organization. After 15 years, the trust is to terminate and distribute all of its assets to S, another section 501(c)(3) organization. Distribution of the corpus of the trust to S will not be subject to the rules governing termination of private foundation status.

Limit to segregated amounts. If any amounts held in trust are segregated, the value of the net assets for purposes of determining the tax imposed on the termination of private foundation status under section 507(a), and for determining the amount of tax to be abated, will be limited to the segregated amounts for which a charitable deduction was allowed.

Split-interest trusts are not subject to the restrictions concerning excess business holdings (Chapter X) and the restrictions concerning investments that jeopardize charitable purpose (Chapter IX) if all of the trust's income interest (and none of the remainder interest) is devoted solely to one or more charitable purposes and all amounts for which a charitable deduction was allowed have a combined value at the time of the deduction of not more than 60% of the fair market value of the entire trust (after the payment of estate taxes and all other liabilities). In addition, these two restrictions will not apply if a charitable contribution deduction was allowed for amounts payable under the terms of the trust to every remainder beneficiary, but not to any income beneficiary. However, in the latter case, the trust will become a charitable trust at the expiration of the income interests.

Income interest includes an interest in property transferred in trust that is in the form of a guaranteed annuity interest or unitrust interest.

Remainder interest includes an interest that succeeds an ***income interest.***

Income beneficiary includes a recipient of payments from a pooled income fund, a recipient of payments from a charitable remainder annuity trust, or a recipient of payments from a charitable remainder unitrust.

Remainder beneficiary includes a beneficiary of a remainder interest.

Foreign Foundations

Foreign organizations that are private foundations and that have been granted tax-exempt status under U.S. tax law are required to pay an excise tax equal to 4% of their gross investment income received from sources in the United States, any territory, any political subdivision of a territory, or the District of Columbia.

An exception to this rule is made when a tax treaty between the United States and the foreign country of which the private foundation is a resident specifically exempts income received by these organizations from any tax.

Foreign private foundations receiving ***at least 85%*** of their support (excluding gross investment income) from sources outside the United States are not subject to the taxes on self-dealing, failure to distribute income, excess business holdings, investments that jeopardize charitable purposes, and taxable expenditures. Such foundations also are not subject to section 507, relating to termination of private foundation status, and section 508, regarding special rules for giving notice that they are applying for recognition of exempt status, which are all discussed in this publication.

An exempt organization that is organized in a foreign country and receives a substantial portion of its support from a foreign government is not a private foundation.

A foreign private foundation can have its exempt status terminated for repeatedly engaging in prohibited transactions. A prohibited transaction is an act or a failure to act by a foreign organization that, if engaged in by a domestic organization, would subject the domestic organization to the taxes and sanctions imposed on private foundations.

If a foreign private foundation engages in one such act or failure to act, and has been warned by the IRS that a second act or failure to act would result in a prohibited transaction, the second act or failure to act will be considered a prohibited transaction.

The repeated act or failure to act does not necessarily have to be related to the earlier act or failure to act that caused the Service to issue a warning.

Any foreign private foundation whose exemption has been terminated under the provisions outlined earlier may reapply for exemption by filing a Form 1023 in the 2nd tax year following the tax year in which exemption was denied.

For further information concerning foreign private foundations contact the District Director, Internal Revenue Service, Baltimore, MD 21201.

Chapter II

Filing, Notice, and Other Requirements

This chapter discusses the notice requirements, annual filing requirements, and other actions that must be complied with for an organization to be recognized as exempt under section 501(c)(3).

Filing of Notice

Except for those organizations noted later, any charitable organization organized after October 9, 1969, will not be treated as tax exempt unless it applies for recognition of exemption by filing a current Form 1023, *Application for Recognition of Exemption,* with the appropriate office listed in the Instructions to that form. A user fee must accompany Form 1023 if it is filed before September 30, 1990. For more information on the specific fee applicable to your organization, obtain Form 8718 from the IRS Forms Distribution Center for your state.

An organization will not be treated as tax exempt for any period before it files Form 1023 unless it files the form within 15 months from the end of the month in which it was organized. If the application is not timely filed, exemption will be recognized only for the period following receipt of the application.

Certain organizations are not required to file Form 1023. These include churches, interchurch organizations of local units of a church, conventions or associations of churches, or integrated auxiliaries of a church, such as a men's or women's organization, religious school, mission society, or youth group. While there are certain other exceptions to the Form 1023 filing requirement that apply to small public charities and to subordinate organizations of a central organization that has a group exemption letter, these exceptions do not apply to private foundations.

If an organization that is required to file Form 1023 does not comply with the filing requirements, charitable contribution deductions will not be allowed for any gift or bequest made to the organization.

Extension of time. An extension of time for filing Form 1023 may be granted by the key District Director if your request is submitted before the 15-month period has passed and you demonstrate that additional time is needed.

If the 15-month period for filing Form 1023 has passed, an extension of time to file it may be granted by the Commissioner of the Internal Revenue Service under section 1.9100 of the Income Tax Regulations if you can show good cause. Since the 15-month period, in which time an organization must file a Form 1023, is fixed by the regulations, rather than by statute, an extension may be granted if the request meets certain conditions.

The following factors will be taken into account in determining if good cause for granting the extension has been shown.

1) Due diligence of the taxpayer.
2) Prompt action by the taxpayer.
3) Intent of the taxpayer.
4) Prejudice to the interests of the government.
5) Statutory and regulatory objectives.

Specific questions are to be answered for each of these factors. These questions can be found in Revenue Procedure 79–63, 1979–2 C.B. 578, which is available from the IRS. The information and other documents submitted must be specifically responsive and relevant to answering these questions.

The information submitted by the organization should include a chronological account of the events leading to the failure to make the application, names and current addresses of each person having knowledge or information about the events, affidavits or statements from such persons, and any other information bearing on the Service's consideration of the request. The request must be signed under penalties of perjury by an officer of the organization who has knowledge of the facts. Supporting affidavits or statements must also be signed under penalties of perjury.

The request for an extension must be sent to the appropriate key District Director.

Appeal Procedures

If an organization applies for tax-exempt status and receives an adverse determination letter as to tax exemption, classification as to status under section 509(a) as an organization that is not a private foundation, classification as a private operating foundation, the organization will be advised of its right to protest the determination by requesting ***Appeals Office*** consideration. The protest must be submitted to the key District Director within 30 days from the date of the adverse determination letter and must state whether it wishes an Appeals Office conference.

Any determination letter issued on the basis of technical advice from the National Office may not be appealed to the Appeals Office for those issues that were the subject of the technical advice.

If an application is referred to the National Office for issuance of a ruling and an adverse ruling is issued, the organization will be informed of the basis for the conclusion, of its right to file a protest within 30 days, and for a conference at the National Office.

Appeals Office consideration. The protest to the Appeals Office should be filed with the key district office and contain the following information:

1) The organization's name, address, and employer identification number;
2) A statement that the organization wants to protest the determination;
3) The date and symbols on the determination letter;
4) A statement of facts supporting the organization's position in any contested factual issue;
5) A statement outlining the law or other authority the organization is relying on; and
6) A statement as to whether a conference at the Appeals Office is desired.

The statement of facts (item 4) must be declared true under penalties of perjury. This may be done by adding to the protest the following signed declaration: "Under penalties of perjury, I declare that I have examined the statement of facts presented in this protest and in any accompanying schedules and statements and, to the best of my knowledge and belief, it is true, correct, and complete."

If the organization's representative submits the protest, a substitute declaration must be included, stating:

1) That the representative prepared the protest and accompanying documents; and
2) Whether the representative knows personally that the statements of fact contained in the protest and accompanying documents are true and correct.

Be sure the protest contains all of the information requested. Incomplete protests will be returned for completion.

If a conference is requested, it will be held at the Appeals Office, unless the organization requests that the meeting be held at a district office convenient to both parties.

The Appeals Office, after considering the organization's protest as well as information presented in any conference held, will notify the organization of its decision and issue an appropriate determination letter. An adverse decision may be appealed to the courts (discussed later).

Appeals offices must request technical advice from the National Office on any exempt organization issue concerning qualification for exemption or foundation status for which there is not published precedent or for which there is reason to believe that nonuniformity exists. If an organization believes that its case involves such an issue, it should ask the Appeals Office to request technical advice.

Representation. A principal officer or trustee may represent an organization at any level of appeal. Or, the organization may be represented by an attorney, certified public accountant, or individual enrolled to practice before the Internal Revenue Service.

If the organization's representative attends a conference without a principal officer or trustee, the representative must file a proper power of attorney or a tax information authorization before receiving or inspecting confidential information. Form 2848, ***Power of Attorney and Declaration of Representative,*** or Form 2848–D, ***Tax Information Authorization and Declaration of Representative,*** as appropriate (or any other properly written power of attorney or authorization), may be used for this purpose. These forms may be obtained from the IRS.

Appeal to courts. In addition to administrative remedies, an organization may use certain judicial remedies. If the statutory prerequisites are met, an organization may file suit in a United States District Court or the United States Claims Court for a refund of taxes paid, or in the United States Tax Court for a redetermination of any tax deficiencies. For more information on these types of suits, see Publication 556, ***Examination of Returns, Appeal Rights, and Claims for Refund.*** An exempt organization may also file suit for a declaratory judgment (discussed later) in certain situations. Any of these suits may result in a decision that an organization was exempt for the period considered by the court.

If the final judicial determination is that an organization is exempt from tax, is not a private foundation, or is a private operating foundation, the Service will issue a favorable ruling or determination letter, under the following procedures, providing the underlying facts and applicable law are the same as in the period considered by the court.

An organization that had previously filed an application for recognition of exemption and has been determined to be exempt by the court does not need to submit a new application. The organization should submit a brief statement that its activities are the same as those in the period considered by the court. The statement must be signed by a principal officer. If the applicable law has not changed, the Service will issue a favorable ruling upon receipt of this statement.

An organization that had not previously filed an application for recognition of exemption but has been determined to be exempt by the court will be issued a ruling or determination letter only when it makes application in the appropriate manner. The application should contain a statement that the organization's activities are the same as those in the period considered by the court.

Declaratory judgments. If an organization has exhausted all administrative remedies, then, in certain cases, the organization may seek a declaratory judgment from the U.S. Tax Court, the U.S. Claims Court, or the U.S. District Court for the District of Columbia. This remedy is available for adverse determinations (or failure by the Service to make a determination) on the initial or continuing qualification or classification of an organization as an exempt organization under section 501(c)(3), as an organization to which a deduction for a contribution is allowed under section 170(c)(2), as other than a private foundation under section 509, or as a private operating foundation under section 4942(j)(3).

The declaratory judgment remedy can be used only after all administrative remedies have been exhausted, or, if the Service has not issued a notice of final determination, 270 days have elapsed since the organization requested a determination as to the issue in question and the organization has taken, in a timely manner, all reasonable steps to secure such determination.

The administrative remedies that must be exhausted within the Internal Revenue Service include these steps:

1) The filing of a substantially completed application Form 1023 (described earlier in this chapter) or the filing of a request for a determination of foundation status;
2) In the case of a late-filed application, requesting relief under section 1.9100 of the Income Tax Regulations regarding applications for extensions of time for making an election or application for relief from tax;
3) The timely submission of all additional information requested to perfect an exemption

application or request for determination of private foundation status; and

4) Exhaustion of all administrative appeals available within the Service, including protest of an adverse ruling in National Office original jurisdiction exemption application cases.

An organization will not be deemed to have exhausted its administrative remedies before the earlier of:

1) The completion of the steps just listed and the sending by certified or registered mail of a notice of final determination, or
2) The expiration of the 270–day period in which the Service has not issued a notice of final determination and the organization has taken, in a timely manner, all reasonable steps to secure a ruling or determination.

The steps described earlier will not be considered completed until the Internal Revenue Service has had a reasonable time to act upon the appeal or protest, as the case may be.

A notice of final determination to which the declaratory judgment procedures apply is a ruling or determination letter sent by certified or registered mail that holds the organization is not described in section 501(c)(3) or section 170(c)(2) of the Code, is a private foundation as defined in section 509(a), is not a private operating foundation as defined in section 4942(j)(3), or is a public charity described in a part of section 509 or section 170(b)(1)(A) other than the part under which the organization requested classification.

The 270–day period will be considered by the Service to begin on the date a substantially completed Form 1023 is sent to the appropriate key District Director. If the application does not contain all of the required items, it will not be further processed and may be returned to the applicant for completion. The 270– period, in this event, will not be considered as starting until the date the application is remailed to the Service with the requested information, or, if a postmark is not evident, on the date the Service receives a substantially completed application.

The following ***procedural limitations*** apply to a suit for declaratory judgment:

1) The petition must be filed by the organization whose qualification for exemption or classification is at issue;
2) A petition for declaratory judgment must be filed with the appropriate court (as specified earlier in this discussion) before the 91st day after the date on which the Internal Revenue Service has mailed a notice of its determination by certified or registered mail; and
3) A declaratory judgment will not be issued unless the organization has exhausted the administrative remedies (described earlier) available to it within the IRS.

Classification as Other Than a Private Foundation

Any organization described in section 501(c)(3), regardless of when it was organized, will be presumed to be a private foundation unless it gives timely notice to the IRS that it is not a private foundation.

The only exceptions to this requirement apply to those organizations that are excepted from filing Form 1023 as stated earlier. Charitable trusts described in section 4947(a)(1) also are excepted.

If the organization received a ruling or determination letter from the IRS dated before July 14, 1970, recognizing its tax-exempt status under section 501(c)(3), and did not file Form 4653, *Notification Concerning Foundation Status,* before March 22, 1973, the organization is presumed to be a private foundation. This presumption is rebuttable; and if the organization is, in fact, one as described in section 509(a)(1), (2), (3), or (4) of the Internal Revenue Code, it is not a private foundation. However, for the Service to recognize that such an organization is not a private foundation, the organization must establish that status by sending a request for a determination to the District Director.

Any organization seeking tax–exempt status under section 501(c)(3) and classification as other than a private foundation should file its notice by sending a completed and signed Form 1023 and provide information that it is not a private foundation.

The notice may not be relied on by the organization or by grantors or contributors until the IRS notifies the organization that it is not a private foundation.

Statement that an organization is an operating foundation. Any organization that is applying for recognition of exemption under section 501(c)(3) may submit information that it is an operating foundation.

The operating foundation should include the following:

1) Necessary supporting information to confirm the determination, and
2) A written declaration by the principal officer, manager, or authorized trustee that there is a reasonable basis in law and in fact that the organization is an operating foundation, and that to the best of the knowledge and belief of the officer, manager, or trustee, the information given is complete and correct.

The notice may not be relied upon by the organization or by its grantors or contributors until the IRS notifies the organization that it is not a private foundation.

Additional information on applying for recognition of exemption and notification of nonprivate foundation status may be found in Publication 557, *Tax–Exempt Status for Your Organization.*

Governing Instruments

A private foundation cannot be tax exempt nor will contributions to it be deductible as charitable contributions unless its governing instrument contains special provisions in addition to those that generally apply to section 501(c)(3) organizations. These special provisions, generally, must require or prohibit, as the case may be, the foundation to act or refrain from acting so that it will not be liable for the taxes imposed by sections 4941, 4942, 4943, 4944, and 4945, discussed later in this publication. Specific reference to these sections generally must be included in the governing instrument, unless equivalent language is used that is considered by the IRS to have the same full force and effect.

A private foundation's governing instrument will be considered to have been amended to conform to this requirement if valid provisions of state law have been enacted that:

1) Require the foundation to act or refrain from acting so that it will not be liable for any of the taxes imposed on the prohibited transactions discussed later, or
2) Treat the required provisions as though they were contained in the foundation's governing instrument.

The IRS periodically updates a published list of states with these statutes. Contact your key District Office for this information.

The following samples of governing instrument provisions meet the special charter requirements that apply to private foundations. Draft A is a sample of provisions in articles of incorporation; Draft B, a trust indenture.

Draft A

General

1) The corporation will distribute its income for each tax year at such time and in such manner so that it will not become subject to the tax on undistributed income imposed by section 4942 of the Internal Revenue Code, or corresponding provisions of any later federal tax laws.
2) The corporation will not engage in any act of self-dealing as defined in section 4941(d) of the Internal Revenue Code, or corresponding provisions of any later federal tax laws.
3) The corporation will not retain any excess business holdings as defined in section 4943(c) of the Internal Revenue Code, or corresponding provisions of any later federal tax laws.
4) The corporation will not make any investments in a manner that would subject it to tax under section 4944 of the Internal Revenue Code, or corresponding provisions of any later federal tax laws.
5) The corporation will not make any taxable expenditures as defined in section 4945(d) of the Internal Revenue Code, or corresponding provisions of any later federal tax laws.

Draft B

Any other provisions of this instrument notwithstanding, the trustees will distribute its income for each tax year at such time and in such manner so that it will not become subject to the tax on undistributed income imposed by section 4942 of the Internal Revenue Code, or corresponding provisions of any later federal tax laws.

Any other provisions of this instrument notwithstanding, the trustees will not engage in any act of self-dealing as defined in section 4941(d) of the Internal Revenue Code, or corresponding provisions of any later federal tax laws; nor retain any excess business holdings as defined in section 4943(c) of the Internal Revenue Code, or corresponding provisions of any later federal tax laws; nor make any investments in a manner that would incur tax liability under section 4944 of the Internal Revenue Code, or corresponding provisions of any later federal tax laws; nor make any taxable expenditures as defined in section 4945(d) of the Internal Revenue Code, or corresponding provisions of any later federal tax laws.

Return Requirements

All private foundations (including nonexempt private foundations, and nonexempt charitable trusts described in section 4947(a)(1) of the Code having no taxable income for the tax year that they are treated as private foundations) are required to file an annual return on Form 990–PF, *Return of Private Foundation.* If your organization has an application for recognition of exemption pending with the IRS, and you acknowledge that your organization is a private foundation, you should file this return.

Split–interest trusts described in section 4947(a)(2) of the Code must file Form 5227, *Split-Interest Trust Information Return,* instead of filing Form 990–PF.

When to file. Form 990–PF must be filed by the 15th day of the 5th month following the close of the organization's accounting period.

If the foundation is on a calendar year, or if it has no established accounting period, the return will be due May 15 each year.

For a complete liquidation, dissolution, or termination, the return must be filed by the 15th day of the 5th month following complete liquidation, dissolution, or termination.

Form 5227 must be filed by the 15th day of the 4th month following the close of the trust's tax year.

Where to file. Form 990–PF or Form 5227, if applicable, should be filed with the Internal Revenue Service Center listed in the instructions for these forms.

Failure to file timely. If an organization fails to file Form 990–PF by the due date (taking into account any extensions granted), it will have to pay $10 for each day the return is late, not to exceed the lesser of $5,000 or 5% of the organization's gross receipts, unless it can show that the failure was due to reasonable cause. The IRS may make written demand that the delinquent return be filed within a reasonable time after the date of mailing the demand. If the organization does not file by the date specified in the demand, the person or persons responsible for the failure to file will be subject to a penalty of $10 a day for each day after the date specified in the notice that the return is not filed unless it is shown that the failure to file is due to reasonable cause. The total amount imposed on all persons responsible for the failure to file is limited to $5,000. The penalty is also applicable to a failure to provide information required by the return, or a failure to provide correct information.

Public inspection. All the information reported on Form 990–PF, including attachments, will be made available by the IRS for public inspection, except any information the release of which would adversely affect the national defense, or information that the IRS determines relates to any trade secret, patent, process, style of work, or apparatus of the organization.

In these cases, the organization must submit a statement, marked "Not Subject to Public Inspection," identifying which items are to be withheld and the reasons. The schedule of contributors will be available for inspection only in the case of private foundations.

In addition, Form 990-PF must be made available by the foundation manager for public inspection at the main office of the foundation. If the foundation has no main office, or if the main office is in a personal residence, the manager may make the return available for public inspection at an appropriate substitute location or by furnishing a copy free of charge (including postage and copying) to persons who request inspection.

The return must be available during regular business hours for inspection by any citizen upon request made within 180 days after the date of the publication of notice of its availability. The notice must be published in a newspaper having general circulation in the county in which the foundation's main office is located, no later than the day prescribed for the filing of the return. The notice must state that the annual return is available at the foundation's main office for inspection during regular business hours by any citizen who requests inspection within 180 days after the date of publication, and must state the address and telephone number of the foundation's main office and the name of its principal manager. A copy of this notice and proof of publication must be filed with the annual return. Proof of publication may consist of a copy of the notice as published, along with a statement signed by a foundation manager saying that the notice was published and listing the date of publication and the name of the publication in which the notice appeared.

Penalty for failure to comply. If the annual return is not made available for public inspection on the date and in the manner prescribed, the person or persons responsible for failing to meet the publicity requirements will be liable for a penalty of $10 a day for each day that the failure continues, not to exceed $5,000, unless the failure is due to reasonable cause. In addition, when the failure to comply with the publicity requirements is willful, the person or persons responsible for the failure will be liable for a penalty of $1,000 for each return.

Listing of states. A private foundation is required to attach to its Form 990–PF a list of all states:

1) To which the organization reports in any fashion concerning its organization, assets, or activities, or
2) With which the organization has registered (or notified in any manner) that it intends to be, or is, a charitable organization or a holder of property devoted to a charitable purpose.

Providing copies to state officers. The foundation managers of a private foundation (except certain foreign organizations) must provide a copy of the annual return to the Attorney General of:

1) Each state listed on the Form 990–PF,
2) The state in which the main office of the foundation is located,
3) The state in which the foundation was incorporated or created, or
4) Any state that requests it.

The annual return must be sent to the Attorney General of these states at the same time it is filed with the Internal Revenue Service. A copy of the Form 4720, if any, filed by the foundation for the year must be attached to each copy of the annual return sent to state officers.

Form 4720, *Return of Certain Excise Taxes on Charities and Other Persons Under Chapters 41 and 42 of the Internal Revenue Code,* is intended primarily for use with Form 990–PF and provides for figuring and reporting the initial taxes imposed under sections 4941, 4942, 4943, 4944, and 4945 on private foundations, foundation managers, and disqualified persons. These sections are discussed in Chapters VI through X of this publication.

Paying the tax and filing Form 4720 are required for each year (or part of a year) in the taxable period applicable to the act or investment. Generally, the taxable period begins with the date of the act or investment and ends on the earlier of the date a notice of deficiency for the initial tax is mailed, or the date the initial tax is assessed.

When to file. Generally, Form 4720 must be filed by the due date for filing Form 990–PF or 5227. Foundation managers and disqualified persons, whose tax years end on the same date as that of the foundation, who are liable for taxes described in Chapters VI through X, and who file separate returns, must file their returns by the due date for filing Form 990–PF or 5227 by the private foundation with respect to which they are liable for tax. However, the Form 4720 of a person whose tax year ends on a date other than that of the foundation's must be filed by the 15th day of the 5th month following the close of that person's tax year. The IRS may, in some cases, require immediate filing of Form 4720 and immediate payment of tax by private foundations, foundation managers, and disqualified persons at an earlier date during the foundation's tax year.

Where to file. Form 4720 is filed at the same place as specified for filing Form 990–PF.

Other returns that may be required for trusts described in section 4947. Forms 1041 and 1041–A are not required to be filed by organizations that are exempt under section 501(a), but they may be required to be filed by certain nonexempt trusts described in section 4947. Form 1041 is required to be filed by all nonexempt charitable trusts having gross income of $600 for the year, unless they owe no tax. Split-interest trusts having gross income of $600 must file Form 1041 except for charitable remainder trusts described in section 664. Charitable remainder trusts must file Form 1041 as an attachment to Form 5227 if they have unrelated business taxable income. Form 1041–A must be filed by split-interest trusts (including trusts described in section 664) that are not required under their governing instruments to distribute all of their income annually.

When to file. The returns must be filed by the 15th day of the 4th month following the close of the trust's tax year.

Where to file. The returns should be filed with the appropriate Internal Revenue Service Center listed in the form instructions.

Extensions. A foundation may file application Form 2758 to request an extension of time to file its return(s).

Reasonable cause for failure to file or pay tax. An organization that is in fact a private foundation will be considered to have ***reasonable cause*** for failure to meet the private foundation filing and payment requirements until 90 days after it is issued a letter from the Service notifying it of the determination of private foundation status or a determination that the organization cannot reasonably be expected to be a public charity. In order for the organization not to be subject to the penalties for failure to file or pay tax, the organization must have filed Form 1023, claiming not to be a private foundation, before the due date for filing Form 990–PF. By the end of the 90–day period, the organization must file all the necessary returns for the prior years and pay all taxes due, including interest. A statement explaining the basis for reasonable cause for failure to file timely should be attached to the returns. Revenue Procedure 79–8, 1979–1 C.B. 487, should also be cited in the statement.

Chapter III

Termination of Private Foundation Status

Once an organization is determined to be a private foundation, its status may be terminated only under the provisions of section 507 of the Code. Under section 507, an organization's status as a private foundation may be terminated voluntarily or involuntarily.

If the organization's status is terminated either voluntarily or involuntarily under section 507(a), the organization becomes liable for tax under section 507(c). After assessment is made, it is possible to have the tax abated by the IRS if certain actions, discussed later, are taken.

An organization may voluntarily terminate its status under section 507(b)(1) and not be subject to tax under section 507(c). This is often a major consideration for organizations considering a voluntary termination.

Termination under Section 507(a)

Voluntary termination. To voluntarily terminate under section 507(a)(1), the organization must send a statement to its District Director of its intent to terminate its status under section 507(a)(1). The statement must provide, in detail, the computation and amount of tax imposed under section 507(c). Unless the organization requests abatement, it must pay the tax at the time the statement is filed. The organization may request abatement of all the tax imposed under section 507(c), or it may pay part of the tax and request abatement of the unpaid part. However, if the organization's request for abatement is denied, the organization must pay the tax in full when notified by the Service that the tax will not be abated.

Termination of private foundation status under section 507(a)(1) will not relieve the foundation, or any disqualified person, of any liability for Chapter 42 excise taxes (the taxes described in Chapters VI through X of this publication).

If an organization that has terminated its private foundation status under section 507(a) continues in operation and wishes to be treated as a charitable, educational, religious, scientific, etc., organization, it must apply for appropriate exemption recognition. See *Status of organization after termination of private foundation status in Chapter I.*

Notice to the public. The Internal Revenue Service will publish in the *Internal Revenue Bulletin* any notice it receives of voluntary termination under section 507(a)(1) (or any notice it issues of involuntary termination of exempt status, discussed later).

No termination can take place under section 507(a)(1) if the private foundation transfers all or part of its assets to another private foundation or to one or more private foundations and to one or more section 509(a)(1), (2), (3), or (4) organizations, under a liquidation, merger, redemption, recapitalization, or other adjustment, organization, or reorganization.

Transferee liability. A termination under section 507(a) does not result from either a transfer of all its assets or a significant disposition of its assets (defined later) by a private foundation unless it chooses to terminate under section 507(a)(1), or an involuntary termination occurs. If a private foundation incurs any liability for the Chapter 42 excise taxes before or in connection with the transfer, transferee liability may be applied against the transferee organization for payment of those taxes. Liability for Chapter 42 excise taxes is considered to be incurred on the date the act or failure to act occurs that gives rise to the initial tax liability.

A private foundation that transfers all of its net assets must file Form 990–PF, *Return of Private Foundation.* However, neither a private foundation nor its managers are required to file this form for any tax year after the tax year in which the last transfer occurs if during those later years the foundation has neither legal nor equitable title to any assets nor engages in any activity.

Section 507(c) tax. The tax imposed under section 507(c) on the termination of a private foundation is the lesser of:

1) The combined tax benefit resulting from the section 501(c)(3) status of the organization, or
2) The value of the net assets of the organization.

The combined tax benefit resulting from the section 501(c)(3) status of any private foundation is the sum of:

1) The combined increases in income, estate, and gift taxes that would have been imposed on all ***substantial contributors*** if deductions for all contributions made by those contributors to the foundation after February 28, 1913, had been disallowed, and
2) The combined increases in income tax that would have been imposed on the private foundation's income for tax years beginning after 1912 if —
   a) The foundation had not been tax exempt, and
   b) In the case of a trust, its charitable deduction had been limited to 20% of its taxable income, and
3) Amounts received from private foundations to which transferee liability applies, and
4) The interest on the tax increases in (1), (2), and (3) from the first date the increase would have been due or payable to the date the organization ceases to be a private foundation.

In figuring the combined increases in tax under (1), all deductions for a particular contribution for income, estate, or gift tax purposes must be included. For example, if a substantial contributor had taken income tax and gift tax deductions for a charitable contribution to the foundation, the amount of each deduction must be included. The combined tax benefit may be more than the fair market value of the property transferred.

The value of the net assets of the organization is the greater of:

1) The value on the first day action was taken to terminate private foundation status, or
2) The value on the date the organization ceased to be a private foundation.

The valuation date in (1) is the date the organization gave notice it was terminating private foundation status.

When tax is imposed. These same dates determine when liability for the section 507(c) tax is imposed because a transfer of assets by a private foundation is involved.

Substantial contributors. See Chapter V for the definition of what is a substantial contributor.

Abatement of section 507(c) taxes. The unpaid part of section 507(c) tax can be abated by the IRS if:

1) The private foundation distributes all of its net assets to one or more charitable organizations described in section 509(a)(1) that have been in existence and so described for at least 60 months, or
2) The Service receives effective assurance through corrective action taken in state proceedings that assets dedicated to charitable purposes will, in fact, be used for charitable purposes.

Corrective action in state proceedings. The section 507(c) tax may be abated by the IRS if, within a year from the date of issuing a notice of deficiency for that tax, an appropriate state officer certifies that ***corrective action*** has been initiated under state law under court order or approval.

Corrective action is the vigorous enforcement of state laws sufficient to assure implementation of the excise tax provisions of Chapter 42 and to insure that foundation assets are preserved for charitable purposes.

Involuntary termination. An organization's status may be involuntarily terminated if the IRS notifies the organization that, because of willful, flagrant, or repeated acts or failures to act giving rise to the Chapter 42 excise taxes, the organization is liable for section 507(c) tax.

Willful repeated acts are at least two acts or failures to act which are voluntarily, consciously, and knowingly committed in violation of the excise tax provisions of Chapter 42, and which appear to a reasonable person to be a gross violation of these provisions. The act or failure to act may result in termination of the foundation's status even though the tax is imposed on the foundation's managers rather than on the foundation itself. Furthermore, the failure to correct the act or acts (or failure or failures to act) that gave rise to excise tax liability under Chapter 42 may cause involuntary termination of the private foundation. No motive to avoid legal restrictions or incur tax is necessary to make the act or failure to act willful. However, a foundation's act or failure to act is not willful if the foundation or its manager, if applicable, does not know that the act or failure to act is an act of self dealing, a taxable expenditure, or other act or failure to act giving rise to liability for excise taxes.

In the case of an involuntary termination, section 507(c) tax is computed in the same manner as for voluntary terminations. However, in determining the value of net assets of the foundation on the first day action was taken to terminate private foundation status, the valuation date is the date a willful and flagrant act, failure to act, or series of repeated acts or failures to act first occurred.

Although the section 507(c) tax resulting from an involuntary termination may be abated (see *Abatement of section 507(c) taxes* earlier), this is not true for any excise tax liability attributable to the acts or failures to act that caused the involuntary termination.

Voluntary Termination under Section 507(b)(1)

A private foundation may voluntarily terminate its status under section 507(b)(1) by either transferring all its net assets to one or more public charities, or by meeting the requirements of sections 509(a)(1), (2), or (3) continuously for 60 months beginning with the first day of any tax year. Private foundation status may not be terminated under either of these methods if there have been either willful repeated acts (or failures to act) or a willful and flagrant act (or failure to act) that gives rise to liability for excise taxes on transactions discussed in Chapters VI through X, known as "Chapter 42" excise taxes.

Transfer of Assets to a Public Charity

A private foundation may terminate its status under section 507(b)(1)(A) by distributing all its net assets to one or more organizations with a ruling or determination letter described in section 509(a)(1). However, the organization to which the distribution is made must have been in existence and so described for a continuous period of at least 60 months before the distribution.

A distribution to a public charity formed from the consolidation of two public charities, for the same purpose and with the same activity, each of which would have met the 60-month existence requirement, had they not consolidated, is a qualifying distribution.

A private foundation that terminates its status in compliance with section 507(b)(1)(A) is not required to notify the IRS of its intent to terminate.

An organization will have distributed all its net assets only if it transfers all of its right, title, and interest in, and to, all of its net assets.

An organization that continues in existence after terminating its private foundation status under section 507(b)(1)(A) must file a new application on Form 1023 in order to be treated as a section 501(c)(3) organization, unless it is a type of organization that is not required to file Form 1023. A list of these types of organizations can be found in Publication 557, *Tax–Exempt Status for Your Organization.*

Operation as a Public Charity

An organization may terminate its private foundation status under section 507(b)(1)(B) if it meets the requirements of section 509(a)(1), (2), or (3) for a continuous 60–month period beginning with the first day of any tax year, and notifies its District Director before the beginning of the 60–month period that it is terminating its private foundation status. Also, it must establish immediately after the end of the 60–month period that it has met the requirements of section 509(a)(1), (2), or (3).

Notification to the Service by a foundation that it is terminating under section 507(b)(1)(B) does not constitute notice of a section 507(a) termination even if the foundation fails to meet the requirements of section 507(b)(1)(B). However, a successful section 507(b)(1)(B) termination will incur no tax under section 507(c) and, therefore, will require no abatement of tax.

Notice of termination. The notice of termination should include:

1) The name and address of the private foundation,
2) Its intention to terminate its private foundation status,
3) The Code section under which it seeks classification (section 509(a)(1), (2), or (3)),
4) If section 509(a)(1) applies, the specific type of section 170(b)(1)(A) organization for which it seeks classification,
5) The date its regular tax year begins, and
6) The date the 60-month period begins.

Effect of satisfaction of termination requirements. If the organization meets the requirements of section 507(b)(1)(B) during the continuous 60–month period, it will be treated as a section 509(a)(1), (2), or (3) organization for the entire 60–month period.

Failure to meet 60–month requirements. Generally, any organization that does not meet section 507(b)(1)(B) termination requirements during the 60–month period will be treated as a private foundation for the entire 60–month period. Any grants or contributions made to such an organization will be treated as contributions made to a private foundation.

However, the organization will be treated as a section 509(a)(1), (2), or (3) organization for any tax year or years that the requirements are met. Any grants or contributions to the organization during such year or years will be treated as made to a section 509(a)(1), (2), or (3) organization and the organization itself will not be subject to Chapter 42 taxes and restrictions for such year or years.

In determining whether an organization meets section 509(a)(1), (2), or (3) requirements for any year in the 60–month period, the organization will be treated as if it were a new organization with its first tax year beginning on the date the 60–month period begins.

Advance rulings for 60–month terminations. An organization which files the notification required for a 60–month termination may receive, at the discretion of the Service, an advance ruling that the organization can reasonably be expected to terminate its private foundation status over the 60–month period.

To receive an advance ruling, the organization must also agree to an extension of time to assess the section 4940 tax on net investment income (discussed in Chapter IV) for the years in the 60–month termination period. If an organization agrees to the extension and it is accepted, it will not have to pay the tax on net investment income during the 60–month period. The signed and dated agreement Form 872, *Consent to Extend the Time to Assess Tax,* should be filed with the request for the advance ruling. The assessment period for all years in the termination period must be extended to 4 years, 4 months and 15 days after the end of the last year in the 60–month termination period.

The decision to grant a favorable ruling will be based on the facts and circumstances, taking into account organizational structure, proposed programs and activities, intended methods of operation, and projected sources of support.

Grantors or contributors to an organization that has obtained a favorable advance ruling may rely on that ruling until notice of revocation is published in the *Internal Revenue Bulletin.* However, a grantor or contributor may not rely on such a ruling if the grantor or contributor was responsible for, or aware of, the action or inaction that resulted in the organization's failure to meet the requirements of section 509(a)(1), (2), or (3) or knew that the Service had notified the organization that its advance ruling would be revoked.

A potential grantee organization may request an advance ruling before receiving a grant or contribution, to the effect that the grant or contribution will not result in the grantee's failing to meet section 509(a)(1), (2), or (3) requirements. The ruling request may be filed by the grantee organization with its District Director. If a favorable ruling is issued, the grantor or contributor may rely upon it.

However, an advance ruling may not be relied upon by the organization obtaining that ruling. If the organization later fails to complete a successful termination under section 507(b)(1)(B) and was not a section 509(a)(1), (2), or (3) organization, it will have to pay interest on the amount of tax imposed on net investment income under section 4940 that is unpaid as of the last date for payment of that tax. However, since the failure to pay the tax during the 60–month period (or before revocation of the ruling) is due to reasonable cause, no penalty will be assessed.

Organizations without advance rulings. An organization that does not receive an advance ruling does not have to pay the tax on net investment income during the 60–month termination period if it signs the consent to extend the assessment period for the tax. The same rules regarding interest and penalties apply if the organization does not complete a successful termination of its private foundation status under section 507(b)(1)(B).

Transferee Foundations Section 507(b)(2)

The transfer of assets of a private foundation to another private foundation in a liquidation, merger, recapitalization, redemption, or other adjustment, organization, or reorganization is a section 507(b)(2) transfer. A transfer under this section will not cause the transferee to be treated as a newly created organization for purposes of the private foundation provisions. However, the transferee may be required to reapply for exemption if it wishes to be exempt under section 501(c)(3) of the Code.

The term "other adjustment, organization, or reorganization" includes any partial liquidation, or any other significant disposition of assets (defined later), to one or more private foundations, other than transfers for full and adequate consideration or distributions out of current income (including qualifying distributions out of current and earlier years' undistributed income).

A transferee organization will succeed to the combined tax benefit of the transferor organization to the extent of the combined tax benefit multiplied by a fraction. The numerator of the fraction is the fair market value of the assets (minus encumbrances) transferred, and the denominator is the fair market value of the total assets of the transferor (minus encumbrances) immediately before the transfer. Fair market value is determined as of the time of the transfer. A transferee organization not effectively controlled, directly or indirectly, by the same person or persons who control the transferor organization will not succeed to a combined tax benefit greater than the fair market value of assets transferred at the time of the transfer.

Example. In a liquidation, the White Foundation, a private foundation, transfers to the Oak Foundation, a private foundation, all of its assets, which have a fair market value of $400,000. Immediately before the transfer the White Foundation's combined tax benefit was $200,000, and the Oak Foundation's combined tax benefit was $300,000. After the transfer, the Oak Foundation has a combined tax benefit of $500,000 ($200,000 + $300,000).

Except as otherwise provided in *Transfer to an effectively controlled foundation* later, a private foundation must meet the distribution requirements described in Chapter VII for any year in which it makes a section 507(b)(2) transfer of all or part of its net assets to another private foundation. The transfer itself will be counted as a qualifying distribution if it meets the requirements given in Chapter VII. However, when the transferor has disposed of all its assets, the recordkeeping requirements will not apply to any period in which it has no assets.

Whenever a private foundation makes a section 507(b)(2) transfer of all or part of its net assets to another private foundation, the applicable time period described in Chapter X will include the respective holding periods of both the transferor and the transferee. Except as otherwise provided in *Transfer to an effectively controlled foundation,* the provisions of Chapter VI will not apply to the transferee or to the transferor for any expenditure responsibility grants as discussed in Chapter VI made by the transferor during any period in which the transferor has no assets. However, the information reporting requirements described in Chapter VI remain in effect.

A substantial contributor of the transferor foundation will be considered a substantial contributor of the transferee organization even if the individual does not meet the definition of a substantial contributor with respect to the transferee organization. With respect to the transferor foundation, a person is a substantial contributor if the person contributed or bequeathed an aggregate amount of more than $5,000 to the foundation, provided that the amount contributed is more than 2% of the total contributions received by the foundation before the close of the taxable year in which the contribution or bequest is received by the foundation. See Chapter V for a discussion of the term "substantial contributor."

Also, if a private foundation incurs a liability for any excise taxes discussed in Chapters VI through X of this publication either before a transfer or as a result of a transfer of assets, then the transferee foundation will be considered to have received the assets subject to the tax to the extent that the transferor foundation does not satisfy the liability.

Transfer to an effectively controlled foundation. 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 who effectively controlled the transferor private foundation, then the transferee foundation is treated as if it were the transferor for purposes of all excise taxes discussed in this publication as well as the termination provisions discussed in this chapter. When proportionality is appropriate, the transferee foundation will be treated as if it were the transferor in the proportion that the fair market value of the assets transferred (minus encumbrances) bears to the fair market value of the assets (minus encumbrances) of the transferor immediately before the transfer. This does not relieve the transferor private foundation from filing required returns, reports, and other information.

Example. The trustees of X charitable trust, a private foundation, form Y, a charitable corporation, also a private foundation, to make the conduct of their activities easier. The trustees of X are also the directors of Y. Y has the same charitable purposes as X. All the assets of X are transferred to Y, and Y continues to carry on X's charitable activities. Under these circumstances, Y is treated as if it were X. Y will be permitted to take advantage of any special rules relating to excise tax requirements to the same extent as could X if X had continued in existence.

Status of transferee organization under section 507(b)(2). A transfer of assets under any liquidation, merger, redemption, recapitalization, or other adjustment, organization, or reorganization to an organization other than a charitable, educational, religious, scientific, etc. organization (other than an organization engaged in testing for public safety) or a nonexempt charitable trust described in section 4947(a)(1) is a ***taxable expenditure*** (see Chapter VI). For a transfer of assets not to be a taxable expenditure, it must be to one of the organizations described earlier. Unless the transferee is a section 509(a)(1), (2), or (3) organization, section 507(b)(2) applies.

However, if the assets are transferred to a transferee organization other than a section 501(c)(3) organization (excluding organizations engaged in testing for public safety) or section 4947(a)(1) organization, and the assets are ***then*** transferred to a private foundation to correct a taxable expenditure, section 507(b)(2) applies as if the transfer of assets had been made directly to a private foundation.

A significant disposition of assets to one or more private foundations includes any disposition for the tax year when both:

1) The dispositions to one or more private foundations for the tax year, and
2) The total related dispositions made during earlier tax years in which any disposition to one or more private foundations for the tax year was part of a series of related dispositions made during those years. These total 25% or more of the fair market value of the foundation's net assets at the start of the tax

year, or at the start of the first tax year in which any of the series of related dispositions was made.

A significant disposition of assets may occur in a single tax year or over two or more tax years. The determination of whether a significant disposition has occurred through a series of related dispositions will be based on the facts and circumstances of the particular case. However, if one or more persons who are disqualified persons (see Chapter V) with respect to the transferor's private foundation are also disqualified persons with respect to any of the transferee's private foundations, this fact will be considered as evidence that the transfer is part of a series of related dispositions. For a series of related dispositions, each transferee private foundation is considered a transferee in a section 507(b)(2) transaction.

Example. The White Foundation is a private foundation that had net assets of $100,000 on January 1, 1987. In 1987, in addition to distributions made out of current income, the White Foundation transferred $10,000 to the Rose Foundation, $10,000 to the Black Foundation and $10,000 to the Green Foundation, all of which are private foundations. Therefore, the White Foundation made a section 507(b)(2) distribution because it disposed of more than 25% of the fair market value of its net assets on January 1, 1987.

Section 507(a) does not apply to section 507(b)(2) transfers. A private foundation may not terminate under section 507(a)(1) unless it voluntarily gives notice as required for section 507(a)(1) terminations. The transfer must satisfy the applicable requirements of Chapter 42 (discussed in Chapters VI through X) concerning acts or failures to act that give rise to excise tax liability. However, if the transfer is an act or failure to act giving rise to excise tax liability, then the transfer may be considered an involuntary termination.

Transfers to certain section 509(a)(1), (2), or (3) organizations will be treated as section 507(b)(2) transfers from the date a private foundation transfers all or part of its assets to a section 509(a)(1), (2), or (3) organization if, within 3 years from the date of the transfer, the transferee loses its section 509(a)(1), (2), or (3) status and becomes a private foundation.

If a section 507(b)(2) transfer is made during the course of a 60–month termination under section 507(b)(1)(B), the rules governing section 507(b)(2) transfers will apply and the transfers will not be treated as made from a section 509(a)(1), (2), or (3) organization.

Chapter IV

Tax on Net Investment Income

Section 4940 imposes an excise tax of 2% on the net investment income of most domestic tax-exempt private foundations, including private operating foundations. Some exceptions apply. An ***exempt operating foundation,*** defined in Chapter I, is not subject to the tax. Further, the tax is reduced to 1% in certain cases. See *Reduction in tax,* below.

This tax must be reported on Form 990–PF, *Return of Private Foundation. Payment of the tax is subject to estimated tax requirements. For more information concerning payment of estimated tax, see the Instructions for Form 990–PF.*

Nonexempt private foundations are also subject to this tax, but only to the extent that the sum of the 2% tax plus tax on unrelated business income, applied as if the foundation were tax-exempt, is greater than income tax liability for the year.

Example. A taxable private foundation had an income tax liability for 1985 of $10,000. If the foundation were tax exempt, it would have a $4,000 liability for tax on net investment income and a $7,000 liability for tax on unrelated business income. The foundation is liable under section 4940 for $1,000, the amount by which the sum of the tax on net investment income and the tax on unrelated business income ($11,000) exceeds the amount of income tax liability ($10,000).

Reduction in tax. For tax years beginning after 1984, the tax rate on net investment income is reduced from 2% to 1% for any private foundation that meets the following distribution requirements:

1) The foundation makes ***qualifying distributions*** during the tax year at least equal to the sum of (a) the assets of the foundation for the tax year multiplied by its ***average percentage payout*** for the ***base period,*** plus (b) 1% of the foundation's net investment income for the tax year, and
2) The foundation was not liable for Chapter 42 excise taxes (see Chapters VI through X of this publication) for any year of the base period.

Qualifying distributions for this purpose are the same as those for purposes of the tax on failure to distribute income (see the discussion of *Qualifying distributions* in Chapter VII).

Average percentage payout is the average of the percentage payouts for each of the tax years in the foundation's base period. For each tax year, the percentage payout is figured by dividing the qualifying distributions made during the year by the foundation's assets for that year. If, for any tax year in the foundation's base period, the foundation's tax rate on net investment income is reduced to 1% by meeting these distribution requirements, the qualifying distributions made by the foundation during that year must be reduced by the amount of the reduction in tax.

The assets of the foundation for any tax year are the excess of the total fair market value of all the foundation's assets, other than those used or held for use directly in carrying out the foundation's exempt purpose, over the acquisition indebtedness with respect to those assets.

The base period with respect to any tax year is the 5 tax years preceding that year. If an organization has not been a private foundation throughout those 5 tax years, the base period consists of the tax years during which the foundation has been in existence. However, if a private foundation is a successor to another private foundation, it must take into account the experience of that other foundation.

Net investment income is the amount by which the sum of gross investment income and the capital gain net income exceeds the allowable deductions discussed later.

Tax-exempt interest on governmental obligations and related expenses are excluded.

Gross investment income means the total amount of income from interest, dividends, rents, payments with respect to securities loans (as defined in section 512(a)(5)), and royalties (including overriding royalties) received by a private foundation from all sources. It does not include any income included in figuring the tax on unrelated business income. However, it does include interest, dividends, rents, and royalties received from assets devoted to charitable activities. Therefore, interest received on a student loan would be includible in the gross investment income of a private foundation making the loan.

Distributions in redemption of stock. Any distribution by a corporation that is a disqualified person (defined in Chapter V) in redemption of stock held by a private foundation in a business enterprise will be treated as not essentially equivalent to a dividend if all the following conditions are met:

1) The stock was owned by the private foundation on May 26, 1969,
2) The foundation is required to dispose of the stock in order not to be liable for the tax on excess business holdings (discussed in Chapter X), and
3) The foundation receives in return an amount that equals or exceeds the fair market value of the stock at the time of disposition (or at the time a contract for the disposition was previously executed) in a transaction that would not be a prohibited transaction (under section 503(b) of the Code).

For purposes of (1) above, if a private foundation acquired stock under the terms of a trust that was irrevocable on May 26, 1969, or under the terms of a will executed by that date, which is in effect on that date and at all times thereafter, the foundation will be considered as owning the stock on that date.

Capital gains and losses. In figuring the tax on net investment income, a private foundation must include any capital gains and losses from the sale or other disposition of property held for investment purposes or for the production of income. This includes capital gain dividends received from a regulated investment company. If the foundation sells or otherwise disposes of property used in the production of income that is subject to the unrelated business income tax, any gain or loss from the sale of that property must be included in net investment income, but only to the extent that it is not included in figuring the tax on unrelated business income. Property is treated as held for investment purposes even though the property is disposed of by the foundation immediately upon its receipt, if it is the kind of property that generally produces interest, dividends, rents, royalties, or capital gains through appreciation.

Property used for exempt purposes. Any gain or loss from the sale or other disposition of property used for the exempt purposes of the foundation is not included in figuring the tax on net investment income. If the foundation uses property for its exempt purposes, but also incidentally receives income from the property that is subject to the net investment income tax, any gain or loss from the sale or other disposition of the property would not be subject to the tax. For example, if a tax-exempt private foundation maintains historic buildings that are open for public inspection, but it requires a number of employees to live in these buildings and charges rent, the rent is subject to the tax on net investment income, but any gain or loss resulting from the sale of these buildings is not subject to the tax.

However, if a private foundation uses property both for exempt purposes and (other than incidentally) for investment purposes, (for example, a building in which the foundation's charitable and investment activities are carried on) that part of the gain or loss from the sale or other disposition of the property that is allocable to the investment use of the property must be taken into account in figuring the tax on net investment income.

Losses. Capital losses from the sale or other disposition of investment property may be subtracted from capital gains incurred in the sale or disposition of other investment property during the same tax year, but only to the extent of the gains. If the capital losses are greater than the capital gains, the excess may not be subtracted from gross investment income, nor may the losses be carried back or forward to other tax years regardless of whether the foundation is a corporation or a trust.

Basis. The basis for determining gain from the sale or other disposition of property is the greater of:

1) The fair market value of the property on December 31, 1969, plus or minus all adjustments after 1969 and before the date of disposition if the property was held by the private foundation on that date and continuously thereafter until disposition, or
2) The basis of the property on the date of disposition under normal basis rules (actual basis).

For purposes of determining gain on property acquired by gift after December 31, 1969, the basis of the property is its basis in the hands of the donor at the time of the gift.

Normal basis rules are used in determining a loss on disposition. For purposes of determining a loss, the basis of property acquired by gift is the lesser of the donor's basis at the time of the gift or the fair market value at the time of the gift.

Example 1. A private foundation held depreciable real property on December 31, 1969, that had a basis of $127,500 and a depreciable basis of $102,000. The fair market value of the property on that date was $100,000. For tax years 1970 through 1984 the foundation was allowed $61,200 depreciation, figured under the straight line method using a 25—year useful life (4%) on the $102,000 basis. The property was sold on January 2, 1985, for $175,000. Since the fair market value on December 31, 1969 ($100,000) minus adjustments ($61,200 depreciation), or $38,800, is less than the actual adjusted basis on the date of sale ($66,300 ($127,500 − $61,200)), a gain of $108,700 is recognized ($175,000 sales price minus the greater of $66,300 or $38,800).

Example 2. A private foundation held depreciable real property on December 31, 1969, valued at $110,000, with a basis of $102,000 and a depreciable basis of $82,000. It was allowed $26,240 depreciation for years 1970 through 1977, figured under the straight line method using a 25—year useful life on the $82,000 depreciable basis. The property was sold on January 2, 1978, for $80,000. The fair market value minus adjustments after 1969 ($110,000 − $26,240 = $83,760) is greater than the basis of the property on the date of disposition ($102,000 − $26,240 = $75,760). The greater figure would be used to figure a gain. Because basis for determining a gain is greater than the selling price, there is no gain. The basis for determining a loss is the actual basis on the date of disposition ($75,760). Because this figure is less than the selling price, there is no loss. In this situation there is no recognized gain or loss for section 4940 purposes.

Example 3. On January 1, 1987, a private foundation received a gift of rental property with a fair market value of $100,000. At the time of the gift, the adjusted basis of the donor was $20,000. On January 2, 1987, the private foundation sold the property for $99,000. The gain to be recognized from the sale of donated property is $79,000 ($99,000 sales price minus $20,000 donor's basis).

Example 4. On February 1, 1987, a private foundation received a gift of rental property with a fair market value of $100,000. At the time of the gift, the adjusted basis of the donor was $105,000. On February 2, 1987, the private foundation sold the property for $99,000. The loss to be recognized from the sale of donated property is $1,000 ($100,000 fair market value minus $99,000 sales price).

Securities listed on recognized stock exchange. The fair market value for figuring basis for determining gain on the sale or exchange of stocks and bonds traded on a stock exchange, in an over-the-counter market, or otherwise, is the mean between the highest and lowest quoted selling prices on the valuation date.

Example. A private foundation bought 100 shares of common stock of the M Corporation on February 27, 1968, for $4,000. The foundation sold the stock on December 27, 1987, for $10,000. At all times the stock was registered and listed on a recognized securities exchange. On December 31, 1969, sales of M Corporation common stock on the exchange ranged from a high of $45 a share to a low of $40 a share, whereas the closing price was $44 a share. There were no adjustments to basis for the period the stock was held. The foundation's capital gain net income is figured as follows:

Amount received from sale		$10,000
Minus the greater of (1) or (2):		
1) Fair market value as of 12/31/69 $\frac{\$45 + \$40}{2} \times 100$ shares =	$4,250	
2) Adjusted basis	$4,000	4,250
Capital gain net income		$ 5,750

Deductions. In determining net investment income, a private foundation may deduct from gross investment income all the ordinary and necessary expenses paid or incurred for the production or collection of gross investment income or for the management, conservation, or maintenance of property held for the production of income, subject to the modifications given later. Expenses include the part of the foundation's operating expenses that is paid or incurred for the production or collection of gross investment income. A private foundation's operating expenses include compensation of officers, other salaries and wages of employees, outside professional fees, interest, rent, and taxes on property used in the foundation's operations. However, the tax on net investment income may not be deducted.

If any expenses, including salaries and compensation, are incurred for both investment purposes and exempt purposes, they must be allocated between the investment activities and the exempt activities. Expenses paid or incurred for exempt functions are not deductible in figuring net investment income. Also, any expenses that are taken into account in figuring the tax on unrelated business income may not be deducted in figuring net investment income.

No deduction is allowed for any expense that was not incurred for the purposes stated earlier. Thus, no deduction is allowed for charitable contributions, net operating losses, or any of the special deductions for corporations.

Deduction modifications. The following modifications must be made to otherwise allowable deductions in arriving at net investment income:

1) Depreciation is allowed only on the basis of the straight line method,
2) Depletion is allowed only on the basis of the cost depletion method,
3) The basis used in figuring depreciation or depletion is the basis determined under normal basis rules, without regard to the fair market value on December 31, 1969 (see *Basis,* earlier), and
4) The deduction for expenses paid or incurred in any tax year for the production of gross investment income earned as an incident to a charitable function cannot be greater than the income earned from the function that is includible as gross investment income for the year. For example, when rental income is incidentally realized in 1988 from historic buildings held open to the public, deductions paid or incurred in 1988 for the production of that income will be limited to the amount of rental income includible as gross investment income for 1988.

Chapter V

Disqualified Persons

For the rules discussed in this publication, the following persons are considered disqualified persons with respect to a private foundation:

1) All substantial contributors to the foundation (defined later),
2) All foundation managers of the foundation (defined later),
3) An owner of more than 20% of—
   a) The total combined voting power of a corporation,
   b) The profits interest of a partnership, or
   c) The beneficial interest of a trust or unincorporated enterprise, which is (during the ownership) a substantial contributor to the foundation,
4) A member of the family (defined later) of any of the individuals described in (1), (2), or (3),
5) A corporation of which more than 35% of the total combined voting power is owned by persons described in (1), (2), (3), or (4),
6) A partnership of which more than 35% of the profits interest is owned by persons described in (1), (2), (3), or (4),
7) A trust, estate, or unincorporated enterprise of which more than 35% of the beneficial interest is owned by persons described in (1), (2), (3), or (4),
8) For purposes of the tax on excess business holdings only (Chapter X), another private foundation which either
   a) is effectively controlled, directly or indirectly, by the same person or persons who control the private foundation in question, or
   b) receives substantially all of its contributions, directly or indirectly, from the same persons described in (1), (2), or (3), or members of their families, who made, directly or indirectly, substantially all the contributions to the private foundation in question, and
   c) For purposes of the tax on self-dealing only (Chapter VIII), a government official (as defined later).

Attribution of ownership. Indirect ownership of stock in a corporation, profits interest in a partnership, or beneficial interest in a trust, estate, or unincorporated enterprise is taken into account for determining whether:

1) The stockholdings, or profits or beneficial interest, amount to more than 20% of the total combined voting power of the corporation or more than 20% of the profits or beneficial interests, or
2) More than 35% of the total combined voting power of the corporation or more than 35% of the profits or beneficial interests are owned by persons described in categories (1), (2), (3), or (4).

The following rules apply for determining the ownership of stock or profits or beneficial interests:

1) Stock (or profits or beneficial interests) owned directly or indirectly by or for a corporation, partnership, estate, or trust is considered owned proportionately by or for its shareholders, partners, or beneficiaries,
2) An individual is considered to own the stock (or profits or beneficial interests) owned, directly or indirectly, by or for his or her family members. An exception to this rule is that, for the more than 35% ownership described in categories (5), (6), and (7), stock (or profits or beneficial interests) is not treated as constructively owned by an individual solely because that individual is a member of the family of another disqualified person. For purposes of these 35% ownership rules, an individual will be treated as a constructive owner only if that individual himself or herself is a substantial contributor, a foundation manager, or a 20% owner of the combined voting power, profits interest, or beneficial interest, of a substantial contributor.
3) An individual's family includes only those persons described in *A member of the family,* later, and
4) Any stockholdings, profits interest, or beneficial interest, that have been counted once (whether because of actual or constructive

ownership) in applying categories (5), (6), and (7) may not be counted a second time.

Combined voting power includes voting power represented by actual or constructive holdings of voting stock, but does not include voting rights held only as a director or trustee.

Voting power includes outstanding voting power and does not include voting power obtainable, but not obtained, such as voting power obtainable by converting securities or nonvoting stock into voting stock, by exercising warrants or options to obtain voting stock, and voting power available to preferred shareholders if dividends on preferred stock are in arrears.

The profits interest of a partner is the partner's distributive share of partnership income.

The beneficial interest in an unincorporated enterprise, other than a trust or estate, includes any right to receive a share of distributions from the profits of the enterprise, or if there is no profit-sharing agreement, the right to receive a share of the assets on liquidation of the enterprise, except as a creditor or employee. When no agreement fixing the rights of the participants in the enterprise exists, the fraction of the respective interests of each participant in the enterprise will be determined by dividing the total investment or contributions to capital made or obligated to be made by the participant by the amount of all investments and capital contributions made by all participants.

The beneficial interest in a trust will be determined in proportion to the person's actuarial interest in the trust.

A substantial contributor includes any person who contributed or bequeathed a total amount of more than $5,000 to the private foundation if the amount is more than 2% of the total contributions and bequests received by the foundation from its creation up through the close of the tax year of the foundation in which the contribution or bequest is received from that person. For a trust, a substantial contributor includes the creator of the trust. However, in no case does the term include a governmental unit.

In determining whether the total contributions and bequests from a person are more than 2% of the total contributions and bequests received by a private foundation, both the total of the amounts received by the foundation, and the total of the amounts contributed and bequeathed by the person, are determined as of the last day of each tax year. Although the determination is made on the last day of the foundation's tax year, a donor is a substantial contributor as of the first day the foundation receives a gift large enough to make the donor a substantial contributor. Each contribution or bequest is valued at its fair market value on the date it is received by the foundation. Gifts by an individual include all contributions and bequests made by that individual and his or her spouse.

A determination is to be made as to whether a person is a substantial contributor as of the end of each of the foundation's tax years, based on the respective totals of all contributions received and the total amount received from a particular person by that date. Status as a substantial contributor will date from the time the donor first met the $5,000 — 2% test. Once a person is a substantial contributor to a private foundation, generally that person remains a substantial contributor even though the individual might not be so classified if a determination were first made at some later date. For instance, even though the total contributions and bequests of a person become less than 2% of the total received by a private foundation, generally the person remains a substantial contributor to the foundation.

However, a person ceases to be a substantial contributor as of the end of a private foundation's tax year if:

1) That person (and all related persons) have not made any contributions to the foundation during the 10-year period ending with that tax year, and
2) That person (or any related person) was not a foundation manager of the foundation at any time during that 10-year period, and
3) The total contributions made by that person (and related persons) are determined by the IRS to be insignificant compared to the total contributions to the foundation by one other person. For the purpose of this comparison, appreciation on contributions while held by the foundation is taken into account.

A person is related to a substantial contributor, for this rule, if that person's relationship to the contributor would make that other person a disqualified person with respect to the contributor, as discussed in this chapter. If the contributor is a corporation, the term "related person" also includes any officer or director of the corporation.

Special rules. A substantial contributor does not include an entity that is described in section 509(a)(1), (2), or (3) or any organization wholly owned by such an entity. In addition, only for purposes of section 4941 excise taxes on self-dealing, a substantial contributor does not include any other organization described in section 501(c)(3) (other than an organization with section 509(a)(4) status).

The term ***contribution*** includes gifts, and grants to the foundation, as well as bequests, devises, legacies, or transfers as outlined in the rules relating to estate and gift tax.

Entities excluded from the definition of substantial contributor as discussed earlier are also excluded from the definition of disqualified person.

Foundation manager. A foundation manager means:

1) An officer, director, or trustee of a foundation (or an individual having powers or responsibilities similar to those of officers, directors, or trustees of the foundation), or
2) For any act or failure to act, any employee of the foundation having final authority or responsibility (either officially or effectively) for the act or failure to act.

A person who is specifically designated as an officer under the incorporation certificate, bylaws, or other documents of the foundation, or who regularly exercises general authority to make administrative and policy decisions for a foundation is considered an officer of the foundation.

For any act or failure to act, any foundation employee who has authority merely to recommend particular administrative or policy decisions, but not to implement them without approval of a superior, is not an officer. Independent contractors, such as accountants, lawyers, and investment managers or advisors, acting in their capacity as such, are not considered officers of the foundation.

A member of the family includes: a spouse, ancestors, children, grandchildren, great grandchildren, and spouses of children, grandchildren, and great grandchildren. A brother or sister of an individual is not a member of the family for this purpose. A legally adopted child of an individual will be treated as a child by blood.

Government official. For the excise tax on self-dealing (described in Chapter VIII) a government official also is a disqualified person.

The term government official means an individual who at the time of the act of self-dealing holds any of the following offices or positions:

1) An elective public office in the executive or legislative branch of the United States Government,
2) An office in the executive or judicial branch of the U.S. Government, appointment to which was made by the President,
3) A position in the executive, legislative, or judicial branch of the U.S. Government—
   a) Which is listed in Schedule C of Rule VI of the Civil Service Rules, or
   b) The compensation for which is at least equal to the lowest rate prescribed for GS–16 of the General Schedule under 5 U.S.C. 5332,
4) A position under either the U.S. House of Representatives or the U.S. Senate, held by an individual who receives ***gross*** annual pay of at least $15,000 (including expense allowances for which no accounting need be made),
5) An elective or appointive public office in any branch of the government of any state, possession of the United States, or any subdivision of the foregoing, or the District of Columbia, held by an individual who receives gross annual pay of at least $20,000, or
6) A position as personal or executive assistant or secretary to any individual already described.

Public office. For the purpose of (5) under *Government official,* a holder of public office must be distinguished from a public employee. Although the determination depends on the facts and circumstances of each case, the essential element is whether a significant part of the activities of the individual is the independent performance of policymaking functions. Among the factors to be considered are that the office is created by the Congress, a state constitution, or state legislature, or by a municipality or other governmental body under powers created in it, and the duties to be discharged by the office are defined either directly or indirectly by the body that created it or through legislative authority.

Examples. The following are illustrations of positions of public employment that do not involve policymaking functions and are not a public office:

1) The chancellor, president, provost, dean, and other officers of a state university who are appointed, elected, or otherwise hired by a State Board of Regents or equivalent public body and who are subject to the direction and supervision of that body,
2) The superintendent of public schools and other public school officials who are appointed, elected, or otherwise hired by a Board of Education or equivalent public body and who are subject to the direction and supervision of that body, or
3) Members of police and fire departments, except for department heads who, under the facts and circumstances of the case, independently perform policymaking functions as a significant part of their activities.

Chapter VI

Taxes on Taxable Expenditures

A private foundation that makes any ***taxable expenditures***, defined later, becomes liable for taxes on these expenditures under section 4945 of the Internal Revenue Code. The taxes are imposed on both the foundation and on any foundation manager who knowingly and willfully agrees to the expenditures. Both an initial tax and an additional tax may be imposed.

Initial tax. The initial tax on the foundation is 10% of the amount expended. The foundation will not be liable for the tax if it can show that the expenditure was due to reasonable cause and not to willful neglect, and that the expenditure was corrected within the ***correction period*** (described later). In the case of a foundation manager who knowingly, willfully, and without reasonable cause agrees to the taxable expenditure, the initial tax is 2 ½% of the amount expended, up to a maximum

tax of $5,000 for any one expenditure. A foundation manager who acts on advice of counsel, given in a reasoned legal opinion in writing, is not liable for the tax.

Additional tax. If the expenditure is not corrected within the ***taxable period*** (described later), an additional tax of 100% of the amount expended is imposed on the foundation. The tax will not be assessed, or if assessed will be abated, if the expenditure is corrected within the ***correction period*** (described later). Any foundation manager who refuses to agree to part or all of the correction must pay an additional tax of 50% of the expenditure, up to a maximum tax of $10,000.

If more than one foundation manager is liable for either the initial or additional tax, all are jointly and severally liable.

The initial tax on foundation managers is imposed only in cases when the following circumstances are present:

1) The initial tax on taxable expenditures is imposed on the private foundation making the expenditure,
2) The foundation manager knows that the expenditure to which he or she agrees is a taxable expenditure, and
3) The agreement is willful and not due to reasonable cause.

The tax on any particular expenditure applies only to agreements of foundation managers with authority to approve or to exercise discretion in recommending approval for expenditures by the foundation and to those foundation managers who are members of a group authorized to make or recommend those expenditures.

Agreement. The agreement of any foundation manager to making a taxable expenditure consists of any manifestation of approval of the expenditure which is sufficient to constitute an exercise of the foundation manager's authority to approve or to exercise discretion in recommending approval for making an expenditure by the foundation. Whether or not the foundation manager's action is the final or decisive approval on behalf of the foundation is not the determining factor.

Knowing. A foundation manager will be considered to have agreed to an expenditure ***knowing*** that it is a taxable expenditure only if:

1) The foundation manager has actual knowledge of enough facts so that, based only on these facts, the expenditure would be a taxable expenditure,
2) The foundation manager is aware that an expenditure under these circumstances may violate the law governing taxable expenditures, and
3) The foundation manager negligently fails to make reasonable attempts to determine whether the expenditure is a taxable expenditure or is in fact aware that it is a taxable expenditure.

The term ***knowing*** does not mean having reason to know. However, any evidence indicating that a foundation manager has reason to know of a particular fact or rule is relevant in determining whether he or she had actual knowledge of this fact or rule.

Willful. A foundation manager's agreement to a taxable expenditure is ***willful*** if it is voluntary, conscious, and intentional. No motive to avoid the restrictions of the law or the incurrence of any tax is necessary to make an agreement willful. However, a foundation manager's agreement to a taxable expenditure is not willful if he or she does not know that it is a taxable expenditure.

Due to reasonable cause. A foundation manager's actions are ***due to reasonable cause*** if he or she has exercised responsibility on behalf of the foundation with ordinary business care and prudence.

Advice of counsel. If a foundation manager has made full disclosure of the factual situation to legal counsel (including house counsel) and relies on the advice of counsel expressed in a reasoned written legal opinion that an expenditure is not a taxable expenditure and the expenditure is later held to be taxable, the foundation manager's agreement to the expenditure will ordinarily not be considered ***knowing*** or ***willful*** and will ordinarily be considered due to reasonable cause.

A written legal opinion will be considered reasoned even if it reaches a conclusion that is later determined to be incorrect as long as the opinion addresses itself to the facts and applicable law. However, a written legal opinion will not be considered reasoned if it does nothing more than recite the facts and express a conclusion.

The absence of advice of counsel on an expenditure will not, by itself, give rise to any inference that a foundation manager agreed to making the expenditure knowingly, willfully, or without reasonable cause.

Correction of a taxable expenditure. In cases other than those of inadequate reporting or failure to obtain advance approval, discussed later, a correction is accomplished by recovering part or all of the expenditure to the extent possible. When full recovery is not possible, any additional corrective action will be prescribed by the IRS. The type of additional action depends on the circumstances, and the Service may require any of the following:

1) Withholding any unpaid funds due a particular grantee,
2) Stopping further grants to the grantee,
3) Periodic reports to the IRS from the foundation for all its expenditures,
4) Improving methods of exercising expenditure responsibility (discussed later),
5) Improving methods of selecting recipients of individual grants, and
6) Any other actions that the Service may prescribe in a particular case.

The foundation is not required to attempt recovery of the taxable expenditure by legal action if it appears a judgment could not be satisfied.

Correction for failure to obtain advance approval. When an expenditure is taxable as a grant for travel, study, etc., only because of a failure to obtain advance approval of procedures for those grants, correction may be accomplished by obtaining approval of the grant-making procedures and establishing to the satisfaction of the Service that:

1) No grant funds have been diverted to any use not for a purpose specified in the grant,
2) The grant making procedures instituted would have been approved if advance approval of the procedures had been properly requested, and
3) When advance approval of grant making procedures is later required, the approval will be properly requested.

Correction for inadequate reporting. If an expenditure is taxable only because of a failure to make or obtain a full and complete report as required (discussed later in this chapter), correction may be made by obtaining or making the report in question.

In addition, if the expenditure is taxable only because of a failure to obtain a full and complete report as required and an investigation indicates that no grant funds have been diverted to any use not for a purpose specified in the grant, correction will be accomplished if all reasonable efforts are made to obtain the report and the Service is notified of the failure to obtain the report.

The taxable period begins on the date the taxable expenditure occurs and ends on the earlier of either:

1) The date a notice of deficiency for the ***initial tax*** is mailed, or
2) The date the ***initial tax*** is assessed.

The correction period begins on the date of the taxable expenditure and ends 90 days after a notice of deficiency for the ***additional tax*** is mailed. The period is extended for the time during which a deficiency cannot be assessed under section 6213(a) (relating to pending Tax Court and other proceedings), and for any other period the Service determines is reasonable and necessary for correction of the taxable expenditure.

Taxable Expenditures

A ***taxable expenditure*** is an amount paid or incurred to:

1) Carry on propaganda or otherwise attempt to influence legislation,
2) Influence the outcome of any specific public election or carry on any voter registration drive, unless certain requirements (explained later under *Influencing elections and carrying on voter registration drives*) are satisfied,
3) Make a grant to an individual for travel, study, or other similar purposes, unless certain requirements (explained later under *Grants to individuals*) are satisfied,
4) Make a grant to an organization (other than an organization described in section 509(a)(1), (2), or (3) or an exempt operating foundation as defined in Chapter I), unless the foundation exercises expenditure responsibility with respect to the grant, or
5) Carry out any purpose other than a religious, charitable, scientific, literary, or educational purpose, the fostering of national or international amateur sports competition (with exceptions) or the prevention of cruelty to children or animals.

These categories of taxable expenditures are discussed in greater detail in this chapter.

Influencing legislation

A taxable expenditure includes amounts used to attempt to influence legislation:

1) By affecting public opinion, or
2) By communicating with any member or employee of a legislative body, or with any other government official or employee who may participate in formulating the legislation.

Legislation includes ***action*** by Congress, any state legislature, any local council or similar governing body, or the public by way of referendum, constitutional amendment, or the like. The word ***action*** includes the introduction, enactment, defeat, or repeal of legislation. Actions by executive, judicial, or administrative bodies are not legislation. Therefore, expenditures made to influence action by these bodies are not attempts to influence legislation.

School boards, housing authorities, sewer and water districts, zoning boards, and other similar federal, state, or local special purpose bodies, whether elective or appointive, are considered administrative bodies.

A proposed treaty required to be submitted by the President to the Senate for its advice and consent will be considered legislation being considered by, or to be submitted imminently to, a legislative body at the time the President's representative begins to negotiate its position with the parties to the proposed treaty.

Jointly funded projects. A private foundation will not be treated as having paid or incurred any amount to attempt to influence legislation merely because it makes a grant to another organization on the condition that the recipient obtain a matching support appropriation from the government. In addition, it will not be treated as having made a taxable expenditure of amounts paid or incurred in carrying on discussions with government officials if:

1) The subject is a new program or an existing program jointly funded by the foundation and the government,
2) The discussions are undertaken for the purpose of exchanging data and information on the subject matter of the program, and
3) The discussions are not undertaken to make any direct attempt to persuade government officials or employees to take a particular position on specific legislative issues other than the program.

Certain expenditures by recipients of program-related investments. Any amount paid or incurred by a recipient of a program-related investment in connection with an appearance before, or communication with, any legislative body on legislation or proposed legislation of direct interest to the recipient will not be attributed to the investing foundation if:

1) The foundation does not earmark its funds to carry on propaganda or otherwise attempt to influence legislation, and
2) A trade or business deduction is allowable to the recipient for this expenditure.

Grants to public organizations. A grant by a private foundation to an organization that is ***not a private foundation*** (except certain organizations organized and operated exclusively for testing for public safety) is not a taxable expenditure if the grant is not earmarked to be used for, or in a manner outlined in, items (1) through (5) under *Taxable Expenditures,* discussed earlier. In addition, a grantor foundation may not enter into an oral or written agreement with a grantee that causes the grantee to engage in any prohibited activity nor may the grantor select the recipient of the grant. A grant is earmarked if the grant is given under an agreement, oral or written, that the grant be used for specific purposes.

Attempts to affect the opinion of the general public. Generally, expenditures paid or incurred by a private foundation in an attempt to influence any legislation through an attempt to affect the opinion of any segment of the general public is a taxable expenditure. Exceptions are discussed later in this chapter.

Lobbying activities. Generally, expenditures paid or incurred by a private foundation to influence legislation through communication with any member or employee of a legislative body, or with any government official or employee who may participate in the formulation of the legislation is a taxable expenditure. Exceptions are discussed next.

Exception for nonpartisan analysis, study, and research. Engaging in nonpartisan analysis, study, or research and making the results of this work available to the general public or to governmental bodies, officials, or employees is not carrying on propaganda, or otherwise attempting to influence legislation. Nonpartisan analysis, study, or research means an independent and objective exposition of a particular subject matter, including activities that qualify as educational activities. Nonpartisan analysis, study, or research may advocate a particular position or viewpoint as long as there is a sufficiently full and fair exposition of the relevant facts to enable the public or an individual to form an independent opinion or conclusion. However, a mere presentation of unsupported opinion does not qualify as nonpartisan analysis, study, or research.

Presentation as part of a series. Normally, whether a publication or broadcast qualifies as nonpartisan analysis, study, or research will be determined on a presentation-by-presentation basis. However, if a publication or broadcast is one of a series prepared or supported by a private foundation and the series as a whole meets the standards of nonpartisan analysis, study, or research, then any individual publication or broadcast in the series will not result in a taxable expenditure even though such individual broadcast or publication does not, by itself, meet the standards of nonpartisan analysis, study, or research. Whether a broadcast or publication is considered part of a series will ordinarily depend on all the facts and circumstances of each particular situation. However, for broadcast activities, all broadcasts in any period of 6 consecutive months will ordinarily be eligible to be considered as part of a series. If a private foundation times or channels a part of a series in a manner designed to influence the general public or the action of a legislative body for a specific legislative proposal, the expenses of preparing and distributing that part of the analysis, study, or research are a taxable expenditure.

Making available results of analysis, study, or research. A private foundation may choose any suitable means, including oral or written presentations, to distribute the results of its nonpartisan analysis, study, or research, with or without charge. This may include distribution of reprints of speeches, articles, and reports, presentation of information through conferences, meetings, and discussions, and dissemination to the news media, including radio, television, and newspapers, and to other public forums. These presentations may not be limited to or directed toward persons who are interested only in one side of a particular issue.

Example 1. M, a private foundation, establishes a research project to collect information for showing the dangers of using pesticides in growing crops. The information collected includes data on proposed legislation, pending before several state legislatures, that would ban the use of pesticides. The project takes favorable positions on the legislation ***without*** producing a sufficiently full and fair exposition of the relevant facts to enable the public or an individual to form an independent opinion or conclusion on the pros and cons of the use of pesticides. This project is not within the exception for nonpartisan analysis, study, or research because it is designed to present information only on one side of the legislative controversy.

Example 2. N, a private foundation, establishes a research project for the apparent purpose of examining and reporting information as to the pros and cons of the use of pesticides in growing crops. The information is collected and distributed in the form of a published report that analyzes the effects and costs of the use and nonuse of various pesticides under various conditions on humans, animals, and crops. The report also presents the advantages, disadvantages, and economic cost of allowing the continued use of pesticides unabated, of controlling the use of pesticides, and of developing alternatives to pesticides.

Even if the report gives conclusions that the disadvantages, as a result of using pesticides, are greater than the advantages of using pesticides and that prompt legislative regulation of the use of pesticides is needed, the project is within the exception for nonpartisan analysis, study, or research because it is designed to present information on both sides of the legislative controversy. In addition, the report presents a sufficiently full and fair exposition of the relevant facts to enable the public or an individual to form an independent opinion or conclusion.

Exception for technical advice or assistance. Amounts are not taxable expenditures if they are paid or incurred in connection with providing technical advice or assistance to a governmental body, a government committee, or a subdivision of either, in response to a ***written request.*** Under this exception, the request for assistance or advice must be made in the name of the requesting governmental body, committee, or subdivision rather than an individual member. Similarly, the response to the request must be available to every member of the requesting body, committee, or subdivision.

Nature of technical advice or assistance. Technical advice or assistance may be given as a result of knowledge or skill in a given area. Because this assistance or advice may be given only at the express request of a governmental body, committee, or subdivision, the oral or written presentation of assistance or advice need not qualify as nonpartisan analysis, study, or research. Offering opinions or recommendations will ordinarily qualify under this exception only if the opinions or recommendations are specifically requested by the governmental body, committee, or subdivision or are directly related to the materials requested.

Example 1. A Congressional committee is studying the feasibility of legislation to provide funds for scholarships to U. S. students attending schools abroad. X, a private foundation that has engaged in a private scholarship program of this kind, is asked, in writing, by the committee to describe the manner in which it selects candidates for its program. X's response, disclosing its methods of selection, is technical advice or assistance.

Example 2. Assume the same facts given in Example 1, except that X's response not only includes a description of its own grant-making procedures, but also includes its views regarding the wisdom of adopting such a program. Because these views are directly related to the subject matter of the request for technical advice or assistance, the amount paid or incurred for the presentation of these views is not a taxable expenditure. However, the amount paid or incurred in connection with a response that is not directly related to the subject matter of the request for technical advice or assistance would be a taxable expenditure unless the presentation can qualify as making available nonpartisan analysis, study, or research.

Exception for decisions affecting the powers, duties, etc., of a private foundation. Taxes on lobbying activities, discussed earlier, do not apply to any amount paid or incurred in connection with an appearance before, or communication with, any legislative body on a possible decision of the body that might affect the existence of the private foundation, its powers and duties, its tax-exempt status, or the deductibility of contributions to the foundation. Under this exception, a foundation may communicate with the entire legislative body, committees, or subcommittees of the legislative body, individual congressmen or legislators, members of their staffs, or representatives of the executive branch, who are involved in the legislative process if the communication is limited to the prescribed subjects. In addition, the foundation may make expenditures to initiate legislation if the legislation concerns only matters that might affect the existence of the private foundation, its powers and duties, its tax-exempt status, or the deductibility of contributions to the foundation.

Exception for examinations and discussions of broad social, economic, and similar problems. Expenditures for examinations and discussions of broad social, economic, and similar problems are not taxable expenditures even if the problems are the type the government would be expected to deal with ultimately.

The term "any attempt to influence any legislation" does not include public discussion, or communications with members of legislative bodies or governmental employees, the general subject of which is also the subject of legislation before a legislative body, as long as the discussion does not address itself to the merits of a specific legislative proposal.

For example, a private foundation may, without incurring the tax on taxable expenditures, present discussions of problems such as environmental pollution or population growth that are being considered by Congress and various state legislatures, but only if the discussions are not directly addressed to specific legislation being considered.

Influencing elections and carrying on voter registration drives.

Taxable expenditures include amounts paid or incurred by a private foundation to influence the outcome of any specific public election or to carry on, directly or indirectly, any voter registration drive. Activities that are considered participation or intervention in a political campaign include, but are not limited to:

1) Publishing or distributing written or printed statements or making oral statements on behalf of or in opposition to a candidate,
2) Paying salaries or expenses of campaign workers, and
3) Conducting or paying the expenses of conducting a voter registration drive limited to the geographic area covered by the campaign.

Exceptions. This rule does not apply to nonpartisan activities carried on under all the following conditions:

1) The organization making the expenditure is described in section 501(c)(3) and is exempt from tax,
2) Its activities are nonpartisan, are not confined to one specific election period, and are carried on in at least 5 states,
3) The organization spends at least 85% of its income directly for the active conduct of the exempt purposes or functions for which it is organized and operated,
4) The organization receives at least 85% of its support (other than gross investment income) from exempt organizations, the general public, governmental units, or any combination of these; it does not receive more than 25% of its support (other than gross investment income) from any one exempt organization; and it does not receive more than 50% of its support from gross investment income, and
5) Contributions to the organization for voter registration drives are not subject to conditions that they may be used only in specified states or other localities of the United States, or that they may be used in only one specific election period.

In determining whether the organization meets the support test in item (4) for a tax year, the support received during the tax year and the 4 immediately preceding tax years of the organization is taken into account.

For organizations with less than 4 years of operational experience, the support test may be determined by taking into account all available years the organization has been in existence.

Advance ruling. An organization will be given an advance ruling that it qualifies under the exceptions that apply to nonpartisan activities if it submits evidence establishing that it can reasonably expect to meet these tests for the year. Grantors or contributors to these organizations may rely on the advance ruling until a notice of change of status of the organization is made to the public. This does not apply, however, if the grantor or contributor was responsible for, or was aware of, the fact that the organization did not qualify under these provisions at the end of the tax year for which it obtained an advance ruling or determination letter, or acquired knowledge that the Service had given notice to the organization advising that it would be deleted from this classification.

Grants to individuals

Grants to individuals for travel, study, or other similar purposes (including loans made for charitable purposes, and program-related investments as defined in Chapter IX) are taxable expenditures, ***unless*** the following conditions are met:

1) The grant must be awarded on an objective and nondiscriminatory basis under a procedure approved in advance by the Service, and
2) It must be shown to the satisfaction of the Service that one of the following requirements is met—
   a) The grant is a scholarship or fellowship and is to be used for study at an educational institution that normally maintains a regular faculty and curriculum and normally has a regularly organized body of students in attendance at the place where the educational activities are carried on. For these purposes, there is no requirement that the grant recipients be limited to degree candidates, nor must the grant be limited to tuition, fees, and course-required books, supplies, and equipment. A recipient may use grant funds for room, board, travel, research, clerical help, or equipment, that are incidental to the purposes of the scholarship or fellowship grant.
   b) The grant qualifies as a prize or award under section 74(b), if the recipient is selected from the general public. For this purpose, the recipient may keep the prize or award, and need not authorize the foundation to transfer the prize or award to a governmental unit or to another charity.
   c) The grant's purpose is to achieve a specific objective, produce a report or similar product, or improve or enhance a literary, artistic, musical, scientific, teaching, or similar capacity, skill, or talent of the grantee.

Advance approval of grant-making procedure. The grant-making procedure, to be approved in advance by the Internal Revenue Service, must provide the following:

1) The group from which the grantees are selected must be reasonably related to the purposes of the grant, and the group must be large enough to constitute a charitable class (unless, taking into account the purposes of the grant, only a few individuals are qualified to be grantees—as in the case of scientific research).
2) The criteria used in selecting grant recipients from the potential grantees should be related to the purpose of the grant. For example, proper criteria for selecting scholarship recipients might include (but are not limited to) the following: past academic performance, performance on tests designed to measure ability and aptitude for college work, recommendations from instructors, financial need, and the conclusions the selection committee might draw from personal interviews.
3) The person or persons who select recipients of grants should not be in a position to receive a private benefit, directly or indirectly, if certain potential grantees are selected over others.
4) Periodic progress reports must be made to the foundation, at least once a year, to determine whether the grantees have performed the activities the grants are intended to finance.
5) When these reports are not made or there are other indications that the grants are not being used as intended, the foundation must investigate and take corrective action.
6) The foundation must keep all records relating to all grants to individuals, including—
   a) Information obtained to evaluate grantees,
   b) Identification of grantees, including any relationship of the grantee to the foundation sufficient to make the grantee a disqualified person,
   c) Amount and purpose of each grant, and
   d) Follow-up information, including required annual reports and investigation of jeopardized grants.

However, no single procedure or set of procedures is required. Procedures may vary depending upon such factors as the size of the foundation, the amount and purpose of the grants, and whether one or more recipients are involved.

Requests for approval of grant-making procedures should be sent to the District Director of the IRS office servicing your area. If, by the 45th day after a request for approval of grant procedures has been properly submitted, the foundation has not been notified that the procedures are unacceptable, they may be considered approved from the date of submission until receipt of actual notice from the Service that they do not meet the requirements.

Payments of remaining installments of fixed-sum grants awarded during the period the foundation's procedures were considered approved, after the foundation is notified that the procedures are unacceptable, are not taxable expenditures.

Renewals. A renewal of a qualified grant will not be treated as a grant to an individual subject to the requirements of this chapter if:

1) The grantor has no information indicating that the original grant is being used for any purpose other than that for which it was made,
2) The reports due under the terms of the grant have been provided, and
3) Any additional criteria and procedures for renewal are objective and nondiscriminatory.

Any extension of a period over which a grant is to be paid will not by itself be regarded as a grant or a renewal of a grant.

Company scholarship programs are usually administered by company-created private foundations. These foundations may give preference in awarding scholarships to employees, the children or relatives of employees, or the children of deceased or retired employees of the company or related companies. Scholarship grants awarded by these private foundations are taxable expenditures unless the grant programs meet the requirements for individual grants (discussed earlier) and receive advance approval from the Service.

Company scholarship programs will not qualify if grants are essentially providing extra pay, an employment incentive, or an employee fringe benefit. Similarly, if scholarship programs are compensatory in nature, an organization administering such a program will not qualify for tax exemption because it is operated for private benefit. A private foundation administering such a program could also be involved in direct or indirect self-dealing.

Company-related scholarship programs can meet the scholarship requirements by ensuring that the scholarships awarded are for the main purpose of furthering the recipients' education rather than compensating company employees. Certain conditions and tests must establish three facts:

1) The preferential treatment derived from employment must not have any significance beyond that of an initial qualifier,
2) The selection of scholarship grantees must be controlled and limited by substantial nonemployment related factors, including a selection committee of individuals who are independent and separate from the private foundation, its organizer, and the employer concerned, and
3) There must exist only a limited probability that qualified employees or their children will receive scholarship grants.

Ruling requests for advance approval of procedures are to be sent to your key District Director, and should include the statements described earlier under *Grants to Individuals,* in addition to information responsive to the seven conditions and the percentage test described below.

Educational loans made by a private foundation under an employer-related loan program are not taxable expenditures if the loan program—

1) Meets the applicable requirements for grants to individuals, discussed earlier, and
2) Satisfies the seven conditions and the percentage tests described below.

The seven conditions for approval include the following items:

1) ***Inducement.*** The programs must not be used by the employer, the private foundation, or the organizer thereof, to recruit employees or to induce employees to continue their employment or otherwise follow a course of action sought by the employer.
2) ***Selection committee.*** Selection of loan recipients must be made by a committee of individuals who are totally independent (except for participation on this committee) and separate from the private foundation, its organizer, and the employer concerned. An individual who is a former employee of either the foundation or the employer concerned will not be considered totally independent. These committees preferably should consist of individuals knowledgeable in the field of education so that they have the background and knowledge to properly evaluate the potential of the applicants.

   Forwarding the selections by the independent selection committee to the employer or private foundation only for the purpose of verifying the eligibility requirements and selection criteria followed by the committee in considering the candidates and in making its selection will not disqualify the program. Any public announcement of the awards, however, must be made by the selection committee or by the foundation. The awards may be announced in the employer's newsletter, if the foundation or the selection committee is clearly identified as the grantor of the awards.

   Loans must be awarded only in the order recommended by the selection committee. The number of loans to be awarded may be reduced but may not be increased from the number recommended by the selection committee. Only the committee may vary the amounts of the loans awarded.
3) ***Eligibility requirements.*** The program must impose identifiable minimum requirements for loan eligibility. These requirements must be related to the purpose of the program and must limit the independent selection committee's consideration to those employees, or children of employees, who meet the minimum standards for admission to an educational organization for which the loans are available. No persons will be considered eligible if they would not reasonably be expected to attend such an organization, however, even if they meet the minimum standards. If an employee must have been employed for some minimum period by the employer to which the program relates to be eligible to receive a loan, or to make that employee's children eligible to receive a loan, the minimum period of employment may not be more than 3 years. Moreover, eligibility must not be related to any other employment-related factors, such as the employee's position, services, or duties.
4) ***Objective basis of selection.*** Selection of loan recipients must be based only upon substantial objective standards that are completely unrelated to the employment of the recipients or their parents and to the employer's line of business. Such standards as past academic performance, performance on tests designed to measure ability and aptitude for higher education, recommendations from instructors or other individuals not related to the potential awardees, financial need, and conclusions drawn from personal interviews as to motivation and character, may be used.
5) ***Employment.*** Once a loan has been awarded, it may not be terminated because the recipient or the recipient's parent no longer works for the employer, regardless of the reason for the termination of employment. If a loan is awarded for one academic year and the recipient must reapply for an additional loan or loans to continue studies for a later year, the recipient may not be considered ineligible for a subsequent loan simply because that individual or the individual's parent is no longer employed by the employer. If a loan is awarded for a period of more than one academic year, subject to renewal, the standards for renewal must be based only on nonemployment related factors such as need and maintenance of scholastic standards. At the time the loan is awarded or renewed, there must be no requirement, condition, or suggestion, express or implied, that the recipient or parent is expected to perform future employment services for the foundation or the employer, or be available for future employment, even though the future employment is at the discretion of the foundation or the employer.
6) ***Course of study.*** The courses of study for which loans are available must not be limited to those that would be of particular benefit to the employer or to the foundation. If the courses of study for which loans are available include one or more that would be of particular benefit, a loan may not be conditioned on the recipient choosing such a course of study. The recipient must have free choice to use the loan in the pursuit of a course of study for which the loan is otherwise available that is not of particular benefit to the employer or to the foundation.
7) ***Other objectives.*** The terms of the loan and the courses of study for which loans are available must be consistent with a disinterested purpose of enabling the recipients to obtain an education in their individual capacities only for their personal benefit. The terms of the loan and courses of study must not include any commitments, understandings, or obligations, conditional or unconditional, suggesting that the studies are undertaken by the recipients for the benefit of the employer or the foundation or have as their objective the accomplishment of any purpose of the employer or the foundation, even though consistent with its exempt status, other than to enable the recipients to obtain an education in their individual capacities.

Percentage test. For a program that awards loans to children of employees of a particular employer, the program meets the percentage test if the number of loans awarded under that program in any year to those children are not more than:

1) 25% of the number of employees' children who—
   a) Were eligible,
   b) Were applicants for such loans, and
   c) Were considered by the selection committee in selecting the recipients of loans in that year, or
2) 10% of the number of employees' children who can be shown to be eligible for loans (whether or not they submitted an application) in that year. For purposes of this 10% test, children can be shown to be eligible only if they meet the minimum eligibility requirements of the loan program and the minimum standards for admission to an educational institution for which grants or loans are available. A private foundation may include as eligible only those children who submit a written statement (or on behalf of whom a statement is submitted by an authorized representative), or for whom sufficient information is maintained to demonstrate that:
   a) the child meets the foundation's eligibility requirements; and
   b) the child has enrolled in or has completed a course of study to prepare for admission to an educational institution at the level for which loans are available and has applied, or intends to apply, to such an institution for enrollment in the immediately succeeding academic year with the expectation, if accepted by the institution, of attending the institution; or
   c) in lieu of b) above, the child is currently enrolled in an educational institution for which loans are available and is not in the final year for which awards may be made.

   For a program that awards loans to employees of a particular employer, the program meets the percentage test if the number of loans awarded under that program in any year to the employees are not more than 10% of the number of employees who:
   a) Were eligible,
   b) Were applicants for such loans, and
   c) Were considered by the selection committee in selecting the recipients of loans in that year.

In meeting these percentage tests, an employee or child of an employee will be considered eligible only if the individual meets all of the eligibility requirements imposed by the program. Renewals of loans awarded in earlier years will not be considered in determining the number of loans awarded in a current year. Loans awarded to children of employees and those awarded to employees will be considered as having been awarded under separate programs whether or not they are awarded under separately administered programs.

If a private foundation's employer-related program includes educational loans and scholarship or fellowship grants to the same group of eligible employees' children, the percentage tests apply to the total number of individuals receiving combined grants of scholarship, fellowship, and educational loans.

If the loan program satisfies the seven conditions, but does not meet the percentage test, all the relevant facts and circumstances will be considered in determining the primary purpose of the program.

If your private foundation holds a ruling letter issued before September 29, 1980, you may continue to rely on that ruling letter provided the loan program fully complies with the seven conditions and the percentage tests continuously from the date on which the ruling letter was issued. Upon written request, the Service will issue a current ruling letter affirming the qualification of the loan program under these requirements.

Certain designated grants. A grant by a private foundation to another organization that makes payments to a qualified individual will not be treated as a grant by the private foundation to the individual if the foundation does not earmark the use of the grant for any named individual and there is no agreement (oral or written) whereby the grantor organization has any part in selecting the individual grantee.

Certain grants to public charities. A grant by a private foundation to a public charity, other than an organization organized and operated exclusively for testing for public safety, that the grantee organization uses to make payments to an individual as a qualified grant, will not be treated as a grant by the private foundation to the individual grantee if the grant is made for a project to be undertaken and controlled by the public charity. The public charity must also control the selection of the grantee, although the selection need not be completely independent of the private foundation.

Grants to governmental agencies. If a private foundation makes a grant to a governmental agency, and the grant is earmarked for use by an individual for travel, study, or other similar

purposes, the grant is not a taxable expenditure by the private foundation if the governmental agency satisfies the Service in advance that its grant-making program:

1) Is in furtherance of exempt purposes under section 501(c)(3),
2) Requires the individual grantee to submit annual progress reports, and
3) Requires the organization to investigate jeopardized grants.

Earmarked grants to individuals. A grant by a private foundation to an individual is a taxable expenditure if:

1) The grant is earmarked to be used for a purpose described earlier under *Taxable Expenditures*,
2) The grantor foundation causes the grantee, through an oral or written agreement, to engage in a prohibited activity and the grant is in fact a taxable expenditure, and
3) The grant is made for a purpose other than a purpose of an organization organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, the fostering of national or international amateur sports competition (but only if no part of its activities involve providing athletic facilities or equipment), or the prevention of cruelty to children or animals.

A grant by a private foundation is ***earmarked*** if it is given under an agreement (oral or written) that the grant will be used for specific purposes.

Grants to organizations (including loans and program-related investments) are taxable expenditures, unless the recipients are public charities described in section 509(a)(1), (2), or (3), or unless the private foundation exercises expenditure responsibility with respect to the grant. However, expenditure responsibility is not required if the grantee organization meets the exception requirements described earlier under *Influencing elections and carrying on voter registration drives.*

Reliance by grantors on public charity status of grantees. As discussed in the preceding paragraph, a private foundation need not exercise expenditure responsibility with respect to a grant if the grant is made to a public charity described in section 509(a)(1), (2), or (3). If an organization to which a private foundation wishes to make a grant has received a final ruling or determination letter classifying it as an organization described in section 509(a)(1), (2), or (3), the treatment of grants and contributions and the status of grantors and contributors to the organization will generally not be affected by reason of a later revocation by the Service of the organization's classification until the date on which notice of change of status is made to the public (such as by publication in the *Internal Revenue Bulletin*) or another applicable date, if any, specified in the public notice. In appropriate cases, however, the treatment of grants and contributions and the status of grantors and contributors to an organization described in section 509(a)(1), (2), or (3) may be affected pending verification of the continued classification of the organization. Notice to this effect will be made in a public announcement by the Service. In these cases the effect of grants and contributions made after the date of the announcement will depend on the statutory qualification of the organization as an organization described in section 509(a)(1), (2), or (3).

Note. The preceding paragraph shall not apply if the grantor or contributor:

1) Had knowledge of the revocation of the ruling or determination letter classifying the organization as an organization described in section 509(a)(1), (2), or (3), or
2) Was in part responsible for, or was aware of, the act, the failure to act, or the substantial and material change on the part of the organization that gave rise to the revocation.

A grantor or contributor will not be considered responsible for the substantial and material change if:

1) The total support received from such grantor or contributor for a taxable year is 25% or less of the total support received by the donee organization from all sources (excluding support provided by the grantor or contributor or related parties) for the four immediately preceding taxable years, or
2) The grant or contribution qualifies as an unusual grant.

Expenditure responsibility means that the foundation exerts all reasonable efforts and establishes adequate procedures:

1) To see that the grant is spent only for the purpose for which it is made,
2) To obtain full and complete reports from the grantee organization on how the funds are spent, and
3) To make full and detailed reports on the expenditures to the IRS.

Pre-grant inquiry. If expenditure responsibility must be exercised, the foundation should conduct a limited inquiry concerning the potential grantee before the grant is made. The inquiry should deal with matters such as the identity, past history and experience, management, activities, and practices of the grantee organization, and should be complete enough to give reasonable assurance that the grantee will use the grant for the purposes for which it is made.

Terms of grants. To meet the expenditure responsibility requirements, each grant must be made subject to a written commitment signed by an appropriate officer, director, or trustee of the grantee organization. This commitment must include the following agreements by the grantee:

1) To repay any amount not used for the purposes of the grant,
2) To submit full and complete annual reports to the grantor foundation on the manner in which the funds are spent and the progress made in accomplishing the purposes of the grant,
3) To keep records of receipts and expenditures and to make its books and records available to the grantor at reasonable times, and
4) Not to use any of the funds to influence legislation, to influence the outcome of elections, to carry on voter registration drives, to make grants to individuals or other organizations, or to undertake any nonexempt activity, when such use of the funds would be a taxable expenditure if made directly by the foundation.

Terms of program-related investment. To meet the expenditure responsibility requirements in making a program-related investment, a private foundation must require that each investment be made subject to a written commitment signed by an appropriate officer, director, or trustee of the recipient organization.

The commitment should specify the purpose of the investment and should contain an agreement by the organization:

1) To use all amounts received from the private foundation only for the purposes of the investment and to repay any amount not used for those purposes, provided that, for equity investments, the repayment is within the limitations concerning distributions to holders of equity interests,
2) To submit, at least once a year, a full and complete financial report of the type ordinarily required by commercial investors under similar circumstances and a statement that it has complied with the terms of the investment,
3) To keep adequate books and records and to make them available to the private foundation at reasonable times, and
4) Not to use any of the funds to carry on propaganda, influence legislation, influence the outcome of any public elections, carry on voter registration drives, or, when the recipient is a private foundation, to make grants that do not comply with the requirements regarding individual grants or expenditure responsibility.

Certain grants to foreign organizations. Grants made to foreign organizations, other than an organization described in section 509(a)(1), (2), or (3), are subject to the same restrictions on the use of the grant as those imposed on domestic private foundations. These restrictions may be phrased in appropriate terms under foreign law or custom and ordinarily will be considered sufficient if an affidavit or opinion of counsel (of the grantor or grantee) is obtained stating that, under foreign law or custom, the agreement imposes the same restrictions on the use of the grant as those imposed on a domestic private foundation.

Special rules for grants by foreign private foundations. The failure of a foreign private foundation to comply with the restrictions imposed on grants will not constitute an act or failure to act that is a prohibited transaction under section 4948(c) of the Code.

Reports from grantees. The granting private foundation must require reports on the use of the funds, compliance with the terms of the grant, and the progress made by the grantee toward achieving the purposes for which the grant was made. The grantee must make an annual accounting of the funds at the end of its accounting period and must make a final report on all expenditures made from the funds in addition to the progress made toward the goals of the grant.

Reliance on information supplied by grantee. A private foundation, exercising expenditure responsibility with respect to its grants, may rely on adequate records or other sufficient evidence supplied by the grantee organization showing the information that the grantor must submit to the IRS.

Recordkeeping requirements. In addition to the information required when filing a return, the granting foundation must make available to the IRS at its main office each of the following items:

1) A copy of the agreement covering each expenditure responsibility grant made during the year,
2) A copy of each report received during the tax year for each grantee on any expenditure responsibility grant, and
3) A copy of each report made by the grantor's personnel or independent auditors of any audits or other investigations made during the tax year on any expenditure responsibility grant.

Violations of expenditure responsibility requirements. Any diversion of grant funds (including income from an endowment grant) for a use not specified in the grant may result in that part of the grant being treated as a taxable expenditure. If the use of the funds is consistent with the purpose of the grant, the fact that a grantee does not use any funds as indicated in the original budget projection is not a diversion of funds.

If a grantor foundation determines that any part of the grant has been used for improper purposes and the grantee has not previously diverted grant funds, the foundation will not be treated as having made a taxable expenditure if it:

1) Takes all reasonable and appropriate steps either to recover the grant funds or to ensure the restoration of the diverted funds and the dedication of the other grant funds held by the grantee to the purposes of the grant, and

2) Withholds any further payments to the grantee, after being made aware that a diversion of funds may have taken place, until it has received the grantee's assurance that future diversions will not occur and required the grantee to take extraordinary precautions to prevent further diversions from occurring.

If a foundation is considered to have made a taxable expenditure, the amount of the taxable expenditure can be the amount of the diversion plus any further payments, or just the amount of further payments depending on the measure of compliance by the foundation.

Grantee's failure to make reports. A failure to make the required reports by the grantee will result in the grant being treated as a taxable expenditure by the grantor unless the grantor:

1) Awarded the grant according to the expenditure responsibility requirements discussed earlier,
2) Complied with all the reporting requirements,
3) Made a reasonable effort to get the required reports, and
4) Withholds all future payments on this grant and on any other grant to the same grantee until the report is provided.

Violations by the grantor. In addition to the circumstances discussed earlier concerning taxable expenditures, a granting foundation will be treated as making a taxable expenditure if it:

1) Fails to make a pre-grant inquiry,
2) Fails to obtain the required written commitments described earlier, or
3) Fails to make reports to the IRS as discussed earlier.

The reports to the Internal Revenue Service by the foundation on each expenditure responsibility grant must be made each year that any part of the grant remains unexpended by the grantee at any time during the year. The required reports must be submitted with the organization's annual return (Form 990–PF or Form 5227). They must include the following information on each grant:

1) The name and address of the grantee,
2) The date and amount of the grant,
3) The purpose of the grant,
4) The amounts spent by the grantee (based on the most recent report received from the grantee),
5) Whether, to the knowledge of the grantor foundation, the grantee has diverted any funds from the purpose of the grant,
6) The dates of any reports received from the grantee, and
7) The date and results of any verification of the grantee's reports undertaken by or at the direction of the grantor foundation.

Exceptions to taxable expenditures. Examples of expenditures ordinarily not treated as taxable expenditures include:

1) Expenditures to acquire investments that generate income to be used to further the purposes of the organization,
2) Reasonable expenses related to acquiring these investments,
3) Payment of taxes,
4) Expenses that qualify as allowable deductions in figuring the tax on unrelated business income,
5) Any payment that is a qualifying distribution,
6) Any deduction allowed in arriving at taxable net investment income,
7) Reasonable expenditures to evaluate, acquire, modify, and dispose of program-related investments, and
8) Business expenses of the recipient of a program-related investment.

However, payment of unreasonable administrative expenses, including wages, consultant fees, and other fees for services performed, ordinarily will be taxable expenditures unless made by the foundation in the good faith belief that the amounts were reasonable and were consistent with ordinary business care and prudence.

Grants to noncharitable organizations. A private foundation cannot make a grant for a purpose not described in section 170(c)(2)(B). Permitted purposes are religious, charitable, scientific, literary or educational purposes, fostering national or international amateur sports competition (but only if no part of the activities involve providing athletic facilities or equipment), and preventing cruelty to children or animals. Section 501(c)(3) describes organizations that are organized and operated exclusively for these purposes. Grants for nonpermitted purposes are taxable expenditures.

Accordingly, a private foundation may not make a grant to an organization that is not described in section 501(c)(3) unless, making the grant itself is a direct charitable act or a program-related investment, or the grantor is reasonably assured that the grant will be used exclusively for the purposes of an organization described here.

If a private foundation makes a grant that is not a transfer of assets resulting from any liquidation, merger, redemption, recapitalization, organization, reorganization, or other adjustment to any organization (other than an organization described in section 501(c)(3) that is not exclusively organized and operated for testing for public safety), the grantor is reasonably assured that the grant will be used exclusively for section 170(c)(2)(B) purposes (described earlier) only if the grantee organization agrees to keep these funds in a separate fund dedicated to section 170(c)(2)(B) purposes. In addition, the grantor must comply with the expenditure responsibility requirements discussed earlier.

If a private foundation makes a transfer of assets under any liquidation, merger, etc., to any person, the transferred assets will not be considered to be used exclusively for section 170(c)(2)(B) purposes unless the assets are transferred to a fund or organization described in section 501(c)(3) (other than an organization organized and operated for testing for public safety).

Chapter VII

Taxes on Failure to Distribute Income

Generally, section 4942 of the Internal Revenue Code imposes an excise tax on any undistributed income of a private foundation. An additional excise tax will be imposed on any income remaining undistributed at the end of the ***taxable period***.

The income of the foundation must be distributed as ***qualifying distributions***, defined later. Private foundations must make qualifying distributions to the extent of their ***minimum investment return*** for the year. However, a foundation may ***set aside*** funds for periods up to 60 months for certain major projects. ***Excess qualifying distributions*** may be carried forward for a period of 5 tax years immediately following the tax year in which the excess was created. Special transitional rules apply to foundations created before May 27, 1969.

Initial tax. An excise tax of 15% is imposed on the undistributed income of a private foundation that has not been distributed before the first day of the 2nd (or any succeeding) tax year following the year earned, if the first day falls within the ***taxable period.*** A short tax year is considered a tax year.

The initial tax may be abated if the foundation can show that the failure was due to reasonable cause and not to willful neglect, and that the failure to distribute was corrected within the ***correction period*** (described later).

Additional tax. If the initial tax is imposed and the undistributed income has not been distributed by the end of the ***taxable period,*** an additional tax of 100% of the amount remaining undistributed will be imposed. The tax will not be assessed, or if assessed will be abated, if the undistributed income is reduced to zero during the ***correction period***.

Payment of the excise tax is required in addition to, rather than instead of, making required distributions of undistributed income.

Exceptions. The tax does not apply to the undistributed income of a private operating foundation or of an exempt operating foundation.

Certain long-established private foundations that have provided long-term care facilities continuously since May 26, 1969, are treated as private operating foundations and, therefore, are not subject to the excise tax on failure to distribute income.

To qualify for this treatment, the foundation must, on May 26, 1969, and continuously thereafter to the end of the tax year, operate and keep up facilities for the long-term care, comfort, maintenance or education of the permanently and totally disabled, elderly, needy widows, or children as its principal functional purpose. In addition, the foundation must meet the requirements of the ***endowment test*** (defined in Chapter I) that applies to private operating foundations.

An organization will meet the principal function purpose requirement if it is organized for the principal purpose of operating and maintaining these residential facilities and at least 50% of the qualifying distributions normally made by the organization are spent for the operation and upkeep of these facilities.

These foundations are treated as private operating foundations ***only*** for the purposes of the distribution requirements of section 4942 of the Code. All other rules governing nonoperating private foundations, including rules governing deductibility of contributions, apply.

Incorrect valuation of assets. The tax also does not apply to the undistributed income of a private foundation that failed to distribute only because of an incorrect valuation of assets, if:

1) The incorrect valuation was not willful and was due to reasonable cause,
2) The undistributed income is distributed as qualifying distributions during the ***allowable distribution period,***
3) The foundation notifies the Service that the income has been distributed to correct its earlier failure to distribute, and
4) The distribution is treated as a correction of deficient distributions for earlier tax years that would otherwise be subject to this tax.

The foundation must be able to show it has made all reasonable efforts in good faith to value its assets according to applicable rules (see *Valuation of assets,* later).

If a foundation, after full disclosure of the facts, obtains a good faith appraisal of an asset's fair market value by a qualified appraiser (whether or not that appraiser is a disqualified person with respect to the foundation), and the foundation relies on that appraisal, then failure to properly value an asset will ordinarily be regarded as not willful and due to reasonable cause. However, if a foundation does not obtain a good faith appraisal, the lack of such an appraisal will not, by itself, imply that the foundation's failure to properly value an asset was willful and not due to reasonable cause.

Example. In 1986 the Martin Foundation, which was established in 1985, incorrectly valued its assets in a manner that was not willful and was due to reasonable cause. As a result of the incorrect valuation, $20,000, which should have

been distributed by the end of 1987, is still undistributed as of January 1, 1988. On September 29, 1988, a notice of tax deficiency is mailed to the foundation.

On November 5, 1988, (within the allowable distribution period) the foundation makes a qualifying distribution of $20,000 which is treated as made out of the foundation's undistributed income for 1986. The foundation notifies the Service of its action. Under these circumstances the foundation would have been liable for an initial tax of $3,000 (15% of $20,000). However, because the foundation meets the exception for failure to distribute because of an incorrect valuation of assets, it is not liable for the taxes.

Taxable period. The taxable period begins on the first day of the tax year and ends on the earlier of either:

1) The date a notice of deficiency for the ***initial tax*** is mailed, or
2) The date the ***initial tax*** is assessed.

The allowable distribution period begins on the first day of the first tax year following the tax year in which an incorrect valuation of foundation assets occured. The period ends 90 days after a notice of deficiency for the ***initial tax*** is mailed. This period is extended by any period in which the deficiency cannot be assessed, and any other period which the IRS determines is reasonable and necessary to permit a distribution of undistributed income as required under section 4942. Where a notice of deficiency is not mailed because there is a waiver of restrictions on assessment and collection of a deficiency, or because the deficiency is paid, the filing date of the waiver or the date of payment, is treated as the end of the allowable distribution period.

The correction period begins with the first day of the tax year in which there was a failure to distribute income and ends 90 days after a notice of deficiency for the ***additional tax*** is mailed.

The correction period is extended by any period during which a deficiency cannot be assessed. In addition, this period may be extended by any period that the IRS determines is reasonable and necessary to make distributions of undistributed income as required to comply with section 4942.

Example 1. In 1985 the Jones Foundation, a private foundation that uses the calendar year as its tax year, made an error in asset valuation that was not willful and was due to reasonable cause. The error caused the Jones Foundation not to distribute $25,000 that should have been distributed for 1985. On March 2, 1988, a notice of deficiency for the ***initial*** and ***additional*** tax was mailed to the Jones Foundation. For the undistributed 1985 income, the taxable period runs from January 1, 1985, through March 2, 1988, and the allowable distribution period runs from January 1, 1986, through May 31, 1988 (90 days after the notice of deficiency was mailed). If the Service determines that it is reasonable and necessary to extend the distribution period through June 15, 1988, the allowable distribution period runs from January 1, 1986, through June 15, 1988.

Example 2. Assume the facts given in Example 1 except that the failure to distribute was not due to an incorrect valuation of assets. On April 1, 1988, a notice of deficiency for the ***initial*** and ***additional*** tax was mailed to the foundation. If the Jones Foundation has not filed a petition with the Tax Court for a redetermination of the deficiency, the correction period runs from January 1, 1985, through June 30, 1988, unless the Service determines it is reasonable and necessary to extend the correction period to permit the Jones Foundation to distribute the 1985 undistributed income.

Undistributed income means the amount by which the distributable amount for any tax year exceeds the qualifying distributions made out of the distributable amount before the end of the following tax year.

Distributable amount is equal to the minimum investment return of a private foundation reduced by the sum of any income taxes and the tax on investment income, and increased by

1) Amounts received or accrued as repayments of amounts taken into account as qualifying distributions for any tax year,
2) Amounts received or accrued from the sale or other disposition of property to the extent that the acquisition of the property was considered a qualifying distribution for any tax year, and
3) Any amount set aside for a specific project (see *Set-asides,* later) to the extent the amount set aside was not necessary for the purposes for which it was set aside.

If a private foundation has income from distributions from a split-interest trust (defined in Chapter I) attributable to the income portion of amounts placed in trust after May 26, 1969, this income is included in the distributable amount.

If a split-interest trust distributes income from amounts placed in trust both on or before and after May 26, 1969, these distributions must be allocated between those amounts placed in trust during these periods to determine the extent to which the distributions are included in the foundation's distributable amount.

The income portion of a distribution from a split-interest trust to a private foundation is the greater of:

1) The amount of the distribution that is treated as trust income (under the governing instrument and local law that applies), or
2) The guaranteed annuity, or fixed percentage of the fair market value of the trust property as determined annually, that the private foundation is entitled to receive for a particular tax year, regardless of when the amount is actually received.

Limits. A private foundation does not have to distribute an amount greater than required for any tax year (without regard to the rules discussed earlier) if for that year the entire corpus of the split-interest trust making distributions to the foundation had been taken into account by the foundation as an asset used in figuring minimum investment return.

Minimum investment return. The minimum investment return for any private foundation is 5% of the excess of the combined fair market value of all assets of the foundation, other than those used or held for use for exempt purposes, over the amount of indebtedness incurred to buy these assets.

The combined fair market value of all foundation assets includes:

1) The average of the fair market values on a monthly basis of securities for which market quotations are readily available,
2) The average of the foundation's monthly cash balances (minus cash balances excluded as cash held for charitable and related activities), and
3) The fair market value of all other assets (except assets excluded from the computation of minimum investment return or assets used for exempt purposes) for the period of time during the tax year those assets are held by the foundation. For the determination of the fair market value of the asset, see *Valuation of assets,* later in this chapter.

Certain assets are not included in determining minimum investment return. These include:

1) Any ***future interest*** (such as a vested or contingent remainder, whether legal or equitable) of a foundation in the principal or income of any real or personal property (other than a future interest created by the foundation after 1969) until all intervening interests in, and rights to the actual possession or enjoyment of, that property have expired, or until the future interest has been constructively received by the foundation even though the future interest has not been actually reduced to possession by the foundation. Examples of a constructively received future interest are a future interest that has been credited to the foundation's account, set apart for the foundation, or otherwise made available so that the foundation may acquire it at any time, or could have acquired the interest had the foundation given notice of its intention to acquire,
2) The ***assets of an estate*** until those assets are distributed to the foundation or, due to a prolonged period of administration, the estate is considered terminated for federal income tax purposes,
3) Any ***present foundation interest*** in any trust created and funded by another person,
4) Any ***pledge of money or property*** to the foundation, whether or not the pledge is legally enforceable, and
5) Any ***assets used (or held for use) for exempt purposes.***

Assets used for exempt purposes. An asset is used (or held for use) for exempt purposes only if it is actually used by the foundation in carrying on the charitable, educational, or similar function that gives rise to its exempt status, or if the foundation owns the asset and establishes to the satisfaction of the Service that its immediate use in exempt functions is not practical and that definite plans exist to begin the use within a reasonable period of time.

Assets held for the production of income or for investment (for example, stocks, bonds, interest-bearing notes, endowment funds, or generally, leased real estate) are not considered used or held for use for exempt purposes even though the income from those assets is used to carry out an exempt purpose. Whether an asset is held for the production of income or for investment rather than used or held for use directly by the foundation for exempt purposes is a factual question. For example, an office building used to provide offices for employees engaged in managing endowment funds for the foundation is not considered an asset used for exempt purposes.

However, where property is used both for exempt and nonexempt purposes, the property will be considered as being used entirely for exempt purposes if at least 95% of its total use is for exempt purposes. But, if less than 95% of its total use is for exempt purposes, a reasonable allocation must be made between exempt and nonexempt use. Property acquired by the foundation to be used for an exempt purpose will be considered an asset used for exempt purposes even though all or part of the property is leased for a limited and reasonable time (generally no more than one year) while arrangements are made to convert it to use for exempt purposes.

Where the income-producing use continues beyond a reasonable time, the property will not be considered an asset used for exempt purposes. Instead, at the time the income-producing use becomes unreasonable, the property will be considered disposed of to the extent the acquisition was taken into account as a qualifying distribution. If the property is later used by the foundation for exempt purposes, a qualifying distribution in an amount equal to its fair market value at that time will be considered to have been made at the time the exempt use begins.

Assets used for exempt purposes include:

1) Administrative assets, such as office equipment and supplies, used by foundation employees and consultants to the extent these assets are devoted to and used directly in the administration of exempt activities,
2) Real estate or the part of a building used by the foundation directly in its exempt activities,
3) Physical facilities used in exempt activities such as paintings or other works of art owned by the foundation on public display, classroom

fixtures and equipment, and research facilities and related equipment which, under the facts and circumstances, serve a useful purpose in the conduct of the exempt activities,

4) Any interest in a functionally related business (see Chapter X), or in a program-related investment (see Chapter IX),

5) The reasonable cash balances necessary to cover current administrative expenses and other normal and current disbursements directly connected with the foundation's charitable, educational, or other similar exempt activities, and

6) Any property leased by a foundation in carrying out its exempt purpose at no cost, or at a nominal rent, to the lessee or for a program-related purpose such as the leasing of renovated apartments to low-income tenants at a low rental as part of the lessor-foundation's program for rehabilitating a blighted area of a community.

Reasonable cash balance. The reasonable cash balances that a private foundation needs to have on hand to cover current administrative expenses and other normal and current distributions for exempt purposes generally will be considered to be an amount figured on an annual basis equal to 1½% of the combined fair market value of all foundation assets used in figuring minimum investment return (reduced by any acquisition indebtedness for those assets but without reduction for the reasonable cash balance). A foundation may exclude 1½% under this rule even if it is more than the average cash balance of the foundation. However, if an additional amount is necessary to pay expenses and make disbursements, that amount does not have to be included in figuring minimum investment return. All remaining cash balances will be included in the computation.

If an amount in excess of the 1½% figure is claimed for any year, a statement must be attached to Form 990–PF for that year explaining the reasons for the larger amount.

Valuation of assets. When figuring the minimum investment return, a foundation may use any reasonable method to determine the fair market value on a monthly basis of securities including, but not limited to, common and preferred stock, bonds, and mutual fund shares, for which market quotations are readily available as long as that method is consistently used. Market quotations are considered readily available if a security is:

1) Listed on the New York or American stock exchanges or any city or regional exchange for which quotations appear on a daily basis, including foreign securities listed on a recognized foreign, national, or regional exchange,

2) Regularly traded in the national or regional over-the-counter market for which published quotations are available, or

3) Locally traded, for which quotations can readily be obtained from established brokerage firms.

For securities held in trust for, or on behalf of, a foundation by a bank or other financial institution that values those securities periodically using a computer, a foundation may determine the correct value of the securities by use of this computer pricing system if the system is acceptable to the IRS for federal estate tax purposes.

Example 1. The Young Foundation, a private foundation, owns 1,000 shares of Smith Corporation stock, which is regularly traded on the New York Stock Exchange. The Young Foundation may follow a consistent practice of valuing Smith Corporation stock on the last trading day of each month based on its closing price for that day.

Example 2. The Young Foundation, a private foundation, owns 1,000 shares of an unlisted corporation, which is locally traded. Quotations on unlisted stock can be readily obtained from established brokers. The Young Foundation may consistently value its unlisted stock as of the 15th day of each month by getting a bona fide quote of the bid and asked prices from an established brokerage firm and by taking the mean of those prices on that day. If a quotation is not available on the regular valuation dates, the Young Foundation may value its unlisted stock based on a bona fide quote obtained on the first day after the regular valuation date that the quotation is available.

Reductions in value for blockage or similar factors. In determining the value of securities, the private foundation may establish that as a result of (1) the size of the block of securities, (2) the fact that the securities are in a closely held corporation, or (3) the fact that the sale of the securities would result in a forced or distress sale, the price at which the securities could be sold outside the usual market may be a more accurate indication of value than market quotations. In such a case, any reduction in value for all of these reasons together may not be more than 10% of the fair market value of the securities to which the discount applies.

Unlisted securities effectively controlled by foundation and disqualified persons. If the foundation owns voting stock of an issuer of unlisted securities and has, or together with disqualified persons or another private foundation has, effective control of the issuer, then, to the extent that the issuer's assets consist of shares of listed securities issues, the assets shall be valued monthly on the basis of market quotations.

Cash. For purposes of the minimum investment return, a foundation figures its cash balances on a monthly basis by averaging the amount of cash on hand on the first and last days of each month.

Common trust funds. If a private foundation owns a participating interest in a common trust fund established and administered under a plan providing for the periodic valuation of participating interests during the fund's tax year and reporting these valuations to participants, the value of the foundation's interest in the common trust fund based on the average of the valuations reported to the foundation during its tax year will ordinarily be an acceptable method of valuation for purposes of the minimum investment return.

Other assets. The fair market value of assets other than those described earlier is determined annually except as described later. The valuation may be made by private foundation employees or by any other person, whether or not that person is a disqualified person. Such a valuation, if accepted by the IRS, is valid only for the tax year for which it is made. A new valuation is required for the following tax year. However, the fair market value of any interest in realty, including any improvements thereon, may be determined on a 5–year basis by a written, certified, independent appraisal by a qualified person who is neither a disqualified person (see Chapter V) nor an employee of the private foundation.

The appraisal must contain a statement to the effect that, in the appraiser's opinion, the appraised assets were valued in accordance with valuation principles regularly employed in making appraisals of such property using all reasonable valuation methods. The foundation must keep a copy of the independent appraisal for its records. If a valuation is reasonable, the foundation may use it for the tax year for which the valuation is made and for each of the 4 following tax years.

Any valuation of real property by a certified, independent appraisal may be replaced during the 5–year period by a later 5–year valuation by a certified, independent appraisal or by an annual valuation. The most recent valuation will be used in figuring the foundation's minimum investment return.

The valuation must be made no later than the last day of the first tax year for which the new valuation applies.

A valuation, if properly made according to the rules discussed here, will not be disturbed by the IRS during the 5–year period for which it applies, even if the actual fair market value of the property changes during that period.

Commonly accepted valuation methods must be used in making the appraisal. A valuation based on acceptable methods of valuing property for federal estate tax purposes is acceptable. An appraisal is a determination of fair market value and should not be construed in a technical sense to be peculiar to particular property or interests therein as, for example, mineral interests in real property.

Valuation date. If an asset is required to be valued annually, the asset may be valued as of any day in the private foundation's tax year if the foundation follows a consistent practice of valuing the asset as of that date in all tax years. A valuation of real estate determined on a 5–year basis by a certified, independent appraisal may be made as of any day in the first tax year of the private foundation to which the valuation is to be applied.

Assets held for less than a tax year. If an asset is held for less than one tax year, the value of that asset is found by multiplying the fair market value of the asset by a fraction. The numerator of the fraction is the number of days in the tax year that the foundation held the asset, and the denominator is the total number of days in the tax year.

Qualifying distributions. A qualifying distribution is:

1) Any amount (including program-related investments and reasonable and necessary grant administrative expenses, subject to the limit discussed later) paid to accomplish religious, charitable, scientific, literary, or other public purposes. Qualifying distributions ***do not include*** contributions to organizations controlled by the contributing foundation or by one or more disqualified persons with respect to the foundation (see Chapter V) or to private nonoperating foundations (with exceptions for certain contributions to exempt organizations, discussed later).

2) Any amount paid to buy an asset used (or held for use) directly to carry out a charitable or other public purpose. Depreciation on these assets, however, is not considered a qualifying distribution.

3) Any qualifying amount set aside (discussed later).

In general, a distribution to a public charity described in section 509(a)(1), (2), or (3) to accomplish a religious, charitable, scientific, literary, educational, or other permitted public purpose is a qualifying distribution. See Chapter VI, under the heading *Grants to Organizations,* for rules on when a private foundation may rely on the public charity status of a grantee.

The amount of a qualifying distribution of property is the fair market value of the property on the date it is made. The amount of a qualifying distribution is determined only under the cash receipts and disbursements method.

A private foundation that bought an asset and claimed a qualifying distribution under item (2) will be allowed a second qualifying distribution for the same asset if the asset is later given to a publicly supported charitable organization that is not controlled by the foundation, and it is donated for a purpose described in item (1).

The amount of the second qualifying distribution will be the difference between the fair market value of the asset on the date of the contribution and the amount of the first qualifying distribution.

Limit on administrative expenses. For tax years beginning after 1984 and before 1991, the beginning amount of grant administrative expenses that may be included in any tax year as a qualifying distribution is limited to the excess of:

1) 0.65% of the sum of the foundation's net assets for the tax year and the immediately preceding 2 tax years, over
2) The total amount of grant administrative expenses paid during the 2 preceding tax years that were included as qualifying distributions. However, the amount of grant administrative expenses taken into account for any preceding tax year that began before 1985 is limited to 0.65% of the foundation's net assets for that year.

For this purpose, "grant administrative expenses" are any administrative expenses allocable to the making of contributions, gifts, or grants that are qualifying distributions. "Net assets" are the combined fair market values of all the foundation's assets other than those used or held for use in carrying out exempt purposes, minus the amount of indebtedness incurred to buy these assets.

Borrowed funds. If a private foundation borrows money during a tax year to make a charitable expenditure, then a qualifying distribution is considered made only at the time the borrowed funds are actually distributed for a charitable purpose.

Control. An organization is controlled by a foundation or by one or more disqualified persons if any of these persons may, by combining their votes or positions of authority, require the organization to make an expenditure or prevent the organization from making an expenditure, regardless of the method by which control is exercised or exercisable. Control of a donee organization is determined without regard to any conditions imposed on the donee as part of the distribution or any other restrictions as to how the distribution may be used unless the conditions and restrictions are imposed on a distribution of net assets to terminate private foundation status (as discussed in Chapter III).

In general, it is the donee, not the distribution, that must be controlled by the distributing private foundation to disqualify an otherwise qualifying distribution. If a foundation provides support to an organization and imposes budgetary procedures on that organization, this will not, of itself, constitute control of the donee. Budgetary procedures include expenditure responsibility to require reports from the donee organization on:

1) The use of the funds,
2) Compliance with the terms of the grant, and
3) The progress made by the donee toward achieving the purposes for which the grant was made.

The controlled organization does not have to be a private foundation. It may be any kind of exempt or nonexempt organization including a school, hospital, operating foundation, or social welfare organization.

Changes in asset use. If an asset not used or held for use for public or charitable, educational, etc. purposes is later converted to exempt use, the foundation may treat the conversion as a qualifying distribution. The amount of the qualifying distribution is the fair market value of the converted assets on the conversion date. For determining fair market value of the assets, see *Valuation of Assets,* discussed earlier.

The date a foundation adopts and immediately begins to implement a plan to convert property from nonexempt to exempt uses is the conversion date even if the actual conversion occurs later.

Payment of any Chapter 42 excise tax imposed on the foundation is not considered a qualifying distribution.

Set-asides. An amount set aside for a specific project may be treated as a qualifying distribution in the year set aside (but not in the year actually paid) if at the time of the set-aside the foundation establishes to the satisfaction of the Service that:

1) The amount will actually be paid for the specific project within 60 months from the date of the first set-aside, ***and***
2) The set-aside satisfies the ***suitability test,*** that is, that the project is one that can be better accomplished by a set-aside than by immediate payment, ***or*** the foundation satisfies the ***cash distribution test*** (discussed later).

Suitability test. To satisfy the suitability test, the foundation must show that the specific project for which the amount is set aside is one that can be better accomplished by the set-aside than by the immediate payment of funds. Such a specific project includes, but is not limited to, situations where relatively long-term grants or expenditures must be made to assure the continuity of particular charitable projects or program-related investments, or where grants are made as part of a matching-grant program. An example of a specific project is a plan to build an art museum even though the exact location and architectural plans have not been finalized. For good cause shown, the period for paying the amount set aside may be extended by the Service.

To qualify under the suitability test, a set-aside must be approved by the IRS, as explained later.

Cash distribution test. The foundation satisfies the cash distribution test if:

1) The specific project for which the amount is set aside will not be completed before the end of the tax year in which the set-aside is made,
2) The foundation actually distributes for exempt purposes, in cash or its equivalent, the ***start-up period minimum amount*** during the foundation's start-up period, and
3) The foundation actually distributes the ***full-payment period minimum amount*** in each tax year of the foundation's full-payment period.

Start-up period minimum amount. Generally, the start-up period consists of the 4 tax years following the tax year in which the foundation was created (or otherwise became a private foundation). For this purpose, a foundation is considered created in the tax year in which its distributable amount first exceeds $500. The start-up period minimum amount, the amount that a private foundation must actually distribute during its start-up period, is not less than the sum of:

1) 20% of its distributable amount (as defined earlier) for the first tax year of the start-up period,
2) 40% of its distributable amount for the second year of the start-up period,
3) 60% of its distributable amount for the third year of the start-up period, and
4) 80% of its distributable amount for the fourth year of the start-up period.

The ***sum*** of these amounts must be distributed before the end of the start-up period. There is no requirement that any part be distributed in any particular tax year of the start-up period.

In general, only a distribution actually made during the start-up period is taken into account in determining whether the foundation has distributed the start-up period minimum amount. However, a distribution actually made during the tax year in which the foundation was created (the year immediately preceding the foundation's start-up period) may be treated as made during the start-up period. Also, a distribution actually made within 5½ months after the end of the start-up period will be treated as made during the start-up period if (a) the foundation was unable to determine its distributable amount for the fourth tax year of the start-up period until after the end of the period, and (b) the foundation actually made distributions before the end of the start-up period based on a reasonable estimate of its distributable amount for that fourth tax year.

Full payment period minimum amount. The foundation's full-payment period includes each tax year that begins after the end of the start-up period. The full payment period minimum amount, the amount that the foundation must actually distribute in cash or its equivalent in each tax year of the full-payment period, and must be not less than 100% of its distributable amount, described earlier, for that year, without regard to the *Carryover of excess qualifying distributions,* discussed later.

However, if the foundation distributes in a tax year an amount in excess of the full-payment period minimum amount for that year, the excess reduces the full-payment period minimum amount for the 5 tax years immediately following the tax year in which the excess distribution is made. The excess is applied to reduce the full-payment period minimum amount in each successive tax year of the 5-year period, in order, until completely used up.

Failure to distribute minimum amounts. If the foundation fails to actually distribute the start-up period minimum amount during the start-up period or, generally, if it fails to distribute the full-payment period minimum amount during a tax year of the full-payment period, then any set-aside made by the foundation during the appropriate period will not be treated as a qualifying distribution unless it was approved by the IRS under the ***suitability test.*** Also, any set-aside made after the year of such a failure to distribute a minimum amount will be treated as a qualifying distribution only if the Service approves it under the suitability test.

However, if the foundation's failure to distribute the full-payment period minimum amount during a tax year of the full-payment period is not willful and is due to reasonable cause, the foundation may correct the failure. To do so, it must distribute within the correction period (discussed earlier) cash or its equivalent in an amount not less than the difference between the full-payment period minimum amount for the tax year and the amount actually distributed during that year. The additional distribution is treated as though it had been made in the year in which it originally should have been made, for purposes of meeting the cash distribution test. If a foundation fails to distribute the full-payment period minimum amount during the appropriate tax year because the amount can be determined only after the end of that tax year, no "willful failure to distribute" will occur if the foundation makes an additional distribution within 5½ months after the end of the tax year.

Contingent set-aside. If a private foundation is involved in litigation and may not distribute assets or income because of a court order, it may seek and obtain a set-aside for the purpose of making a qualifying distribution. The amount that may be set aside is equal to the part of the foundation's distributable amount that is attributable to the assets or income held under the court order that would otherwise have been distributed.

If the litigation lasts more than one tax year, the foundation may seek additional contingent set-asides. The amounts must actually be distributed by the last day of the tax year following the tax year in which the proceedings end. Amounts the foundation does not distribute by the end of that year will be considered gross income to the foundation for the following tax year.

Approval of a set-aside must be obtained from the IRS for the set-aside to qualify under the ***suitability test.*** No advance approval is required for qualification under the cash distribution test. A foundation must apply for Service approval by the end of the tax year in which the amount is to be set aside. If the foundation fails to seek approval before that date, an otherwise proper set-aside will not be treated as a qualifying distribution.

To obtain approval for a set-aside under the suitability test, a foundation must write to the Internal Revenue Service, 1111 Constitution Avenue,

N.W., Washington, DC 20224, Attention: E:EO, and include:

1) A statement describing the nature and purposes of the specific project and the amount of the set-aside for which approval is requested,
2) A statement describing the amounts and approximate dates of any planned additions to the set-aside after its initial establishment,
3) A statement of the reasons why the project can be better accomplished by the set-aside than by immediate payment,
4) A detailed description of the project, including estimated costs, sources of any future funds expected to be used for completion of the project, and the location or locations (general or specific) of any physical facilities to be acquired or constructed as part of the project, and
5) A statement by an appropriate foundation manager that the amounts set aside will actually be paid for the specific project within a specified period of time ending not more than 60 months after the date of the first set-aside; or a statement showing good cause why the period for paying the amount set aside should be extended (including a showing that the proposed project could not be divided into two or more projects covering periods of no more than 60 months each), and giving the extension of time requested.

Statement required for cash distribution test. Although Service approval is not required for set asides qualifying under the ***cash distribution test,*** the foundation must attach to its annual return for any tax year in which amounts are set aside, the following:

1) A statement describing the nature and purposes of the specific project for which amounts are set aside,
2) A statement that the amounts set aside will actually be paid for the specific project within a specified period that ends no more than 60 months after the date of the set-aside,
3) A statement that the project will not be completed before the end of the tax year in which the set-aside is made,
4) A statement showing the distributable amounts for any past tax years in the foundation's start-up and full-payment periods, and
5) A statement showing the total amount of actual payments in cash or its equivalent for exempt purposes during each tax year in the foundation's start-up and full-payment periods. This statement should include a detailed description of any corrective or other payments that are treated, according to the rules discussed earlier, as distributed during a tax year prior to the tax year in which actually made, and should explain the circumstances that justify the application of those rules.

The foundation must also attach to its annual return for each of the 5 tax years following the tax year in which the amount is set aside (and for each tax year in any extended period for paying the amount set aside) the statements described in (4) and (5) above.

Evidence of set-aside. A set-aside approved by the Service or that meets the cash distribution test should be shown by entering a dollar amount on the books of the foundation as a pledge or obligation to be paid at a future date or dates. Any amount set aside will be taken into account in figuring the foundation's minimum investment return and any income from the set-aside should be taken into account in figuring the adjusted net income of private operating foundations. The amount set aside need not reflect an accumulation of income, but may be a bookkeeping entry that will require funding out of corpus by the end of the set-aside period.

Certain contributions to exempt organizations. A "qualifying distribution" includes a contribution to a private nonoperating foundation or to an organization formed for certain religious, charitable, scientific, educational, or other exempt purposes that is controlled (see *Control,* earlier) by the contributing foundation or by one or more disqualified persons or to a private nonoperating foundation if:

1) Not later than one year after the end of the tax year in which the donee organization received the contribution, it makes a distribution equal to the full amount of the contribution and the distribution is a qualifying distribution that is treated as being made out of corpus (or would be treated as such if the donee organization were a private nonoperating foundation), and
2) The private foundation making the contribution obtains adequate records or enough other evidence from the donee organization showing that the donee organization has made a qualifying distribution. The evidence must also show the names and addresses of the recipients of the qualifying distributions, the amount received by each, and that the distribution is treated as being made out of corpus (or would be so treated if the donee organization were a private nonoperating foundation).

When a distribution is for an administrative expense that is for public charitable purposes or is part of another public charitable expenditure that cannot reasonably be separately accounted for, the record-keeping requirements of item (2), are satisfied if the donee organization submits a statement giving the general purpose for which it is making the expenditure and stating that the amount was distributed as a qualifying distribution.

If both requirements are not met, no part of the contribution will be treated as a qualifying distribution. To meet the distribution requirements, the donee organization must, by the close of the first tax year after the tax year in which the contribution is received, distribute an amount equal in value to the contribution, and it must have no remaining undistributed income for the year in which the contribution was received.

If a donee organization redistributes less than an amount equal to the total contributions from donor organizations that are required to be redistributed by the end of the first tax year after the tax year in which they were received, amounts treated as redistributions will be considered as made pro rata from all contributions received in the prior tax year that are required to be redistributed by the donee organization regardless of any earmarking or identification of the source made by the donee. The amounts considered as not to have been redistributed will be included pro rata in the gross income of each donor foundation in the foundation's first tax year beginning after the close of the donee organization's tax year in which the amount should have been distributed.

The characterization of qualifying distributions made during the tax year (that is, whether out of the prior or current year's undistributed income, or corpus) is made as of the close of the tax year in question, except when the donee organization chooses to treat all or part of the distribution as made out of a distribution from corpus made in a designated prior tax year (see *Treatment of qualifying distributions,* discussed later). Once it is determined that a qualifying distribution is from corpus, that distribution will first be charged to distributions that are required to be redistributed as described earlier.

All amounts contributed to a specific charitable, educational, religious, etc. exempt organization in any one tax year of that organization will be treated as a single contribution by the contributing private foundation.

If the requirements for establishing the contribution as a qualifying distribution to certain exempt organizations are not completely satisfied, then only that part of the contribution that was redistributed will be treated as a qualifying distribution.

To satisfy distribution requirements, a donee organization may choose to treat as a qualifying distribution from corpus for the current year any amount distributed in a prior tax year that was treated as a distribution out of corpus if:

1) That amount has not been used for any other purpose (such as a carryover of excess qualifying distributions, or a prior year redistribution),
2) The corpus distribution occurred within the preceding 5 years, and
3) The amount distributed is not later used for another purpose.

The choice must be made by attaching a statement to the Form 990–PF filed for the tax year for which the choice is to apply. The statement must contain a declaration by the appropriate foundation manager that the foundation is making a choice under these provisions, and must specify that the distribution is to be treated as having been made out of a distribution from corpus in a designated prior tax year or years.

Example. In 1987, the Miller Foundation, a private foundation, made a contribution out of 1986 income to the James Foundation, a private nonoperating foundation. The contribution was the only one received by the James Foundation in 1987. In 1988 the James Foundation made a qualifying distribution to an art museum maintained by an operating foundation in an amount equal to the contribution received from the Miller Foundation. The James Foundation also distributed all of its undistributed 1987 and 1988 income for other charitable, educational, religious, etc. purposes. The distribution to the art museum is treated as made out of corpus.

The Miller Foundation's contribution to the James Foundation is a qualifying distribution out of the Miller Foundation's 1986 income. This is a qualifying distribution if it obtains adequate records or enough other evidence from the James Foundation showing the nature and amount of the distribution, the recipient's identity, and the fact that the distribution is treated as made out of corpus. If the James Foundation's qualifying distributions during 1988 had been equal only to the contribution received from the Miller Foundation and its 1988 undistributed income, the James Foundation could have chosen to treat the amount distributed in excess of its 1987 undistributed income as a qualifying distribution made out of corpus (see *Special choice,* later) and thus satisfy the qualifying distribution requirements.

Limit. A contribution by a private foundation to a recipient organization, which the recipient uses to make payments to a secondary recipient, is not a contribution by the private foundation to the secondary recipient if the foundation does not earmark the use of the contribution for any named secondary recipient, and does not keep the power to control the selection of the secondary recipient by the organization to which the foundation has contributed.

Treatment of qualifying distributions. Any qualifying distribution made during the tax year will be treated as being made:

1) First, out of undistributed income of the immediately preceding tax year (if the private foundation was subject to the initial excise tax for the prior tax year) to the extent thereof,
2) Second, out of undistributed income for the current tax year to the extent thereof, and
3) Then, out of corpus.

Distributions are taken into account in the order of time in which made.

Special choice. If any qualifying distribution is not treated as being made out of undistributed income of the immediately preceding tax year, the

foundation may choose to treat any part of the distribution as made out of the undistributed income of a designated prior tax year or out of corpus.

This choice is made by filing a statement with the IRS during the tax year in which the qualifying distribution is made or by attaching a statement to the foundation's annual return, for the tax year in which it made the qualifying distribution. The statement must contain a declaration by an appropriate foundation manager that the foundation is making the choice, under Regulations section 53.4942(a)–3(d)(2) and must specify whether the distribution is made out of undistributed income for a designated prior tax year (or years) or is made out of corpus.

When the choice is made during the tax year in which the qualifying distribution is made, the choice may be revoked in whole or in part by filing a statement with the Service during the same tax year or by attaching a statement to the foundation's annual return filed for the tax year during which the qualifying distribution was made. The revocation statement must contain a declaration by the appropriate foundation manager that the foundation is revoking the choice described above in whole or in part, and must specify the choice or part thereof being revoked.

Example. The Oak Foundation, a private foundation, has undistributed income of $300 for 1986 and $200 for 1987. On January 14, 1988, the Oak Foundation made its first qualifying distribution in 1988 when it set aside $700 for hospital construction.

On February 22, 1988, a notice of deficiency for the initial and additional excise tax on failure to distribute income with regard to the 1986 undistributed income was mailed to the Oak Foundation. The Oak Foundation notified the Service in writing on March 20, 1988, that it was making a choice to apply the January 14, 1988, distribution (to the extent that it exceeded 1987 undistributed income) against the 1986 undistributed income. The Oak Foundation is liable for an initial excise tax of $45 (15% of $300).

Because the Oak Foundation made the choice described, the $300 of undistributed income for 1986 is treated as distributed during the correction period, and no additional excise tax is imposed. Under these circumstances the $700 distribution is treated as made first out of the undistributed income of 1987 ($200), then out of the remaining undistributed income of 1986 ($300). The $200 remaining may be applied against the distributable amount for 1988 or may be treated as a distribution out of corpus.

Carryover of excess qualifying distributions. For any tax year during which the organization is a private nonoperating foundation, any excess qualifying distributions (described later) may be used to reduce distributable amounts in any tax year of the adjustment period.

If a private foundation that had a carryover of excess qualifying distributions makes a section 507(b)(2) transfer of all its assets to an effectively controlled foundation (defined in Chapter III), the transferee foundation may reduce its distributable amount by the carryover.

The distributable amount for a tax year in an adjustment period will be reduced by the lesser of:

1) The excess of qualifying distributions made in prior tax years to which the adjustment period applies, or
2) The remaining undistributed income at the close of the tax year after applying any qualifying distributions made in that year to the distributable amount for the year.

Example. Maple Foundation, a private nonoperating foundation, has distributable amounts for 1983, 1984, and 1985 of $100 each. It made a qualifying distribution in 1984 of $250 and in 1985 of $70. The qualifying distribution made in 1984 will be treated as $100 made out of the undistributed income for 1983, then as $100 made out of undistributed income of 1984, and finally as $50 out of corpus in 1984. Since the total qualifying distributions with respect to 1984 ($150) exceed the distributable amount for 1984 ($100), a $50 excess of qualifying distributions exists which the Maple Foundation may use to reduce its distributable amounts for the years 1985 through 1989 (the tax years in the adjustment period with respect to the 1984 excess).

Therefore, the $100 distributable amount for 1985 is reduced by $30 (the lesser of the 1984 excess ($50) and the remaining undistributed income at the close of 1985 ($30), after the qualifying distributions of $70 for 1985 were applied to the original distributable amount for 1985 of $100). Maple Foundation then has a $20 excess of qualifying distributions to use for tax years in the adjustment period. If during any tax year of the adjustment period another excess of qualifying distributions is created, that excess will not be taken into account until the earlier excess has been completely applied against distributable amounts during its adjustment period.

An excess qualifying distribution is the amount by which the total qualifying distributions treated as made out of undistributed income for any tax year beginning after 1969, or as made out of corpus for the tax year (other than distributions by donee organizations described in *Certain contributions to exempt organizations*, earlier, or the amount applied to a prior tax year by the choices with respect to qualifying distributions) exceed the distributable amount for that tax year.

The adjustment period is the 5 tax years immediately following the tax year in which the excess of qualifying distributions is created. Thus, an excess qualifying distribution for any one tax year may not be carried over for more than 5 tax years. However, if during any tax year of the adjustment period, the organization ceases to be subject to the initial tax (such as by becoming a private operating foundation), any portion of the excess qualifying distributions, that, before that tax year, has not been applied against distributable amounts may not be carried over to that tax year or later tax years in the adjustment period. This rule applies even though during any of those tax years the organization again becomes subject to the initial tax.

Chapter VIII

Taxes on Self-Dealing

Section 4941 of the Internal Revenue Code imposes an excise tax on certain transactions (acts of self-dealing) between a private foundation and disqualified persons.

Initial tax. An excise tax of 5% of the amount involved (described later) in the act of self-dealing is imposed on the disqualified person, other than a foundation manager acting only as a manager, for each year or part of a year in the taxable period (discussed later).

An excise tax of 2½% of the amount involved is imposed on a foundation manager who knowingly participates in an act of self-dealing, unless participation is not willful and is due to reasonable cause, for each year or part of a year in the taxable period.

Additional tax. An excise tax of 200% of the amount involved is imposed on the disqualified person, other than a foundation manager acting only as a manager, who participated in the act of self-dealing, if the act of self-dealing is not corrected within the taxable period. The additional tax will not be assessed, or if assessed will be abated, if the act of self-dealing is corrected during the correction period (described later).

If the additional tax described above is imposed on the disqualified person, an excise tax of 50% of the amount involved is imposed on any foundation manager who refuses to agree to part or all of the correction of the self-dealing act.

Limits on liability for management. The maximum initial tax imposed on the foundation manager is $10,000 and the maximum additional tax is $10,000 for any one act.

There is no maximum on the liability of the self-dealer, including one who is a foundation manager.

If more than one person is liable for the initial and additional taxes imposed for any act of self-dealing, all parties will be jointly and severally liable for those taxes.

Acts of self-dealing. The following transactions are generally considered acts of self-dealing between a private foundation and a disqualified person:

1) Sale, exchange, or leasing of property,
2) Lending money or other extensions of credit,
3) Providing goods, services, or facilities,
4) Paying compensation or reimbursing expenses to a disqualified person,
5) Transferring foundation income or assets to, or for the use or benefit of, a disqualified person, and
6) Certain agreements to make payments of money or property to government officials.

Government officials. As noted in the discussion of disqualified persons in Chapter V, a government official may be a disqualified person for the tax on self-dealing. However, the tax will be imposed only if the government official knows that the act is an act of self-dealing.

Participation. A ***disqualified person*** who engages or takes part in a transaction alone or with others, or directs any person to do so will be treated as participating in an act of self-dealing.

Participation by a ***foundation manager*** includes silence or inaction on the manager's part where there is a duty to speak or act, as well as any affirmative action by the manager. However, a foundation manager will not have participated in an act of self-dealing when the manager has opposed the act in a manner consistent with carrying out the manager's responsibilities to the private foundation.

Willful. Participation by a foundation manager is willful if it is voluntary, conscious, and intentional. No motive to avoid the restrictions of the law or the incurrence of any tax is necessary to make the participation willful. However, participation by the foundation manager is not willful if the manager does not ***know*** (discussed later) that participation in the transaction is an act of self-dealing.

Reasonable cause. Participation is due to reasonable cause if the foundation manager has exercised responsibility on behalf of the foundation with ordinary business care and prudence.

Advice of counsel. A person who, after full disclosure of the factual situation to legal counsel (including house counsel), relies on the advice of counsel expressed in a reasoned written legal opinion that a transaction is not an act of self-dealing under the law, although the transaction is later held to be an act of self-dealing, will ordinarily not be liable for the initial tax imposed for self-dealing.

A written legal opinion is considered reasoned even if it reaches a conclusion that is later determined to be incorrect as long as it addresses itself to the facts and applicable law. However, a written legal opinion will not be considered reasoned if it does nothing more than recite the facts and express a conclusion. The absence of advice of counsel will not, by itself, imply that a person participated in the act knowingly, willfully, or without reasonable cause.

Knowing. A person will be considered to have participated in a transaction knowing that it is an act of self-dealing only if:

1) The person has actual knowledge of enough facts so that, based only upon those facts, the transaction would be an act of self-dealing,

2) The person is aware that such an act may violate the provisions of federal tax law governing self-dealing, and
3) The person negligently fails to make reasonable attempts to learn whether the transaction is an act of self-dealing, or the person is aware that the transaction is an act of self-dealing.

The term "knowing" does not mean having reason to know. However, evidence tending to show that a person had reason to know of a particular fact or rule is relevant in determining whether that person has actual knowledge of the fact or rule. The burden of proof that a foundation manager has knowingly participated in an act of self-dealing is on the IRS.

Taxable period. The tax on self-dealing is imposed for each year or part of a year within the taxable period. The taxable period begins on the date the act of self-dealing occurs and ends on the earliest of:

1) The date a notice of deficiency for the ***initial tax*** is mailed,
2) The date the ***initial tax*** is assessed, or
3) The date correction of the act of self-dealing is completed.

Example 1. On July 2, 1986, Joe Jones, a manager of private foundation X, acting on behalf of the foundation, knowing the act to be one of self-dealing, willfully and without reasonable cause sold certain real estate to Paul Smith, a disqualified person. On March 1, 1988, the IRS mailed a notice of deficiency to Smith for the initial and additional tax imposed by section 4941 on the sale. The taxable period for both Jones and Smith is July 2, 1986, through March 1, 1988.

Example 2. The facts are the same as in Example 1 except that on July 2, 1987, correction of the act of self-dealing is completed. The taxable period for both Jones and Smith is July 2, 1986, through July 2, 1987.

The initial tax is figured based on the tax year of the disqualified person liable for the tax, rather than the tax year of the private foundation.

An act of self-dealing occurs on the date all the terms and conditions of the transaction and the liabilities of the parties are fixed. For example, if a private foundation gives a disqualified person a binding option on June 17, 1985, to buy property owned by the foundation at any time before June 16, 1986, the act of self-dealing has occurred on June 17, 1985.

Correction period. The correction period starts on the day the act of self-dealing occurs and ends 90 days after a notice of deficiency for the ***additional tax*** is mailed.

The correction period may be extended by:

1) Any period in which the deficiency cannot be assessed because of a petition to the Tax Court, or
2) Any period the IRS determines is reasonable and necessary.

What Is Self-Dealing

The term, ***self-dealing*** includes the following transactions whether direct or indirect. However, see *Indirect Self-Dealing, Exceptions to Self-Dealing,* and *Transitional Rules,* for special rules.

Sales or Exchanges of Property

Any sale or exchange of property between a private foundation and a disqualified person is an act of self-dealing. For example, the sale of incidental supplies by a disqualified person to a private foundation is an act of self-dealing regardless of the amount paid to the disqualified person. Similarly, the sale of stock or other securities by a disqualified person to a private foundation in a bargain sale is an act of self-dealing regardless of the amount paid. However, see *Exceptions to Self-Dealing* later in this chapter.

The transfer of real or personal property by a disqualified person to a private foundation is treated as a sale or exchange if the foundation assumes a mortgage or similar lien, which was placed on the property before the transfer, or takes the property subject to a mortgage or similar lien that a disqualified person placed on the property in the 10-year period ending on the date of transfer. A similar lien includes, but is not limited to, deeds of trust and vendors' liens, but does not include any other lien if it is insignificant in relation to the fair market value of the property transferred.

Example. On May 17, 1988, the Gray Foundation, a private foundation, received a donation of a life insurance policy from Joe Brown, a disqualified person. The policy, which had a face value of $100,000, was subject to an outstanding loan of $46,000 that was made to Joe by the insurer within the 10-year period ending on the date of the donation. The cash surrender value of the policy was $50,000 on May 17, 1988. Under the terms of the policy, failure to repay the principal or interest on the policy loan reduces the proceeds that are payable to the beneficiary upon voluntary surrender of the policy or upon the death of the insured. The donation is an act of self-dealing.

Leases

The leasing of property between a disqualified person and a private foundation is an act of self-dealing. But see *Leases,* under *Exceptions to Self-Dealing,* later in this chapter.

Loans

Lending money or other extension of credit between a private foundation and a disqualified person is an act of self-dealing. However, this does not include loaning money by a disqualified person to a private foundation without interest or other charge if the proceeds of the loan are used exclusively for purposes specified in section 501(c)(3) of the Code. For these purposes, a loan by a disqualified person to a private foundation at below-market interest rates is treated as an act of self-dealing to the same extent as a loan at market interest rates.

An act of self-dealing occurs when a third party buys property and assumes a mortgage, the mortgagee of which is a private foundation, and later the third party transfers the property to a disqualified person who either assumes liability under the mortgage or takes the property subject to the mortgage. In this transaction the foundation is considered to have made a loan to the disqualified person in the amount of the unpaid indebtedness on the property at the time of the transfer.

Making a promise, pledge, or similar arrangement regarding money or property to a private foundation by a disqualified person, whether by an oral or written agreement, a promissory note, or other instrument of indebtedness, is not an extension of credit before the date of maturity to the extent that it is motivated by charitable intent and is unsupported by consideration.

Performing trust functions and certain general banking services by a bank or trust company, which is a disqualified person, is not an act of self-dealing if the services are reasonable and necessary in carrying out the exempt purposes of the private foundation and the compensation paid to the bank or trust company is not excessive (considering the fair interest rate for the use of the funds by the bank or trust company).

The general banking services that are not self-dealing are:

1) Checking accounts, as long as the bank does not charge interest on any overdrafts or a service fee greater than the actual cost of processing the amount overdrawn,
2) Savings accounts, as long as the foundation may withdraw its funds on no more than 30 days notice without subjecting itself to a loss of interest on its money for the time the money was on deposit, and
3) Safekeeping activities.

The purchase of certificates of deposit that provide a reduced rate of interest if not held to maturity from a banking institution, a disqualified person with respect to the private foundation, does not fall within the scope of the general banking services permitted, and is an act of self-dealing.

Providing Goods, Services, or Facilities

Generally, providing goods, services, or facilities between a private foundation and a disqualified person is an act of self-dealing. This applies to providing goods, services, or facilities, such as office space, cars, auditoriums, secretarial help, meals, libraries, publications, laboratories, or parking lots. However, it is not self-dealing if a disqualified person provides them to a foundation without charge and the goods, services, or facilities are used exclusively for purposes specified in section 501(c)(3) of the Code. Also, providing goods, services, or facilities to a foundation manager, to an employee, or to an unpaid worker, is not an act of self-dealing if the value of the items provided is reasonable and necessary to the performance of the tasks involved in carrying out the exempt purpose of the foundation and is not excessive.

For example, it is not an act of self-dealing if a private foundation provides meals and lodging which are reasonable and necessary (but not excessive) to a foundation manager. This is true whether or not the value of the meals and lodging is excludable from the manager's gross income.

Paying Compensation

Paying compensation or reimbursing expenses by a private foundation to a disqualified person is an act of self-dealing. But see *Exceptions to Self-Dealing,* discussed later.

Use of Income or Assets

Transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation is an act of self-dealing. For example, an act of self-dealing includes payment by a private foundation of any excise tax imposed on a disqualified person for any prohibited transactions discussed in this publication.

Similarly, payment of premiums for an insurance policy providing liability insurance to a foundation manager for excise taxes on prohibited transactions is an act of self-dealing unless the premiums are treated as compensation to the manager. In addition, the purchase or sale of stock or other securities by a private foundation is an act of self-dealing if the purchase or sale is made in an attempt to manipulate the price of the stock or other securities to the advantage of a disqualified person.

Indemnification by the foundation of its managers against reasonable expenses (other than taxes, penalties, and expenses of correction) incurred in an IRS or court proceeding involving the imposition of the excise taxes described in this publication on the foundation manager will not be an act of self-dealing if:

1) The manager is successful in the defense, or the proceeding is ended by settlement, and
2) The manager has not acted willfully and without reasonable cause in the act or failure to act giving rise to liability for the excise taxes.

Similarly, indemnification of a foundation manager for reasonable expenses incurred for defense in a judicial or administrative proceeding relating to the mismanagement of funds of a charitable organization is not an act of self-dealing if the applicable preceding conditions are met.

The indemnification of a lender or guarantee of repayment by a private foundation of a loan to a disqualified person is treated as a use for the benefit of a disqualified person of the income or assets of a private foundation.

A grant or other payment made by a foundation to satisfy the legal obligation of a disqualified person is an act of self-dealing.

Incidental benefits. The fact that a disqualified person receives an incidental or slight benefit from the use by a foundation of its income or assets will not, by itself, make the use an act of self-dealing. Public recognition that a substantial contributor may receive, arising from charitable activities of a private foundation, does not in itself result in an act of self-dealing since generally the benefit is incidental and tenuous.

Similarly, a scholarship or fellowship grant to a person other than a disqualified person that is paid or incurred by a private foundation according to a program consistent with:

1) The requirements of the foundation's exempt status as a charitable, educational, etc., organization,
2) The requirements for allowance of deductions for charitable contributions made to the foundation, and
3) The requirements of scholarship and fellowship grants awarded on an objective and nondiscriminatory basis under procedures approved by the Service,

will not be an act of self-dealing merely because a disqualified person indirectly receives a benefit from the grant. A scholarship or fellowship grant made by a private foundation under a program to award scholarship or fellowship grants to the children of employees of a substantial contributor will not be an act of self-dealing if these three requirements are satisfied.

Payment to a Government Official

The agreement by a private foundation to make any payment of money or other property to a government official (defined in Chapter V) will ordinarily be an act of self-dealing. But, see *Certain payments to government officials are not considered acts of self-dealing*, later, under *Exceptions to Self-Dealing*.

Indirect Self-Dealing

Certain transactions will not be treated as indirect self-dealing.

Certain business transactions. A transaction between a disqualified person and an organization controlled by a private foundation is not indirect self-dealing if:

1) The transaction arose from a business relationship established before the transaction could be considered an act of self-dealing,
2) The transaction was at least as favorable to the organization controlled by the foundation as an arm's length transaction with an unrelated person, and
3) Either the organization controlled by the foundation would have suffered severe economic hardship by engaging in a transaction with someone other than a disqualified person, or because of the unique nature of the product or services provided by the organization controlled by the foundation, the disqualified person could not have engaged in a transaction with anyone else, or could have done so only by incurring severe economic hardship.

Grants to intermediaries. The term "indirect self-dealing" does not include a transaction engaged in with a government official by an intermediary organization that is a recipient of a private foundation grant and that is not controlled by the grantor foundation, if the foundation does not earmark the use of the grant for any named government official and there is no agreement under which the granting foundation may cause the selection of the government official by the intermediary organization. A grant by a foundation is earmarked if the grant is made under an agreement, either oral or written, that the grant will be used by any named individual. A grant by a private foundation will not be an indirect act of self-dealing even though the foundation had reason to believe that certain government officials would receive benefits from the grant as long as the intermediary organization exercises control, in fact, over the selection process and actually makes the selection completely independently of the private foundation.

Transactions during the administration of an estate or revocable trust. A transaction involving a private foundation's interest or expectancy in property held by an estate (or revocable trust, including a trust that has become irrevocable on a grantor's death), regardless of when title to the property vests under local law, is not indirect self-dealing if:

1) The administrator, executor, or trustee has the power to sell the property or to reallocate the property to another beneficiary, or is required to sell the property under the terms of any option to which the property was subject when acquired by the estate or trust,
2) The transaction is approved by the probate court having jurisdiction over the estate (or by another court having jurisdiction over the estate, trust, or private foundation),
3) The transaction occurs before the estate is considered terminated for federal income tax purposes (or for a trust, before it is considered a trust that is not tax exempt, as explained in Chapter I),
4) The estate (or trust) receives an amount at least equal to the fair market value of the foundation's interest or expectancy in the property, considering any option to which the property was subject when it was acquired, and
5) The transaction results either in the foundation's receiving an interest or expectancy at least as liquid as the one it gave up, or in the foundation's receiving an asset related to the active carrying out of its exempt purpose, or the transaction is required under the terms of any option binding on the estate or trust.

Transactions with certain organizations. A transaction between a foundation and a corporation, partnership, estate, or trust not controlled by the foundation in which disqualified persons hold no more than 35% of the total voting power or profits or beneficial interest, is not an indirect act of self-dealing solely on the basis of ownership.

Certain transactions involving limited amounts. The term "indirect self-dealing" does not include any transaction between a disqualified person and an organization controlled by a private foundation or between two disqualified persons when the foundation's assets may be affected by the transaction if:

1) The transaction arises in the normal and customary course of a retail business engaged in with the general public,
2) In a transaction between a disqualified person and an organization controlled by a private foundation, the transaction is at least as favorable to the organization controlled by the foundation as an arm's length transaction with an unrelated person, and
3) The total amounts involved in all these transactions with any one disqualified person in any one tax year is no more than $5,000.

Statutory exceptions. A transaction described under *Exceptions to Self-Dealing*, later, in which a private foundation could itself engage, involving one or more disqualified persons but to which a private foundation is not a party, is not indirect self-dealing.

For example, even if a private foundation has control of a corporation, the corporation may pay to another disqualified person (except a government official) reasonable compensation for personal services.

Control. An organization is considered controlled by a private foundation if the foundation or one or more of its foundation managers acting only in their capacity as managers, may, only by combining their votes or positions of authority, require the organization to engage in a transaction, which if engaged in with the private foundation would be self-dealing. Similarly, an organization is controlled by a private foundation in the case of such a transaction between the organization and a disqualified person, if the disqualified person together with certain related persons who are disqualified persons (as described in Chapter V) may, only by combining their votes or positions of authority with that of the foundation, require the organization to engage in such a transaction.

The controlled organization does not have to be a private foundation. It may be any kind of exempt or nonexempt organization including a school, hospital, operating foundation, or social welfare organization.

An organization will be considered controlled by a private foundation or by a private foundation and disqualified persons if the persons are able, in fact, to control that organization. This control may be present even if their combined voting power is less than 50% of the organization's total voting power, or if one or more of the individuals has the right to exercise veto power over the actions of the organization relevant to any potential acts of self-dealing. However, a private foundation will not be regarded as having control over an organization simply because it exercises expenditure responsibility.

Exceptions to Self-Dealing

The following transactions between a private foundation and a disqualified person are not considered self-dealing.

Providing goods, services, or facilities by a private foundation to a disqualified person is not self-dealing if the goods, services, or facilities are made available to the general public on at least as favorable a basis as they are made available to the disqualified person ***and*** the goods, services, or facilities are ***functionally related*** (defined in Chapter X) to the exercise or performance by a private foundation of its exempt purpose.

The term "general public" includes those persons who reasonably would be expected to use the foundation's goods, services, or facilities. This does not apply, however, unless a substantial number of persons other than disqualified persons actually use the goods, services, or facilities.

A private foundation that provides recreational or park facilities to the general public may provide those facilities to a disqualified person if they are provided to that person on a basis no more favorable than that on which they are provided to the general public. Similarly, the sale of a book or magazine to disqualified persons is not an act of self-dealing if publishing the book or magazine is functionally related to a charitable or educational activity of the foundation. The publication must be made available to disqualified persons and the general public at the same price. Moreover, if the terms of the book or magazine sale require, for example, payment within 60 days of delivery, and payment is made during the 60-day period, the transaction will not be treated as a loan or extension of credit if these terms are consistent with normal commercial practices.

Payment of compensation or reimbursement of expenses by a private foundation to a disqualified person (except for a government official) for personal services that are reasonable and necessary to carry out the exempt purpose of the private foundation is not considered an act of self-dealing if the compensation or reimbursement is not excessive.

Personal services include the services of a broker serving as the foundation's agent, but not the services of a dealer buying from the foundation as a principal and reselling to a third party.

Furthermore, if a foundation makes a cash advance to a foundation manager or employee to cover anticipated out-of-pocket expenses, it is not an act of self-dealing if the advance is reasonable in relation to the duties and expense requirements of the foundation manager. An advance ordinarily is considered reasonable if it is not more than $500.

For example, if a foundation makes an advance to a foundation manager to cover anticipated out-of-pocket current expenses for a reasonable period (such as a month) and the manager accounts to the foundation under a periodic reimbursement program for actual expenses incurred, the foundation is not considered to have engaged in an act of self-dealing:

1) When it makes the advance,
2) When it replenishes the fund upon receipt of supporting vouchers from the manager, or
3) If it temporarily adds to the advance to cover unusual expenses expected to be incurred in carrying out a special assignment.

Any transaction between a private foundation and a corporation that is a disqualified person is not an act of self-dealing if the transaction is engaged in under a liquidation, merger, redemption, recapitalization, or other corporate adjustment, organization, or reorganization, as long as all the securities of the same class as those held before the transaction by the foundation are subject to the same terms and the terms provide for receipt by the foundation of at least fair market value.

For the securities to be considered subject to the same terms, the corporation must, in connection with the transaction, make a bona fide offer on a uniform basis to the foundation and every other security holder. The fact that a foundation receives property, such as debentures, while all other persons holding securities of the same class receive cash for their interests, will be evidence that the offer was not made on a uniform basis.

If no other persons hold securities of the same class as the private foundation, the consideration received by holders of other classes of securities, or the interests retained by the holders of other classes, when considered in relation to the consideration received by the foundation, must indicate that the foundation received at least as favorable treatment in relation to its interests as the holders of any other class of securities. In addition, the foundation must receive at least the fair market value of its interests.

Certain payments to government officials are not considered acts of self-dealing. These payments are:

1) A prize or award that does not have to be included in gross income if the official receiving the prize or award is selected from the general public (for this purpose, the recipient may keep the prize or award, and need not authorize the foundation to transfer the prize or award to a governmental unit or to another charity),
2) A scholarship or a fellowship grant that is to be used for study at a recognized educational organization. (For this purpose, there is no requirement that the grant recipients be limited to degree candidates, nor must the grant be limited to tuition, fees and course-required books, supplies or equipment. It is permissible for a recipient to use grant funds for room, board, travel, research, clerical help, or equipment, that are incidental to the purposes of the grant.),
3) Any annuity or other payment (forming part of a stock-bonus, pension, or profit-sharing plan) from a qualified trust,
4) Any annuity or other payment under an employees' annuity plan,
5) Any contribution or gift (other than money), or services or facilities made available, if the total value is not more than $25 during any calendar year,
6) Any payment made under a government employees' training program,
7) Any payment or reimbursement of travel expenses, including meals and lodging, for travel only from one point in the United States to another in connection with charitable purposes, but only if the payment or reimbursement is not more than the actual cost of transportation plus an amount for all other traveling expenses not greater than 125% of the maximum payable for similar travel by U.S. government employees (without regard to any higher rates allowed in designated geographical areas),
8) A payment under any agreement to employ or make a grant to a government official for any period after the termination of government service if the agreement is entered into within 90 days before termination, or
9) The cost of a government official's attendance or participation in a conference sponsored by the foundation in furtherance of its exempt purposes, including—
   a) The official's share of the cost of the conference,
   b) Professional and other non-monetary benefits of an intellectual or psychological nature received by the official from attending or participating in the conference,
   c) Benefits to the official resulting from publication or distribution of the conference record to conference participants, and
   d) Payments, reimbursements, or reasonable advances made to the official for expenses in attending the conference.

Leases. The leasing of property by a disqualified person to a private foundation is not an act of self-dealing if the lease is without charge. The lease will be considered without charge even though the foundation agrees to pay for janitorial expenses, utilities, or other maintenance costs it incurs as long as payment is not made directly or indirectly to a disqualified person.

The leasing of office space by a disqualified person to a private foundation in a building with other tenants who are not disqualified persons is not an act of self-dealing if:

1) The lease is pursuant to a binding contract in effect on October 9, 1969 (or renewals thereof),
2) The lease was not a prohibited transaction under section 503(b) or any corresponding provision of prior law at the time of execution, and
3) The terms of the lease (or any renewal) reflect an arm's length transaction.

Transitional Rules

Transactions involving securities acquired by a foundation before May 27, 1969. Any transaction between a private foundation and a corporation that is a disqualified person will not be an act of self-dealing if the transaction is under the terms of securities of the corporation, if the terms were in existence at the time the securities were acquired by the foundation and if they were acquired before May 27, 1969.

Disposition of certain business holdings. The sale, exchange, or other disposition of property that was owned by a private foundation on May 26, 1969, to a disqualified person will not be an act of self-dealing if the foundation is required to dispose of the property so it will not be liable for the tax on excess business holdings (discussed in Chapter X). This rule applies only if:

1) The amount received by the private foundation is at least equal to the fair market value of the business holdings at the time of disposition or at the time a contract for disposition was previously executed, and
2) At the time at which (1) is applied, the transaction would not have been a prohibited transaction under section 503(b) or corresponding provisions of prior law.

Property is considered owned by a private foundation on May 26, 1969, if it is acquired:

1) Under the terms of a will executed by that date,
2) Under the terms of a trust that was irrevocable on that date, or
3) Under the terms of a revocable trust executed by that date if the property would have passed under a will executed by that date, except that the grantor died without revoking the trust.

An amendment or republication of a will that was executed by May 26, 1969, will not prevent any interest in a business that was to pass under the terms of the will (in effect on May 26, 1969, and at all times thereafter) from being treated as owned by a private foundation on that date, only because:

1) There is a reduction in the interest in the business that the foundation was to receive,
2) The amendment or republication was necessary to comply with the requirements of governing instruments as discussed in Chapter II,
3) There is a change in the executor of the will, or
4) There is any other change that does not otherwise change the foundation's rights in the business.

If the amendment or republication ***increases*** the business interest that the foundation was to receive under the terms of the will in effect on May 26, 1969, only the interest that would have been acquired before the increase will be treated as owned by the foundation on that date. The increase is not so treated.

Use of property acquired before October 9, 1969. The use of property in which a private foundation and disqualified person have a joint or common interest is not an act of self-dealing if the interests of both were acquired before October 9, 1969.

Amount Involved

The excise tax on self-dealing is figured on the amount involved, which is the greater of the amount of money and the fair market value of other property given or the amount of money and fair market value of other property received. For payments made for services performed (to persons other than government officials), the amount involved is only the excess compensation paid by the private foundation. When the use of money or other property is involved, the amount involved is the greater of either the amount paid for the use or the fair market value of the use for the period for which the money or other property is used.

For a transaction that would not have been an act of self-dealing had the private foundation received fair market value, the amount involved is the excess of the fair market value of property transferred by the foundation over the amount received by the foundation, but only if the parties

have made a good faith effort to determine fair market value. Ordinarily a good faith effort to determine fair market value will be considered made when:

1) The person making the valuation is not a disqualified person with respect to the foundation, is competent to make the valuation, and is not in a position, whether by stock ownership or otherwise, to receive an economic benefit from the value used, and
2) The valuation is made using a generally accepted method for valuing comparable property, stock, or securities in arm's length business transactions when valuation is a significant factor.

For example, if a corporation that is a disqualified person (as to the foundation) undertakes a recapitalization referred to earlier under the exceptions to the self-dealing rule, but the foundation receives stock worth $95,000 in exchange for stock worth $100,000, the amount involved would be $5,000 if a good faith effort was made to value the stock.

Time for determining fair market value. The fair market value of property or the use thereof, as the case may be, for purposes of the initial taxes is the value as of the date the act of self-dealing occurred and for purposes of the additional taxes is the highest fair market value during the taxable period.

Correction

Correction will be accomplished by undoing the transaction that constituted the act of self-dealing, to the extent possible, but in no case placing the foundation in a worse financial position than that in which it would have been had the disqualified person acted under the highest fiduciary standards. For example, when a disqualified person sells property to a private foundation for cash, correction may be accomplished by recasting the transaction in the form of a gift by returning the cash to the foundation.

The following paragraphs give examples of minimum standards of correction in the case of certain specific acts of self-dealing. Use similar principles and apply them to other acts of self-dealing. Any correction under these standards is not an act of self-dealing.

Sales by foundation. In a sale of property by a private foundation to a disqualified person for cash, undoing the transaction includes, but is not limited to, rescinding the sale if possible. However, to avoid placing the foundation in a position worse than that in which it would be if rescission were not required, the amount returned to the disqualified person may not be greater than the lesser of the cash received by the foundation or the fair market value of the property received by the disqualified person.

Fair market value is determined either at the time of the act of self-dealing or at the time of rescission, whichever results in the lesser fair market value. In addition, the disqualified person must pay the foundation any net profits realized from the property while it was in the disqualified person's possession. For example, the disqualified person must pay the foundation any net profits realized from the property during the correction period, but only to the extent the income is greater than the income received by the foundation during the correction period from the cash originally paid to the foundation.

If, before the end of the correction period, the disqualified person resells the property in an arm's length transaction to a bona fide buyer who is not the foundation or another disqualified person, no rescission is required. The disqualified person must pay the foundation the excess (if any) of the greater of the fair market value of the property on the date of correction or the amount realized in the arm's length resale over the amount that would have been returned to the disqualified person if rescission had been required. In addition, the disqualified person must pay the foundation any net profits realized as described in the preceding paragraph.

Sales to foundation. If a disqualified person sells property to a private foundation, undoing the transaction includes, but is not limited to, requiring rescission of the sale if possible. However, to avoid placing the foundation in a worse position than it would be in if rescission were not required, the amount to be received from the disqualified person will be the greatest of:

1) The cash paid to the disqualified person,
2) The fair market value of the property at the time of the original sale, or
3) The fair market value of the property at the time of rescission.

In addition, the disqualified person is required to pay the private foundation any net profit realized after the original sale from the amount received from the sale, to the extent the net profit during the correction period is greater than the income received by the foundation from the property during the correction period.

If, before the end of the correction period, the foundation resells the property in an arm's length transaction to a bona fide buyer who is not a disqualified person, no rescission is required. But, the disqualified person must pay the foundation the excess (if any) of the amount that would have been paid to the foundation if the original sale had been rescinded over the amount realized by the foundation upon the resale of the property. In addition, the disqualified person must pay the foundation any net profits realized from the amount received from the original sale, described earlier.

Use of property by a disqualified person. If a disqualified person uses property owned by a private foundation, undoing the transaction includes, but is not limited to, terminating the use of the property. In addition, the disqualified person must pay the foundation the excess (if any) of:

1) The fair market value of the use of the property over the amount paid by the disqualified person for the use until termination, and
2) The amount that would have been paid by the disqualified person for the use of the property on or after the date of termination, for the period the disqualified person would have used the property (disregarding further extensions or renewals of the period) were it not for termination, over the fair market value of the use for the period.

In (1), the fair market value of the use of the property will be the greater of the ***rate*** at the time of self-dealing, or the rate at the time of correction of the act of self-dealing. In (2), the fair market value of the use of property will be the rate at the time of correction.

The ***rate*** for use of property other than money will be the fair rental value per period. For use of money, the rate will be the fair interest rate.

Use of the property by a private foundation. If a private foundation uses property that is owned by a disqualified person, undoing the transaction includes, but is not limited to, terminating the use of the property. In addition, the disqualified person must pay the foundation the excess (if any) of:

1) The amount paid to the disqualified person for the use until termination over the fair market value of the use of the property, and
2) The fair market value of the use of the property, for the period the foundation would have used the property (disregarding extensions or renewals of the period) had use not been terminated over the amount that would have been paid to the disqualified person on or after the date of termination for use during that period.

In (1), the fair market value of the use of the property will be the lesser of the rate (that is, the fair rental value per period for use of property other than money or the fair interest rate for the use of money) at the time of self-dealing, or the rate at the time of correction of the act of self-dealing. In (2), the fair rental value of the use of property will be the rate at the time of correction.

Excessive compensation paid by a private foundation to a disqualified person for performing personal services that are reasonable and necessary to carry out the exempt purpose of the foundation may be corrected by repaying to the foundation any excessive amount. Termination of the employment or independent contractor relationship is not required.

Correction of valuation errors. If, but for an error in the valuation of property, a transaction would not have been an act of self-dealing had the foundation received fair market value, a correction of the transaction means that the foundation is paid an amount equal to the excess of the fair market value of the property transferred over the amount that the foundation received for the property (assuming a good faith effort to determine fair market value). In addition, the foundation must receive the amount necessary to compensate it for the loss of the use of the money or other property during the period beginning on the date of the act of self-dealing and ending on the date the transaction is corrected.

Number of Acts

If a transaction is determined to be an act of self-dealing, there is generally only one act of self-dealing. If the transaction involves leasing property, lending money or other extension of credit, other use of money or property, or payment of compensation, the transaction will be treated as an act of self-dealing on the day the transaction occurs plus an act of self-dealing on the first day of each tax year or part of a year within the taxable period that begins after the tax year in which the transaction occurs.

If a transaction involves joint participation by two or more disqualified persons, the transaction will be treated as a separate act of self-dealing for each individual involved.

However, for purposes of terminating tax-exempt status and for purposes of determining a foundation manager's liability for penalties for repeated, willful or flagrant disregard of self-dealing prohibitions, the transaction will be treated as only one act of self-dealing. An individual and one or more members of the individual's family will be treated as one person regardless of whether a member of the family is a disqualified person as defined in Chapter V. The liability imposed on a disqualified person and one or more members of the individual's family for joint participation in an act of self-dealing is joint and several.

Fair market value of a specific asset is determined under the same rules discussed in Chapter VII under *Valuation of Assets.*

Chapter IX

Taxes on Jeopardizing Investments

If a private foundation makes any investments that would financially jeopardize the carrying out of its exempt purposes, both the foundation and the individual foundation managers may become liable for taxes on these jeopardizing investments under section 4944.

Initial tax. An excise tax of 5% of the amount involved (the jeopardizing investment) is imposed on the foundation for each tax year, or part of a year, in the taxable period (described later). The foundation will not be liable for the tax if it can show that the jeopardizing investment was due to reasonable cause and not willful neglect, and that the jeopardizing investment was corrected within the correction period (described later).

An excise tax of 5% of the amount involved is also imposed on any foundation manager who knowingly, willfully, and without reasonable cause participated in making the jeopardizing investment.

This tax applies to investments of either income or principal.

Additional tax. If a private foundation is liable for the initial tax and has not removed the investment from jeopardy within the taxable period, an additional excise tax of 25% of the amount involved will be imposed on the foundation. The additional tax will not be assessed, or if assessed will be abated, if the investment is removed from jeopardy within the correction period.

In each case where this additional tax is imposed on the foundation, an additional excise tax of 5% of the amount involved is imposed on any foundation manager who refuses to agree to all or part of the removal from jeopardy within the correction period.

If more than one individual manager is liable for the excise tax on jeopardizing investments, all parties will be jointly and severally liable.

Limits on liability for management. For any one jeopardizing investment, the maximum initial tax that may be imposed is $5,000, and the maximum additional tax is $10,000.

Willful. A manager's participation in making an investment is willful if it is voluntary, conscious, and intentional. However, it is not willful if the manager does not knowingly participate in a jeopardizing investment.

Due to reasonable cause. A foundation manager's actions are due to reasonable cause if he or she has exercised responsibility on behalf of the foundation with ordinary business care and prudence.

Advice of counsel. A manager's action will be considered due to reasonable cause if the manager relies on advice of counsel expressed in a reasoned written legal opinion (discussed under *Advice of counsel,* in Chapter VIII). In addition, a foundation manager may rely on the advice of a qualified investment counselor, given in writing in accordance with generally accepted practices, that a particular investment will provide for the long and short-term financial needs of the foundation.

Participation. The participation of any foundation manager in the making of an investment shall consist of any manifestation of approval of the investment.

Knowing. Foundation managers will be considered to have participated in making an investment knowing that it is jeopardizing the carrying out of any of the foundation's exempt purposes only if:

1) They have actual knowledge of enough facts so that, based only on those facts, the investment would be a jeopardizing investment,
2) They are aware that an investment under these circumstances may violate the provisions of federal tax law governing jeopardizing investments, and
3) They negligently fail to make reasonable attempts to learn whether the investment is a jeopardizing investment, or in fact are aware that it is such an investment.

The term "knowing" does not mean "having reason to know." However, evidence tending to show that a foundation manager has reason to know of a particular fact or particular rule is relevant in determining whether actual knowledge of such fact or rule is present.

Jeopardizing investments generally are those that show a lack of reasonable business care and prudence in providing for the long and short-term financial needs of the foundation for it to carry out its exempt function. No single factor determines a jeopardizing investment.

No category of investments is treated as an intrinsic violation, but careful scrutiny is applied to:

1) Trading in securities on margin,
2) Trading in commodity futures,
3) Investing in working interests in oil and gas wells,
4) Buying "puts," "calls," and "straddles,"
5) Buying warrants, and
6) Selling short.

In deciding whether the investment of an amount jeopardizes the carrying out of the exempt purposes, the determination must be made on an investment-by-investment basis taking into account the foundation's portfolio as a whole. It is permissible for the foundation managers to take into account expected returns, risks of rising and falling prices, and the need for diversification within the investment portfolio. But to avoid the tax on jeopardizing investments, a careful analysis of potential investments must be made and good business judgment must be exercised.

Whether an investment jeopardizes the foundation's exempt purposes is determined at the time of making the investment. If the investment is proper when made, it will not be considered a jeopardizing investment even if it later results in loss.

These rules do not exempt or relieve any person from compliance with any federal or state law imposing any obligation, duty, responsibility, or other standard of conduct on the operation or administration of an organization or trust. Nor shall any state law exempt or relieve any person from any obligation, duty, responsibility, or other standard of conduct provided in these rules.

The tax on jeopardizing investments does not apply to investments originally made by a person who later transferred them as gifts to the foundation. However, if the person receives any consideration from the foundation on the transfer, the foundation will be treated as having made an investment in the amount of the consideration.

The tax on jeopardizing investments does not apply to investments that are acquired by the foundation as a result of a corporate reorganization nor does the tax apply to investments made before 1970 unless the form or terms of the investments are later changed, or they are exchanged for other investments.

Program-related investments are not subject to the tax on jeopardizing investments. Program-related investments are those in which:

1) The primary purpose is to accomplish one or more of the foundation's exempt purposes,
2) Production of income or appreciation of property is not a significant purpose, and
3) Influencing legislation or taking part in political campaigns on behalf of candidates is not a purpose.

In determining whether a significant purpose of an investment is the production of income or the appreciation of property, it is relevant whether investors who engage in investments only for profit would be likely to make the investment on the same terms as the private foundation.

If an investment incidentally produces significant income or capital appreciation, this is not, in the absence of other factors, conclusive evidence that a significant purpose is the production of income or the appreciation of property.

The investments, to be program related, must significantly further the foundation's exempt activities. They must be investments that would not have been made except for their relationship to the exempt purposes. The investments include those made in ***functionally related activities*** (described in Chapter X) that are carried on within a larger combination of similar activities related to the exempt purposes.

The following are some typical examples of program-related investments:

1) Low-interest or interest-free loans to needy students,
2) High-risk investments in nonprofit low-income housing projects,
3) Low-interest loans to small businesses owned by members of economically disadvantaged groups, where commercial funds at reasonable interest rates are not readily available,
4) Investments in businesses in deteriorated urban areas under a plan to improve the economy of the area by providing employment or training for unemployed residents, and
5) Investments in nonprofit organizations combating community deterioration.

If a foundation changes the form or terms of an investment, and if the investment no longer qualifies as program-related, it then must be determined whether or not the investment jeopardizes carrying out its exempt purposes.

Once an investment is determined to be program-related, it will continue to qualify as a program-related investment if changes in the form or terms of the investment are made primarily for exempt purposes and not for any significant purpose involving the production of income or the appreciation of property. A change made in the form or terms of a program-related investment for the prudent protection of the foundation's investment will not ordinarily cause the investment to cease to qualify as program-related. Under certain conditions a program-related investment may cease to be program-related because of a critical change in circumstances, such as serving an illegal purpose or serving the private purpose of the foundation or its managers.

An investment that ceases to be program-related because of a critical change in circumstances does not subject the foundation making the investment to the tax on jeopardizing investments before the 30th day after the date on which the foundation (or any of its managers) has actual knowledge of the critical change in circumstances.

The taxable period begins with the date of the investment and ends on the earliest of:

1) The date of removal from jeopardy, or
2) The date a notice of deficiency for the ***initial tax*** is mailed, or
3) The date the ***initial tax*** is assessed.

It may include more than one tax year of the foundation.

Example. The Wilson Foundation has the calendar year as its tax year. It makes a jeopardizing investment on November 28, 1988, and does not remove the investment from jeopardy until January 15, 1989. The taxable period is from November 28, 1988, to January 15, 1989. It therefore is liable for a total initial tax of 10% of the amount invested (5% for each tax year or part of a year in the taxable period).

Removal from jeopardy. The foundation removes an investment from jeopardy when it sells or otherwise disposes of it, and the proceeds of the sale or other disposition are not themselves jeopardizing investments.

A change by a foundation in the form or terms of a jeopardizing investment results in the removal of the investment from jeopardy if, after the change, the investment no longer jeopardizes the carrying out of the foundation's exempt purposes. Making one jeopardizing investment and later exchanging this investment for another jeopardizing investment will be treated as only one jeopardizing investment. A jeopardizing investment is not removed from jeopardy by a transfer to another private foundation related to the transferor foundation unless the investment is a program-related investment in the hands of the transferee foundation.

The correction period begins with the date of the investment and ends 90 days after a notice of deficiency for the ***additional*** tax is mailed. This

period is extended by any period during which a deficiency cannot be assessed because of pending Tax Court proceedings, and any other period the IRS determines is reasonable and necessary.

Chapter X

Taxes on Excess Business Holdings

Generally, under section 4943 of the Internal Revenue Code, the combined holdings of a private foundation and all of its disqualified persons are limited to 20% of the voting stock in a business enterprise (described later) that is a corporation. The 20% limitation also applies to holdings in business enterprises that are partnerships, joint ventures, or other unincorporated enterprises. For a partnership or joint venture, profits interest is substituted for voting stock, and for any other unincorporated enterprise, beneficial interest is substituted for voting stock. A private foundation that has excess business holdings (described later), in a business enterprise may become liable for an excise tax based on the amount of the excess holdings.

Initial tax. An excise tax of 5% of the value of the excess holdings is imposed on the foundation. The tax is imposed on the last day of each tax year that ends during the taxable period (described later).

The amount of the excess holdings is determined as of the day during the tax year when the foundation's excess holdings in the business were the greatest.

The initial tax may be abated if the foundation can show that the excess holdings were due to reasonable cause and not to willful neglect, and that the excess holdings were disposed of within the correction period (described later).

Additional tax. After the initial tax has been imposed, an excise tax of 200% of the excess holdings is imposed on the foundation if it has not disposed of the remaining excess business holdings by the end of the taxable period. The additional tax will not be assessed, or if assessed will be abated, if the excess business holdings are reduced to zero during the correction period (described later).

Business enterprise. The term "business enterprise," in general, includes the active conduct of a trade or business including any activity that is regularly carried on for the production of income from the sale of goods or the performance of services and that constitutes an unrelated trade or business under section 513 of the Code. The term does ***not*** include a ***functionally related business,*** a trade or business that obtains at least 95% of its gross income from passive sources, or program-related investments as discussed in Chapter IX.

A functionally related business is:

1) A trade or business the conduct of which is substantially related (aside from the mere provision of funds for the exempt purpose) to the exercise or performance by the private foundation of its charitable, educational, or other purpose or function constituting the basis for its exemption,
2) A trade or business in which substantially all the work is performed for the foundation without compensation,
3) A business carried on by the foundation primarily for the convenience of its members, students, patients, officers, or employees (such as a cafeteria operated by a museum for the convenience of its members, employees, and visitors),
4) A business that consists of the selling of merchandise, substantially all of which has been received by the foundation as gifts or contributions, or
5) An activity carried on within a larger combination of similar activities or within a larger complex of other endeavors that is related to the exempt purposes of the foundation (other than the need to simply provide funds for these purposes).

Gross income from passive sources includes:

1) Dividends, interest, and annuities,
2) Royalties (including overriding royalties), whether measured by production or by gross or taxable income from the property,
3) Rents from real property, and from personal property leased with real property if the rents from the personal property are an incidental amount of the total rents under the lease (determined at the time the personal property is placed in service). Rents are not considered gross income from passive sources if more than 50% of the total rent under the lease is for personal property, or if the determination of the amount of rent depends in whole or in part on the income or profits received from the leased property (unless the amount is based on fixed percentages of gross receipts or sales),
4) Gains from sales, exchanges, or other dispositions of property other than—
   a) Stock in trade or property held primarily for sale to customers in the ordinary course of business, or
   b) Gains on the lapse or termination of options written by the organization in connection with its investment activities to buy or sell securities. Gains from cutting timber, that upon election may be considered a sale or exchange, are not considered gross income from passive sources, and
5) Income from the sale of goods if the seller does not manufacture, produce, physically receive or deliver, negotiate sales of, or keep inventories in the goods.

   Income that is otherwise considered passive will not lose its character merely because it is unrelated debt-financed income described in section 514.

Excess business holdings. The excess business holdings of a foundation are the amount of stock or other interest in a business enterprise that exceeds the permitted holdings. A private foundation is generally permitted to hold up to 20% of the voting stock of a corporation, reduced by the percentage of voting stock actually or constructively owned by disqualified persons (defined in Chapter V, of this publication). There are two exceptions to this rule.

First, if one or more third persons, who are not disqualified persons, have effective control of a corporation, the private foundation and all disqualified persons together may own up to 35% of the corporation's voting stock. Effective control means the power, whether direct or indirect, and whether or not actually exercised, to direct or cause the direction of the management and policies of a business enterprise. It is the actual control which is decisive, and not its form or the means by which it is exercisable.

Second, a private foundation is not treated as having excess business holdings in any corporation in which it (together with certain other related private foundations) owns not more than 2% of the voting stock and not more than 2% of the value of all outstanding shares of all classes of stock.

Nonvoting stock (or capital interest for holdings in a partnership or joint venture) is a permitted holding of a foundation if all disqualified persons together hold no more than 20% (or 35% as described earlier) of the voting stock of the corporation. All equity interests which are not voting stock shall be classified as nonvoting stock.

Interest in sole proprietorships. A private foundation is not permitted any holdings in sole proprietorships that are business enterprises unless they were held before May 26, 1969, or acquired by gift or bequest thereafter. See the discussion on these special rules later.

Attribution of business holdings. For determining the holdings in a business enterprise of either a private foundation or a disqualified person, any stock or other interest owned directly or indirectly by or for a corporation, partnership, estate, or trust is considered owned proportionately by or for its shareholders, partners, or beneficiaries. (This rule does not apply to certain income interests or remainder interests of a private foundation in a split-interest trust, which are discussed in Chapter I).

Example. Tim Jones, a foundation manager of X Foundation, owns 50% of the stock of Y Corporation. (Y Corporation is not actively engaged in a trade or business.) Z Corporation is an 80%–owned subsidiary of Y Corporation. Therefore, 40% of the Z Corporation stock is considered held by a disqualified person to X Foundation. Any holding of more than 2% of the voting stock or 2% of the value of the Z Corporation stock will result in all of the Z Corporation stock held by the foundation being treated as an excess business holding.

In making its computations, the foundation must determine its proportionate interest and that of all disqualified persons in each class of stock, in relation to the proportion that the voting interest of each class has to all votes in the corporation. For example, if the foundation owns 50% of the outstanding shares of a class of stock that has 60% of the voting rights in a corporation, the foundation's holdings in the voting stock would be 30%.

Dispositions of certain excess holdings within 90 days. A private foundation that acquires excess business holdings, other than as a result of a purchase by the foundation, will not be subject to the taxes on excess business holdings if it disposes of the excess business holdings within 90 days from the date on which it knows, or has reason to know, of the event that caused it to have the excess holdings. This 90–day period will be extended to include the period during which a foundation is prevented by federal or state securities laws from disposing of the excess business holdings. The 90–day disposition period applies, for example, when a disqualified person acquires additional holdings. The amount of holdings the foundation must dispose of is not affected by disposals by disqualified persons during the 90–day period.

The taxable period begins on the first day that the foundation has excess business holdings and ends on the earlier of either:

1) The date a notice of deficiency for the ***initial tax*** is mailed, or
2) The date the ***initial tax*** is assessed.

Example. The Y private foundation files tax returns on a calendar year basis. It acquires excess business holdings on July 7, 1987, and does not dispose of them until after the Service mails a notice of deficiency for the initial and additional tax on December 10, 1988. For Y's excess business holdings, the taxable period begins on July 7, 1987, and ends on December 10, 1988. Because the 1987 tax year of the foundation ended in the taxable period, the foundation is liable for a tax of 5% of the largest amount of excess holdings it had at any time during that year.

The correction period begins on the first day that the foundation has excess business holdings and ends 90 days after a notice of deficiency for the ***additional tax*** is mailed.

This period is extended by any period during which a deficiency cannot be assessed or because of pending Tax Court proceedings. In addition, the correction period may be extended

by any other period the Service determines is reasonable and necessary.

Gifts or bequests of business holdings. If there is a change in a foundation's business holdings (other than by purchase by the foundation or by disqualified persons) such as through gift or bequest, and the additional holdings result in the foundation having excess business holdings, the foundation in effect has ***5 years*** to reduce these holdings or those of its disqualified persons to permissible levels. The excess business holdings (or the increase in excess business holdings) resulting from the gift or bequest are treated as being held by a disqualified person, rather than by the foundation itself, during the 5–year period beginning on the date the foundation obtains the holdings.

Additional time to dispose of large gifts or bequests. The IRS may grant the foundation an additional 5-year extension (beyond the initial 5 years) to reduce excess business holdings to permissible levels, if these holdings result from an unusually large gift or bequest of diverse business holdings or holdings with complex corporate structures. To receive this extension:

1) The foundation must establish that it made diligent efforts to dispose of the holdings within the initial 5-year period, and could not do so (except at a price substantially below fair market value) because of the size and complexity or diversity of the holdings,
2) The foundation must submit to the IRS, before the end of the initial 5-year period, a plan for disposing of all the excess business holdings involved in the extension, and
3) The IRS must determine that the foundation's plan for disposal can reasonably be expected to be carried out before the end of the additional 5-year period.

The foundation must also submit the plan mentioned in (2) above to the state Attorney General (or other appropriate official) having administrative or supervisory authority or responsibility for the foundation's disposition of the excess business holdings involved. The foundation must then send to the IRS any response it receives from the Attorney General (or other official) regarding its plan.

A request for extension of the period for disposition, as well as the copy of any response received from state officials, should be addressed to the Assistant Commissioner (Employee Plans and Exempt Organizations), 1111 Constitution Ave., NW, Washington, DC 20224.

Business holdings on May 26, 1969. Transitional rules are provided to prevent holdings of a foundation as of May 26, 1969, that are greater than the 20% (or 35%) limits permitted under the general rules of section 4943(c)(2), from being subject to the initial tax. The foundation is given time, in three phases, to dispose of its excess business holdings.

First, the transitional rules provide that, all foundation holdings on May 26, 1969, are treated as held by disqualified persons for a certain period of time (the "first phase"). Second, the percentage of permitted holdings in a business enterprise is ***initially*** increased to a percentage equal to the difference between —

1) The percentage of combined holdings of the foundation and all disqualified persons on May 26, 1969 (up to a 50% maximum), and
2) The percentage of holdings of all disqualified persons.

The percentage in (1) is called the "substituted level" and it applies to both the voting stock, and, separately, to the value of all outstanding shares of all classes of stock.

The main purpose of the substituted level is to indicate what the permitted holdings will be immediately after the end of the first phase, when the holdings are no longer treated as held by disqualified persons.

The substituted level is reduced by dispositions of holdings by the foundation or disqualified persons (but not below 20% or 35%) after May 26, 1969.

Example. On May 26, 1969, the Watson Foundation and its disqualified persons owned 49% of the voting stock of the Brown Corporation. The foundation could continue to hold its stock during the first phase. However, if the foundation disposes of 10% of its Brown Corporation stock, its permitted holdings could then not be greater than 39% of the stock.

Holdings on May 26, 1969, include business interests acquired later by the foundation under the terms of a trust irrevocable on that date, or under the terms of a will executed before May 27, 1969.

Generally, an active corporation in which a private foundation has excess stock held since May 26, 1969, may acquire new subsidiaries or assets without creating excess business holdings for the foundation.

The first phase is 20 years if the foundation and all disqualified persons owned more than 95% of the voting stock of a corporate business (or more than 95% of comparable interests in an unincorporated business) on May 26, 1969.

The first phase is 15 years if the foundation (and its disqualified persons) owned on that date more than 75% of either the voting stock or the value of all outstanding shares of all classes of stock of a corporation, or more than 75% of the profits or capital interests of an unincorporated business.

The first phase is 10 years in all other cases.

Phase one is suspended during the time a judicial proceeding is pending, for the purpose of reforming or excusing the foundation from complying with its governing instrument or any other instrument in effect on May 26, 1969, to allow disposition of excess business holdings.

During the first phase, business interests owned by the foundation on May 26, 1969, are treated as held by a disqualified person, rather than by the foundation. The combined holdings of the foundation and its disqualified persons must be reduced so that by the end of the first phase they are not greater than either 50% of the voting stock or 50% of the value of all outstanding shares of a corporation (or 50% of comparable interests in an unincorporated enterprise).

Also for holdings acquired under the terms of a will existing before May 27, 1969, or under the terms of a trust irrevocable before May 27, 1969, the first phase begins on the date of actual distribution of the holdings. However, only the 15–year and 10–year first phase periods apply in these circumstances.

Present holdings greater than 20% but less than 50% need not be decreased during the first phase, but also may not be increased.

The second phase is the 15–year period immediately following the first phase. During the second phase, the foundation's ownership of business interests that it held on May 26, 1969, must be reduced so that by the end of the phase the combined holdings of the foundation and its disqualified persons are not greater than 35% of the voting stock of a corporation (or 35% of the value of all outstanding shares of all classes of stock, or 35% of comparable interests in an unincorporated enterprise).

If, at any time during the second phase, the holdings of all disqualified persons together are greater than 2% of the voting stock, the holdings of the foundation itself may not be more than 25% of the voting stock or 25% of the value of all outstanding shares of all classes of stock.

The third phase is the entire period following the second phase. If a foundation enters the third phase with not more than 2% of the voting stock held by all disqualified parties, and any time after the beginning of the third phase these holdings exceed 2%, then the 25% rule applies.

Separation of phases and special rules. A private foundation may acquire other interests in a business enterprise, which are also entitled to be treated as held by disqualified persons for varying holding periods (certain holdings acquired under the terms of a trust or will in effect on May 26, 1969, and the initial and additional 5–year periods to dispose of certain gifts, bequests, etc.). The phase periods for each different interest acquired work independently of one another. For example, the phases for certain holdings acquired under the terms of a trust or will in effect on May 26, 1969, start independently from those for certain other interests of the foundation in the same enterprise. In any case, however, holdings the private foundation disposes of are charged first against those holdings it must dispose of in the shortest period to avoid the initial tax thereon.

In certain situations, holdings during the phase periods may become so reduced that they would be permitted holdings subject to the general rules of section 4943 instead of the transitional rules. For example, when the combined voting levels have been reduced to 20%, the provisions concerning nonvoting stock as permitted holdings generally apply.

There is a limited exception from the taxes on self-dealing for private foundations that dispose of certain excess business holdings to disqualified persons as long as the sales price at least equals the fair market value.

The excess business holdings involved are those interests that are subject to the transitional rules and that would be subject to the initial tax if the required reductions in amount were not accomplished.

Chapter XI

Excise Tax Appeal Procedures

This chapter explains the procedures an organization must follow in appealing the imposition of the excise taxes explained in Chapters VI through X. Appeals of these taxes are handled by the Appeals Division in each of the regional offices of the Internal Revenue Service.

For appeal procedures that apply to cases involving issues subject to the declaratory judgment provisions of section 7428 of the Code, see Publication 557 and Chapter II of this publication. These issues include qualification under section 501(c)(3) or as an operating foundation, classification as a private foundation, and eligibility to receive deductible contributions.

Thirty-Day Letter

Upon conclusion of an examination that results in a proposed tax deficiency, the taxpayer will be issued a 30 –day letter including a report of the examination that indicates the proposed tax deficiency and the reasons for it. The letter will also advise the taxpayer of the right to appeal the proposed action if the taxpayer does not agree with it.

The taxpayer may, within 30 days of the date of the letter, request consideration by the Regional Director of Appeals for the region that has jurisdiction over the case. The procedures regarding the regional consideration and claims for refund or credit are discussed later. In situations where the expiration of the statute of limitations for assessment and collection of tax is imminent, extensions of time to file a 30–day protest will be granted only if the taxpayer signs a consent to extend the statute of limitations.

If the taxpayer does not respond in 30 days, a statutory notice of deficiency will be issued by the key District Director of the Internal Revenue Service. The taxpayer has 90 days (150 days if the notice is mailed to a person outside of the States of the Union and the District of Columbia) to file a petition with the United States Tax Court for a redetermination of the deficiency.

If the taxpayer does not file a petition with the Tax Court, the tax will be assessed.

Protest and Conference Procedures

If, after receiving the 30–day letter, the taxpayer wishes to appeal, the taxpayer must send a written protest to the key District Director within 30 days from the date of the letter. The protest must include a full and detailed statement of the facts, law, and argument in support of the taxpayer's position and, if desired, a request for a conference at the regional office. Deficient protests will be returned to the taxpayer with an explanation why the protest cannot be accepted. Additional time will be given to the taxpayer to perfect the protest.

Upon receipt of a taxpayer's protest and request for a regional office conference, the key District will review the protest and, if it maintains its position, forward the request and the case file to the Regional Director of Appeals which will contact the taxpayer regarding conference rights. In appropriate cases, the examining officer may attend the regional office conference to clarify the facts in the case. If additional issues are raised at the conference, the case will be returned to the key District Director for consideration of these issues.

If, after consideration of the case by Appeals, a satisfactory settlement of the issues is reached with the taxpayer, the taxpayer will be given a revised report of examination prepared at the regional office, if necessary, and will be asked to sign an appropriate agreement form.

If agreement is not reached at this stage, a statutory notice of deficiency will be issued by Appeals after consideration by the Service's Regional Counsel. The taxpayer may then petition, within the statutory period, the United States Tax Court for redetermination of the deficiency.

If the case under consideration in Appeals is docketed in the Tax Court and agreement is reached with the taxpayer on the issues involved, the case is disposed of by filing a stipulation of agreed deficiency or overpayment with the Tax Court, which will enter its order in conformity with the stipulation.

Claims for Refund or Credit

After receiving a 30–day letter, the taxpayer may pay the tax and then contest the assessment (unless an agreement to the contrary is executed) by filing a claim for refund or credit for all or any part of the amount paid. However, this does not apply to certain taxes determined by the Tax Court, the decision of which has become final. A claim for refund or credit is made by filing an appropriate amended return with the Internal Revenue Service Center to which the original return was sent.

When claims for refund or credit are examined by the key District Director, substantially the same procedure within the Service is followed (including appeal steps) as when original exempt organizations returns are examined. The procedure for appealing rejected claims through the Court is outlined in section 601.103(c)(3) of the Statement of Procedural Rules.

Technical Advice

While the case is under the jurisdiction of the key district office or the Appeals office, a taxpayer may request that an issue be referred to the National Office for technical advice on the grounds that a lack of uniformity exists as to the disposition of the issue, or that the issue is so unusual or complex as to warrant consideration by the National Office. Taxpayers should make written requests to the key district office or the Appeals office stating the facts, law, and argument with respect to the issue and reasons for requesting technical advice. At the time taxpayers are informed that the matter is being referred to the National Office, they will also be informed of their right to a conference in the National Office in the event an adverse decision is indicated, and will be asked to state whether they want such a conference.

If, after the National Office considers the case file on a request for technical advice, it appears that advice adverse to the taxpayer should be given and a conference has been requested, the taxpayer will be notified of the time and place of the conference. If a conference has not been requested, the case will be decided on the basis of the existing written records.

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Employer's Guides

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51 ..... Agricultural Employer's Tax Guide (Circular A)
80 ..... Federal Tax Guide for Employers in the Virgin Islands, Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands (Circular SS)

Specialized Publications

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