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Private Foundations: Distribution Choices

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A private foundation is a tax-exempt charitable organization that is generally created and funded by an individual, a family or a business. To a large extent, a private foundation allows the donor to exert control and influence over the contributed assets to ensure the gift is used in accordance with the donor's wishes.

Within limits, donors may deduct contributions to private foundations in computing their federal taxable income. A significant tax advantage of a gift to a private foundation is the current charitable deduction for contributions to the private foundation allowed to a donor while a decision as to which organization to benefit with a distribution from the foundation may be deferred to a later period.

Because they are not funded by a broad cross-section of the public, Congress believed that private foundations generally might lack public oversight. Thus, in 1969, Congress enacted rules that impose financial sanctions if a private foundation engages in certain transactions.

FAILURE TO DISTRIBUTE INCOME

One such sanction imposes an excise tax on the failure by a private foundation to annually distribute a certain amount of cash or property for charitable purposes.

The excise tax will apply if the foundation distributes less than 5% of the fair market value of certain assets each year in the form of "qualifying distributions." The percentage is applied against the value of "non-charitable use" assets (i.e., assets other than those used to carry out the purposes of the foundation). In effect, this results in the application of the percentage to the value of the portfolio assets of a foundation (e.g., stocks, bonds, cash, cash equivalents, and rental and royalty assets) less a small amount of cash.

Qualifying distributions must be made by the close of the foundation's tax year subsequent to the year for which the distribution is required. That is, a foundation is given an additional year within which to make the distribution required for the previous tax year. Failure to do so would subject the foundation to a 15% excise tax on the undistributed amount for each year that the amount remains undistributed.

Qualifying distributions, in general, are funds *paid* to accomplish a charitable purpose. Qualifying distributions generally do not include (a) contributions to public charities that are controlled by the donor's private foundation (or "disqualified persons" with respect to the donor's foundation); and (b) contributions to other private foundations.

The qualifying distribution requirement may be made through a variety of methods:

- Amounts distributed directly to accomplish a charitable purpose;
- Reasonable and necessary administrative expenses;
- Amounts paid to acquire assets used or held for use directly in carrying out a charitable purpose;
- Qualified set-asides;
- Program related investments; and
- Amounts spent to acquire or operate a functionally related business.

Special rules apply with respect to distributions to foreign (non-U.S.) charities. Those rules are beyond the scope of this discussion.

DESCRIPTION OF DISTRIBUTION METHODS

A. Direct Grants

Direct grants of funds to public charities are most commonplace among grant making foundations. A private foundation can direct the use of the grant funds, but cannot place a material restriction on such use. A material restriction involves a limitation that would impede or prevent the recipient organization from effectively using the funds for charitable purposes. Pledges for future grants are not qualifying distributions since only amounts paid are treated as qualifying distributions.

A foundation may also distribute property rather than cash. The fair market value of the property distributed will be treated as a qualifying distribution. This technique can be used to distribute low basis, high value assets (such as stock) to a grantee, thus avoiding the excise tax on the gain element that would be triggered by a disposition of the asset and distribution of sale proceeds.

Direct grants to individuals for travel, study, or research or similar purposes are treated as qualifying distributions, so long as the foundation obtains approval from the IRS for such a program by demonstrating that the grants are awarded in a nondiscriminatory manner.

B. Administrative Expenditures

A reasonable and necessary amount of administrative expenses paid to carry out the foundation's purpose is treated as a qualifying distribution. Such expenses generally include the cost of personnel, facility, supplies, furniture, and equipment, as well as travel to grantee locations. Where the operating expense is not used solely for exempt activities, an allocation is required. The direct costs associated with asset management are not treated as qualifying distributions since they are deductible against investment income.

C. Asset Acquisition Expenditures

The purchase price of an asset used, or held for use, in carrying out the charitable purposes of a foundation is treated as a qualifying distribution when the purchase is made. Common examples of such expenditures include the acquisition of an office or research building that will house foundation programs and activities. Costs for improvements to such facilities are also included as qualifying distributions.

Where 95% or more of the total use of an asset is for charitable purposes, the entire acquisition price is treated as a qualifying distribution. If charitable use is less that 95%, an allocation among uses is required in order to determine that amount of the purchase price that is treated as a qualifying distribution.

D. Qualified Set-Aside

An amount "set-aside" in a year for a specific charitable project may be treated as a qualifying distribution in that year. The IRS must approve the suitability of a set-aside as the appropriate funding mechanism for the project. The foundation must detail the specifics of the project and demonstrate to the IRS that the amounts will be spent within 60 months of the date of the set-aside. Submission to the IRS must be made before the end of the year of the set-aside. If approved by the IRS, the set-aside has the effect of reducing the amount of distributions to be "paid" in the year of the set-aside.

The set-aside opportunity may be used in the case of projects with long-term funding commitments, such as the construction of classroom, health care, or research facilities, or acquisition of land dedicated to public purposes.

There is a second type of set-aside that is of particular usefulness to a newly formed foundation that commits to a long-term project. Under this alternative, the foundation may treat a set-aside that otherwise meets the general rules as a qualifying distribution in the current year, so long as it makes required cash (or property) distributions of prescribed lower amounts in the first four years of operations. In subsequent years, the foundation is required to make the full amount of its annual distribution amount. IRS approval under this option is not required, but Form 990-PF must disclose the details of the project, as well as the amount of distributions during a five-year set-aside period.

E. Program-Related Investment

A program-related investment is treated as a qualifying distribution. Such an investment includes a loan, purchase of stock, or other form of investment that is made primarily for charitable purposes. Examples of such investments include loans to small businesses that cannot access commercial lenders; high risk investments in low income housing; an investment in local businesses located in deteriorated communities; or an investment in a successful business made as an inducement to locate a facility in a blighted community.

Generally, such investment would not be made, but for the relationship between the exempt purposes of the foundation and the investment. The recipient of such an investment need not be a tax-exempt organization, so long as the investment is made for charitable purposes.

Income production or appreciation of the investment amount cannot be a significant purpose for the investment. Also, the amount invested cannot be used in lobbying efforts or in a campaign for or against a candidate for public office.

F. Functionally-Related Business

An amount paid by a private foundation to acquire an interest in a “functionally-related” business is treated as a qualifying distribution. A functionally-related business is a trade or business that is related to the exempt purposes of the foundation or an activity that is carried out within a set of larger activities or endeavors, which is related to the exempt purpose of the foundation. Examples include:

- The purchase of stock of a small business investment corporation to assist small businesses in the geographic area served by a foundation.
- The purchase of the stock of a classical music publishing company by a foundation which supported music education.
- The operation of a restaurant for the convenience of visitors to an historic village museum.

Tax Advice Disclosure: To comply with requirements imposed by the IRS under Circular 230, we inform the reader that this communication was not intended or written to be used for the purpose of avoiding penalties under the Internal Revenue Code.

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