The Tax Benefits of Conduit Foundations

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The Distinction Between Public Charities and Private Foundations

Exemption under IRC §501(c)(3) is a powerful tax status—not only does the organization avoid tax on its income, but donors can claim a charitable contribution deduction for gifts made to the organization. Because of the foregone tax revenue, it is important that only those organizations that fit within the narrow limitations of IRC §501(c)(3) are able to obtain and maintain that status. Section 501(c)(3) organizations are further classified as either public charities or private foundations. At the heart of this distinction is the fact that "someone" has to provide a level of oversight, to ensure that the organizations stay within the bounds of their IRC §501(c)(3) status.

Oversight can be exercised by the general public, through the market for services and contributions, or by the government, through regulation.

Public Charities. Certain types of organizations, such as churches, hospitals, and schools, operate within the public eye and are subject to oversight due to the nature of their activities. Some organizations rely on contributions from a wide segment of the public (rather than just a small handful of individuals) or on program-service revenue they receive from the exercise of their tax-exempt functions. These organizations are classified as public charities,[1] in recognition of the fact that—whether by virtue of the organizations' activities or that the public has an interest in protecting its monetary investment—the public has the opportunity and incentive to keep an eye on these organizations and make sure they operate in compliance with their exempt status. If a public charity "steps out of bounds," members of the public respond with their feet or their wallets.

Private Foundations. An IRC §501(c)(3) organization that does not qualify as a public charity is classified as a private foundation.[2] Thus, private foundations are IRC §501(c)(3) organizations that do not carry on activities or rely on donations to the extent that they would invite oversight by the public at large. For example, consider the stereotypical family foundation: an organization funded by a single donor or small handful of donors that carries out its exempt purpose by making grants to other organizations. The general public has neither the opportunity nor any real incentive to keep an eye on the foundation. As a result, in order to ensure that private foundations stay within the bounds of their IRC §501(c)(3) status, they are subject to more restrictions and oversight than public charities are.

Contribution Limitations for Public Charities Compared to Private Foundations

The charitable contribution rules distinguish between public charities and private foundations, providing a stronger incentive for gifts to public charities. In simple terms, gifts of cash to a public charity are deductible to the extent of 50% of an individual donor's adjusted gross income.[3] Gifts of cash to a private foundation are deductible to the extent of 30% of an individual donor's adjusted gross income.[4] Gifts of capital gain property to a public charity are deductible to the extent of 30% of an individual donor's adjusted gross income.[5] Gifts of capital gain property to a private foundation are deductible to the extent of 20% of the donor's adjusted gross income.[6] Gifts of long-term capital gain property to a public charity may give rise to a deduction based on the property's fair market value, while gifts of long-term capital gain property (other than publicly traded stock) to a private foundation give rise to a deduction based on the lower of the property's fair market value or basis in the hands of the donor.[7]

Why to Consider Gifts to a Conduit Foundation

A gift to a conduit foundation is treated as though it had been made to a public charity rather than to a private foundation. Foundations that qualify for this treatment are sometimes referred to as "pass-through foundations." When a foundation qualifies as a conduit foundation:

1. A donor's contributions are deductible to the extent of the percentage limitations applicable to gifts to public charities (50% for gifts of cash; 30% for gifts of capital gain property); and
2. Contributions of long-term capital gain property are deductible to the extent of fair market value rather than the donor's basis.[8]

Specifically, IRC §170(b)(1)(F)(ii) provides that a private foundation that meets the following definition will be treated as a public charity for purposes of the percentage limitation and valuation of contributions:

> A private foundation that not later than the 15th day of the third month after the close of the foundation's taxable year in which contributions are received, makes qualifying distributions that are treated as distributions out of corpus in an amount equal to 100 percent of such contributions, and with respect to which the donor obtains adequate records or other sufficient evidence from the foundation showing that the foundation made such qualifying distributions.

Thus, for the donor to have the benefit of contributing to a conduit foundation, the foundation must make adequate qualify-

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ing distributions out of corpus, and the donor must obtain adequate records of this fact.

Caution: For purposes of determining whether the above test is met, the 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.[9]

A foundation's qualification as a conduit foundation is measured each year, so a foundation might qualify in one year but not a later year. A foundation does not need to obtain preapproval from the IRS in order to qualify as a conduit foundation.

Qualifying Distributions Out of Corpus

Under a rule that should be familiar to most foundations, each year a private foundation must distribute approximately 5% of the value of its nonexempt use assets for IRC §501(c)(3) purposes.[10] These "qualifying distributions" are treated first as being made out of undistributed income from the preceding taxable year, then out of undistributed income from the current taxable year, and finally, out of corpus.[11]

The term "undistributed income" means, for a particular taxable year at any particular time, the amount by which the distributable amount exceeds the qualifying distributions made before such time, out of the distributable amount.[12]

Practice Point: Under IRC §4942(h)(2), in the case of a qualifying distribution that is not treated as made out of the undistributed income of the immediately preceding taxable year, the foundation may elect to treat any portion of the distributions as made either (1) out of the undistributed income of a designated prior taxable year, or (2) out of corpus. Thus, a foundation can choose to correct an underdistribution from a prior taxable year or to facilitate its qualification as a conduit foundation by making a distribution out of corpus.

The choice is made by filing a statement with the IRS during the year in which the qualifying distribution is made or by attaching a statement to the foundation's Form 990-PF, "Return of Private Foundation," 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 Treas. Reg. §453.4942(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.[13]

Example 1: For 2015, the hypothetical Peterson Family Foundation had a distributable amount of $1 million. It does not have any undistributed income for any prior year. The foundation made qualifying distributions totaling $600,000 in 2015. By applying the ordering rules of IRC §4942(h), the foundation determined that the full $600,000 was treated as being distributed out of 2015 undistibuted income. For 2016, the foundation had a distributable amount of $1.2 million and made qualifying distributions totaling $1.5 million. The first $400,000 is treated as being made out of undistributed income for 2015. The remaining $1.1 million is treated as being made out of undistributed income for 2016. For 2017, the foundation has a distributable amount of only $900,000 and makes qualifying distributions totaling $1.15 million. The first $100,000 is treated as being made out of undistributed income for 2016, the next $900,000 as being made out of undistributed income for 2017, and the remaining $150,000 as being made out of corpus.

Example 2: The hypothetical Hand-Up Foundation uses a calendar year. The foundation's distributable amount for 2016 was $500,000, and as of January 1, 2017, the foundation had no undistributed income for 2016. The foundation receives one gift, $350,000 cash, in 2017, and during 2017 distributes a total of $800,000. The first $500,000 distributed is treated as being made out of undistributed income for 2017. The remaining $300,000 is treated as being made out of corpus. In order to qualify as a conduit foundation for 2017, Hand-Up Foundation must make additional qualifying distributions out of corpus in an amount totaling $50,000 by March 15, 2018.

Example 3: If, in Example 2 , the Hand-Up Foundation had had $75,000 of undistributed income for 2016, the $800,000 distributed in 2017 would be treated as follows: The first $75,000 would be treated as being made out of undistributed income for 2016, the next $500,000 as being made out of undistributed income for 2017, and the final $225,000 as made out of corpus. In order for the Hand-Up Foundation to qualify as a conduit foundation for 2017, it must make additional qualifying distributions out of corpus in an amount totaling $125,000 by March 15, 2018.

Practice Point: A foundation does not need to trace specific contributions of property or amounts into which contributed property is converted to specific distributions.[14]

Calculating the Amount That Must Be Distributed

In order for a foundation to qualify as a conduit foundation for a particular year, it must distribute all contributions received during the year by the fifteenth day of the third month after the close of its tax year (i.e., March 15 for calendar year foundations), and those distributions must be treated as made out of corpus. It is important to recognize that a particular contribution does not qualify as a contribution to a public charity merely because the foundation distributes 100% of that contribution. The foundation must make qualifying distributions equal to 100% of all contributions received during the year.[15] However, for purposes of the conduit foundation rules, the term "contributions" does not include bequests, legacies, devises, or transfers within the meaning of IRC §2055 (for public or charitable uses) or §2106(a)(2) (for public, charitable, or religious uses) with respect to which a deduction was not allowed under IRC §170.[16]

Determining Fair Market Value. The fair market value of contributed property, determined as of the date of the contribution, is used to determine whether an amount equal to 100% of contributions received has been distributed. If the foundation sells the property, the fair market value may be reduced by any selling expenses.[17] However, selling expenses aside

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the fair market value of the property at the time it was received by the foundation, not the amount the foundation receives on sale, is the amount that must be distributed.

Example 4: The hypothetical William Smith Foundation was created in May 1, 2015. On that date, Mr. Smith contributed 2,000 shares of stock to the foundation. The shares were valued at $50 per share, making the value of Mr. Smith's gift $100,000. The foundation began selling the shares in small lots. Because of market fluctuations, the price received for certain lots was as low as $35 per share. Ultimately, the foundation received $95,000 for the sale of 2,000 shares. In order to qualify as a conduit foundation, the foundation must timely distribute $100,000 out of corpus, regardless of the fact that it received only $95,000 in sale proceeds.[18] The foundation must use other funds to make up the shortfall.

Practice Point: However, if a foundation receives a contribution of property and, within 30 days thereafter, either sells the property or distributes it in-kind to a public charity, the foundation may choose to use the gross amount received on the sale (less reasonable selling expenses) or the fair market value of the property on the date of the in-kind distribution (as applicable), not the fair market value of the contributed property on the date of contribution (less reasonable selling expenses) as the fair market value of the contributed property.[19] This rule is useful if the value of the property declines between the time it is contributed to the foundation and the time the foundation either sells or distributes it.

Distributions of All Property (But Not All Cash) Permit Deduction Based on Fair Market Value. For purposes of the donor's qualifying for the higher contribution limit normally applicable to gifts to public charities, a foundation must distribute all contributions (cash and property) received in the relevant year. However, for purposes of permitting the donor a deduction based on the fair market value—rather than the basis— of appreciated property, a foundation only needs to distribute all contributions of property received in the year.[20] In such a case, a donor of appreciated property can claim a higher charitable contribution deduction, but the deduction will be limited to 20% of the donor's adjusted gross income.

Any distributions made by a foundation with respect to a particular taxable year are treated as made first out of contributions of property and then out of contributions of cash received by the foundation in such year.[21]

In order to qualify as a conduit foundation, the foundation must timely distribute $100,000 out of corpus, regardless of the fact that it received only $95,000 sale proceeds. The foundation must use other funds to make up the shortfall.

Using Excess Distribution Carryovers to Facilitate Qualification

A private foundation that makes qualifying distributions in excess of the amount required to be distributed may carry over the excess for up to five years.[22] An excess distribution carryover can be applied to reduce the amount required to be distributed in any of the years in the five-year carryover period. A foundation can use excess distribution carryovers to qualify as a conduit foundation.

Example 5: The hypothetical Edwards Family Foundation uses a calendar year. In 2016, it received contributions of cash totaling $200,000. In order to qualify as a conduit foundation for 2016, it must (1) have satisfied its distribution requirement for 2016 by December 31, 2016, (2) have satisfied its 2017 distribution requirement by December 31, 2016, and (3) redistribute $200,000 by March 15, 2017. Rather than actually distribute $200,000 by March 15, 2017, the foundation can apply any unused excess distribution carryovers.[23]

Using Set-Asides to Facilitate Qualification

A foundation may take advantage of the set-aside provisions of IRC §4942(g)(2)[24] to satisfy the conduit foundation requirements.[25] Under IRC §4942 foundations are permitted to meet their minimum distribution requirements by using "set-asides" that were approved in advance by the IRS.[26] To obtain IRS approval, a foundation must establish that (1) the amount set aside will be paid for a "specific project" within five years, and (2) the project is one that can be better accomplished by the set-aside than by immediate payment of funds. The regulations refer to this test as the "suitability test." Newly formed foundations can use the "cash distribution test" to make set-asides without IRS approval. Amounts set aside are treated as qualifying distributions in the year in which they are set aside, but not in the year in which they actually are paid.[27]

Recordkeeping Requirements

A taxpayer claiming a charitable contribution deduction for a gift to a conduit foundation must obtain adequate records or other sufficient evidence (such as a copy of the foundation's Form 990-PF) showing that the foundation made the required qualifying distributions within the required time period. The records or evidence must be attached to the taxpayer's return for the year in which the deduction is claimed. A taxpayer may file an amended return or refund claim if necessary.[28]

The foundation must attach a statement to its Form 990-PF, for the year in which distributions are made.[29]

Conclusion

In order for a private foundation to qualify as a conduit foundation, its managers must do careful planning, and the foundation must make more significant distribu-

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tions than otherwise would be required. However, for a donor who contributes appreciated property to the foundation or who wants to contribute more than 30% (20% in the case of contributions of property) of adjusted gross income and claim a contribution deduction for the current year, the benefits of qualifying as a conduit foundation are significant.

Endnotes

1. IRC §§509(a)(1), 509(a)(2).

2. IRC §509(a).

3. IRC §170(b)(1)(A).

4. IRC §170(b)(1)(B).

5. IRC §170(b)(1)(C).

6. IRC §170(b)(1)(D).

7. IRC §§170(e)(1)(B)(ii), 170(e)(5).

8. IRC §170(b)(1)(F)(ii).

9. Id.

10. See IRC §4942.

11. IRC §4942(h).

12. IRC §4942(c).

13. See Internal Revenue Service, "Ordering of Qualifying Distributions by Private Foundations—Special Choice" (Feb. 9, 2017). Available online at www.irs.gov/charities-non-profits/private-foundations/ordering-of-qualifying-distributions-by-private-foundations-special-choice.

14 Treas. Reg. §1.170A-9(h)(1)(i).

15. Id.

16. Treas. Reg. §1.170A-9(h)(2)(i).

17. Treas. Reg. §170A-9(h)(2)(iv).

18. See PLR 7825004,

19. Treas. Reg. §170A-9(h)(2)(iv).

20. Treas. Reg. §170A-9(h)(2)(i).

21. Treas. Reg. §170A-9(h)(2)(ii).

22. IRC §4942(i).

23. See Jeffrey D. Haskell, "The Conduit Election." Available online at www.foundationsource.com/resources/library/the-conduit-election/.

24. For a detailed discussion of set-asides, see Katherine E. David, "Private Foundations Can Use the Cash-Distribution Test to Make Set-Asides Without Advance IRS Approval," 14(1) Family Found. Adv. 1 (Nov./Dec. 2014); "Using Set-Asides to Meet the Minimum Distribution Requirement," 16(2) Family Found Adv. 3 (Jan./Feb. 2017).

25. Douglas M. Hill & Frances R. Mancino, "Taxation of Exempt Organizations" (Thomson Reuters/Tax & Accounting, 2002 & Supp. 2016-2) ¶9.02[1][a].

26. IRC §4942(g)(2)(B); see also S. Rep. No. 938, 94th Cong., 2d Sess., p. 593. Available online at www.finance.senate.gov/library/reports/committee/index.cfm?PageNum_rs=3& c =94&maxrows=15.

27. Treas. Reg. §53.4942(a)-3(b)(1).

28. Treas. Reg. §170A-9(h)(4).

29. See Internal Revenue Service, "Private Pass-Through Foundation" (Oct. 13, 2016). Available online at www.irs.gov/charities-non-profits/private-foundations/private-pass-through-foundation; Internal Revenue Service, "2016 Instructions to Form 990-PF. Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation," at 32. Available online at www.irs.gov/pub/irs-pdf/i990pf.pdf. ■