

The Ins and Outs of Private Operating Foundations

Introduction

All IRC §501(c)(3) organizations are not created equal (or regulated equally). Although all are exempt from federal income tax, they are further subclassified as public charities or private foundations. The reason for the distinction turns in part on the need to make sure that—in exchange for their tax-exempt status and ability to attract deductible contributions—all IRC §501(c)(3) organizations are subject to oversight that will ensure that they operate consistently with their exempt purpose. In the case of organizations that operate in the public eye—either because of the nature of their activities (churches, hospitals, schools) or the sources of their financial support (publicly supported organizations), the general public has the opportunity and incentive to make certain that the organizations operate in furtherance of their exempt purposes. In contrast, the general public has no real opportunity, or an incentive, to scrutinize the typical grant-making foundation, which is funded by only a small handful of individuals and achieves its exempt purpose through the relatively non-public act of providing support to other organizations. In recognition of the fact that the public “oversees” some IRC §501(c)(3) organizations more than others, the law further classifies these organizations as either public charities or private foundations.

Private foundations are subject to requirements (such as the annual minimum distribution requirement) and restrictions (such as the absolute prohibition on transactions with insiders) that do not apply to public charities. And, the charitable contribution deductions for gifts to public charities are more favorable than those for gifts to private foundations.

Hybrid Nature of Private Operating Foundations

Private operating foundations are classified as private foundations because they do not qualify as public charities on the basis of their activities or sources of support, but they do nonetheless share some traits with

public charities. At a practical level, a private operating foundation is different from a “typical” private foundation, because rather than simply making grants, it engages in the active conduct of its own tax-exempt purpose. For example, while a private foundation might make a grant to a museum, a private foundation that operates a museum that is open to the public could qualify as a private operating foundation.

In recognition of their hybrid nature, the law allows private operating foundations some of the benefits normally reserved for public charities:

- Contributions of cash to private operating foundations are deductible to the extent of 50% (60% for tax years beginning after December 31, 2017) of the donor’s contribution base rather than to the extent of 30% as applies to contributions of cash to non-operating foundations.¹

requirement of IRC §4941 and instead are required to spend an arithmetically derived amount directly for the active conduct of their exempt purposes.⁴

- Private operating foundations may receive qualifying distributions from unrelated private foundations without an expenditure responsibility requirement.⁵

Qualifying as a Private Operating Foundation

In order to be treated as a private operating foundation in a particular taxable year, a private foundation must make a threshold amount of qualifying distributions directly for the active conduct of activities that constitute its exempt purpose (the “Income Test”) and also must satisfy one of three alternative tests: (1) the “Assets Test,” (2) the “Endowment Test,” or (3) the “Support Test.”⁶

*In recognition of their hybrid nature,
the law allows private operating
foundations
some of the benefits normally reserved
for public charities.*

- Contributions of long-term capital gain property to private operating foundations are deductible to the extent of 30% of the donor’s contribution base, rather than just 20% as applies to contributions of long-term capital gain property to non-operating foundations.²

- Contributions of long-term capital gain property to private operating foundations generally are based on the property’s fair market value rather than its basis (as is the case with contributions to non-operating foundations, except in the case of publicly traded securities).³

- Private operating foundations are not subject to the annual minimum distribution

A foundation may satisfy the Income Test and any one of the Assets Test, the Endowment Test, or the Support Test by satisfying such tests for any three taxable years during a four-year period consisting of the taxable year in question and the three immediately preceding taxable years, or on the basis of all pertinent amounts of income or assets held, received, or distributed during the four-year period.

So, for example, for 2018, a private operating foundation may satisfy the Income Test and one of the alternative tests on the basis that it satisfied the required tests for any three of the taxable years 2018, 2017, 2016, and 2015, or on the basis that it sat-

See INS AND OUTS, next page

INS AND OUTS, from page 3

ified the required tests during the period 2015–2018.

Caution: A foundation may not use one method for satisfying the Income Test and a different method for satisfying one of the alternative tests. However, the foundation may use either the three-of-four-years method or the aggregate method in any given reporting year.⁷

The Income Test in Action

The distribution requirement under the Income Test is less onerous than the distribution requirement that applies to private non-operating foundations, which must make qualifying distributions that equal minimum investment return, less certain taxes paid.⁸ Instead, a private operating foundation must make qualifying dis-

tributions directly for the active conduct of its exempt purpose activities in an amount equal to substantially all (defined as 85%) of the lesser of:

- The foundation's adjusted net income; or
- The foundation's minimum investment return.⁹

tributions directly for the active conduct of its exempt purpose activities in an amount equal to substantially all (defined as 85%) of the lesser of:

- The foundation's adjusted net income; or
- The foundation's minimum investment return.⁹

Prior to 1982, in order to satisfy the Income Test, a private foundation was required to make qualifying distributions equal to substantially all of its adjusted net income. The Economic Recovery Tax Act of 1981 liberalized the Income Test for taxable years beginning after December 31, 1981, however, allowing a private foundation to distribute based on the lesser of adjusted net income or minimum investment return. Thus, a private operating foundation with no adjusted net income could satisfy the Income Test even if it did not make any qualifying distributions at all dur-

ing the year.¹⁰ The following examples show how the Income Test works in practice.

Example 1: The hypothetical Bauer Museum, a private operating foundation, calculates the following amounts:

- Adjusted net income: \$100
- Minimum investment return: \$150

In order to satisfy the Income Test, Bauer Museum must make qualifying distributions directly for the active conduct of its exempt purpose in an amount equal to at least \$85 (.85 x \$100).

IRC §4942(j)(3) provides an additional refinement to the Income Test in cases where a foundation's minimum investment return is less than adjusted net income. If the foundation's total qualifying distributions exceed its minimum investment return but are less than adjusted net income, substantially all of the qualifying distribu-

must be made directly for the active conduct of the foundation's exempt purpose.¹¹

Example 2: In a subsequent year, Bauer Museum calculates the following amounts:

- Adjusted net income: \$100
- Minimum investment return: \$80
- Qualifying distributions: \$90

Ordinarily, Bauer Museum would have to make qualifying distributions directly for the active conduct of its exempt purpose in an amount equal to 85% of the lesser of its adjusted net income or minimum investment return (which in this case is \$80, resulting in a distribution requirement of \$68). However, because total qualifying distributions exceed minimum investment return, 85% of the total qualifying distributions (\$76.50) must be made directly for the active conduct of Bauer Museum's exempt purpose.

However, if the foundation's minimum

investment return is less than its adjusted net income and the foundation's qualifying distributions equal or exceed its adjusted net income, only that portion of the qualifying distributions equal to substantially all (85%) of the foundation's adjusted net income must be made directly for the active conduct of its exempt purpose.¹² Stated differently, in no case would a foundation be required to make qualifying distributions directly for the active conduct of the foundation's exempt purpose in an amount greater than 85% of adjusted net income.¹³

Example 3: In a later subsequent year, Bauer Museum calculates the following amounts:

- Minimum investment return: \$100
- Adjusted net income: \$120
- Qualifying distributions: \$150

In order to satisfy the Income Test, Bauer Museum must make at least \$102 (.85 x 120) of its qualifying distributions directly for the active conduct of its exempt purpose.

Practice Point: In sum, the modern Income Test will never yield a distribution requirement that is more onerous than the one that applied prior to 1982: a private foundation will never have to distribute more than an amount equal to 85% of its adjusted net income directly for the active conduct of its exempt purpose, regardless of the total amount of its qualifying distributions.

However, a foundation with a low minimum investment return cannot satisfy the Income Test by making a relatively small amount of direct qualifying distributions (equal to 85% of minimum investment return) while also making substantial non-direct qualifying distributions, because if qualifying distributions exceed minimum investment return, 85% of qualifying distributions must be made directly for the active conduct of the foundation's exempt purpose.

Adjusted Net Income. Adjusted net income is the excess of gross income (including gross income from any unrelated trade or business) determined with certain modifications (See Exhibit 1) over

See INS AND OUTS, next page

Exhibit 1 Income Modifications Used to Calculate Gross Income*

1. Interest on government obligations normally excluded under IRC §103 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.
3. Net IRC §1231 gains are not included, but net IRC §1231 losses may be included if they are otherwise deductible under the adjusted net income rules.
4. Short-term capital losses may not be deducted, carried back, or carried forward.
5. Capital gain dividends received from a regulated investment company are not included.
6. 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 to the extent the amount set aside was not necessary for the purposes for which it was set aside.
7. Gross income does not include the built-in gain on property distributed for an exempt purpose.
8. Income received from an estate during the administration period is not included in the 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.

* See *Treas. Reg. §53.4942(a)-2(d)(2)*; Internal Revenue Service, “Income Modifications—Adjusted Net Income of Private Operating Foundations.” Available at www.irs.gov/charities-non-profits/private-foundations/income-modifications-adjusted-net-income-of-private-operating-foundations.

INS AND OUTS, from page 4

the total deductions (including any deductions directly connected with carrying on any unrelated trade or business) that would be allowed to a taxable corporation, with certain modifications (see Exhibit 2, on page 6). No exclusions, deductions, or credits are allowed for purposes of calculating adjusted net income other than the income modifications and deduction modifications specifically provided.

Gross income does not include gifts, grants, or contributions received by the foundation, but does include income from a functionally related business.¹⁴ No exclusions, deductions, or credits are allowed for purposes of calculating adjusted net income other than the income modifications and deduction modifications specifically provided.¹⁵

Minimum Investment Return. For purposes of the Income Test, a foundation’s minimum investment return is the same as it would be for other purposes under IRC §4942.¹⁶ In general terms, it is equal to 5% of the excess of the aggregate fair market

value of the foundation’s non-exempt use assets over the acquisition indebtedness with respect to such assets.¹⁷ As a practical matter, a private operating foundation may hold a significant portion of its assets for exempt use. For example, a collection of paintings loaned to a museum or displayed in the foundation’s own museum,¹⁸ and an island held by a private foundation to preserve the island’s ecological system and the archeological remains,¹⁹ are used directly in the active conduct of the foundation’s exempt purpose.

Practice Point: The greater the portion of its assets held for an exempt use, the lower the foundation’s minimum investment return, and the higher the likelihood that the foundation will be subject to the Income Test refinement of IRC §4942(j)(3), under which if total qualifying distributions exceed minimum investment return, substantially all qualifying distributions must be directly for the active conduct of the foundation’s exempt purpose.

Distributions Directly for the Active Conduct of a Foundation’s Exempt Purpose. In order to count toward the Income

Test threshold, a distribution must be made directly for the active conduct of the foundation’s exempt purpose. This requirement means that the distributions must be used by the foundation itself rather than by or through a grantee organization.²⁰ Grants made to other organizations, to assist them in accomplishing their own exempt purposes, are considered an indirect, rather than a direct means of carrying out the grantor foundation’s exempt purpose.

Practice Point: From time to time, foundations that want to fund a particular academic’s research make grants to the institution (such as a university) with which the researcher is affiliated. Because these grants are made to an organization, rather than to an individual, they do not count as qualifying distributions made directly for the active conduct of the foundation’s exempt purpose. In order for these grants to count toward the Income Test, the foundation must make the grants directly to the individual researcher, in accordance with the rules set forth below, under the subheading “Grants to Individuals.” In completing

See INS AND OUTS, next page

Exhibit 2 Deduction Modifications Used to Calculate Gross Income*

For purposes of calculating adjusted net income, deductions 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 compensation of officers and other salaries and wages of employees, interest, rent, and taxes paid or incurred for the production or collection of income.

When only part of the foundation's property is income-producing or held for the production of income, and the remainder is used for exempt purposes, the allowable deductions must be divided between exempt and non-exempt uses.

Example A: The hypothetical Edwards Family Foundation operates out of a converted residence. One portion of the residence is used to operate the Foundation's grant-making activities, and another portion of the residence is used to manage the Foundation's investments and rental real estate. The expenses associated with the portion of the building used for grant-making are not deducted for purposes of calculating the foundation's adjusted net income.

Note: If the expenses for property used for an exempt purpose exceed the income derived from such property, the excess is not allowed as a deduction for purposes of calculating adjusted net income but may be treated as a qualifying distribution.

Example B: The hypothetical Davis Arts Foundation operates a performing arts theater as part of its exempt purpose. The expenses of operating the theater exceed the income generated by the theater. These excess expenses are not allowed as a deduction for purposes of calculating the foundation's adjusted net income but may be treated as qualifying distributions.

Allowances for straight line depreciation and depletion (other than percentage depletion) are deductible. Use of the accelerated cost recovery system is not permitted. Deductions for expenses and interest paid or incurred to carry tax-exempt obligations are allowed.

* See *Treas. Reg. §53.4942(a)-2(d)(2), (4); Internal Revenue Service "Deduction Modifications—Income Test—Private Operating Foundation Status."* Available at www.irs.gov/charities-non-profits/private-foundations/deduction-modifications-income-test-private-operating-foundation-status.

INS AND OUTS, from page 5

Part XIV of its Form 990-PF, the foundation should take care to ensure that grants to organizations (even if used to fund the

- Amounts paid to acquire or maintain assets used directly in the conduct of the foundation's exempt activities, such as the operating assets of a museum, park, or historic site;

In completing Part XIV of its Form 990-PF, the foundation should take care to ensure that grants to organizations (even if used to fund the work of a particular researcher) are reported as qualifying distributions not used directly for the active conduct of exempt activities.

work of a particular researcher) are reported as qualifying distributions not used directly for the active conduct of exempt activities.

Examples of distributions made directly for the active conduct of a foundation's exempt purpose include:

- Reasonable administrative expenses, such as staff salaries, traveling expenses, and other operating costs required to conduct exempt activities (regardless of whether these expenses and costs are "directly for the active conduct" of exempt activities).
- Caution:** Administrative expenses and

operating costs that are not attributable to exempt activities, such as expenses in connection with the production of investment income, are not treated as such qualifying distributions. Expenses attributable to both exempt and nonexempt activities must be allocated between the two types of activities on a reasonable and consistent basis.

- Amounts set aside for specific projects to be used directly for the active conduct of the foundation's exempt activities, if the set-aside meets the requirements of *Treas. Reg. §53.4942(a)-3(b)*²¹;
- Payments of the IRC §4940 tax on net investment income²²;
- Certain grants to individuals (discussed below).

Grants to Individuals. If a foundation awards grants, scholarships, or other payments to individual beneficiaries (including program-related investments made to individuals or corporate enterprises) to sup-

See INS AND OUTS, next page

INS AND OUTS, from page 6

port active programs to carry out the foundation's exempt purpose, these payments will be treated as qualifying distributions made directly for the active conduct of the foundation's exempt purpose *so long as* the foundation—apart from making or awarding the grants, scholarships, or other payments—otherwise maintains some significant involvement in the active programs in support of which the payments were made.²³ In contrast, an organization that provides scholarships to individuals without otherwise conducting educational activities of its own is not a private operating foundation.²⁴

A foundation is considered to maintain a “significant involvement” in the programs in the following situations:

- *Relief of Poverty or Distress:* (1) An exempt purpose of the foundation is the relief of poverty or human distress, and its exempt activities are designed to ameliorate conditions among a poor or distressed class of persons or in an area subject to poverty or natural disaster; (2) the making or awarding of grants or other payments to accomplish this exempt purpose is direct, and without the assistance of an intervening organization or agency; and (3) the foundation maintains a salaried or volunteer staff of administrators, researchers, or other personnel who supervise and direct these activities on a continuing basis.²⁵
- *Specialized Skills, Expertise, or Involvement:* (1) The foundation has developed some specialized skills, expertise, or involvement in a particular discipline or substantive area (such as scientific or medical research, social work, education, or the social sciences); (2) it maintains a salaried staff of administrators, researchers, or other personnel who supervise or conduct programs or activities that support and advance the foundation's work in the particular area; and (3) as a part of such programs or activities, the foundation makes or awards grants, scholarships, or other payments to individuals to encourage and further their involvement in the area of interest and in some segment of the programs or activities car-

If a foundation does not do more than select, screen, or investigate applicants for grants or scholarships, pursuant to 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 purpose.

ried 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 that are under the general direction and supervision of the foundation).²⁶

Example 4: The private foundation described in **PLR 9203004** (August 9, 1991) was organized to provide assistance to needy individuals engaged in the fishing industry. The foundation makes direct distributions to individuals and to publicly supported organizations that assist individuals for such purposes as helping sick fishermen pay boat insurance and electrical bills, make mortgage payments, purchase furniture, and pay for home repairs, rent, and food. The foundation maintains a staff of volunteer and salaried workers, including a nurse and licensed social work-

ers, who are experienced in helping individuals in need. Clients are referred to the foundation by social service agencies. The foundation provides ongoing counseling and assistance, and refers clients to other social services agencies. It often follows recipients for several years, including by making home visits, and maintains follow-up procedures to keep track of clients. The IRS ruled that because (1) the foundation's assistance was targeted to an area and industry that suffered from chronic unemployment; and (2) the foundation maintained an ongoing relationship with many of its clients, providing them with a variety of assistance programs based on their individual circumstances, the foundation's grants and other forms of assistance were qualifying distributions made directly for the active conduct of the activities constituting its exempt purposes.

Caution: If a foundation does not do more than select, screen, or investigate applicants for grants or scholarships, pursuant to 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 purpose. However, the administrative expenses of such screening and investigation (as opposed to the grants or scholarships themselves) may be treated that way.²⁷

The Alternative Tests

As noted above, in addition to the Income Test, a private operating foundation must satisfy either the Assets Test, the Endowment Test, or the Support Test, which are described below.

The Assets Test. A foundation satisfies the Assets Test if substantially more than half (65% or more) of its assets:

1. Are devoted directly to any combination of the active conduct of activities constituting the foundation's exempt purpose, or functionally related businesses;
2. Are stock of a corporation that is controlled by the foundation and substantially all of the assets of which are devoted to the purposes in Point 1; or

See INS AND OUTS, next page

INS AND OUTS, from page 7

3. Are in part assets that are described in Point 1 and in part assets that are described in Point 2.²⁸

Whether a particular asset is devoted directly to the active conduct of activities constituting the foundation's exempt purpose is a question of fact. Examples of assets that would meet the Assets Test are a museum's exhibition building and permanent collection; research facilities and scientific patents; and kitchen facilities and food delivery trucks used to provide meals to the indigent. Generally, assets held for

foundation is not treated as an asset devoted directly to the foundation's exempt purpose.³¹

Example 6: The hypothetical Jones Research Foundation sets aside the sum of \$1 million, to be used to construct a new laboratory facility where the foundation will conduct its research activities. Although the \$1 million set-aside counts as a qualifying distribution for purposes of the Income Test, it does not count toward the requirements of the Assets Test.

The Endowment Test. The Endowment Test is similar to the Income Test, and many organizations that meet the

1. 85% or more of the foundation's support (other than gross investment income) is normally received from the general public and from five or more exempt organizations that are not commonly controlled or related to one another or to the recipient foundation;
2. Not more than 25% of the foundation's support (other than gross investment income) is normally received from any one such exempt organization; and
3. Not more than half of the foundation's support is normally received from gross investment income.³⁴

"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.³⁵

Support From Other Exempt Organizations. For purposes of the first requirement, the support received from any one exempt organization may be counted toward the support test only if the foundation receives support from five or more exempt organizations.³⁶

Example 7: The hypothetical Phillips Foundation normally receives 20% of its support (other than gross investment income) from each of five exempt organizations but does not receive any support from the general public. The Phillips Foundation may satisfy the Support Test. If the Phillips Foundation normally received 10% of its support from each of only three exempt organizations, however, and the balance of its support from other sources, the support from the three exempt organizations could not be taken into account for purposes of the Support Test.

Support From the General Public. "Support" received from an individual, a trust, or a corporation (other than an exempt organization) is taken into account as support from the general public only to the extent that the total amount of support received from that source during the measurement period does not exceed 1% of the foundation's total support (other than

See INS AND OUTS, next page

Generally; assets held for the production of income (including offices for employees engaged in the management of the foundation's endowment funds) are not considered devoted directly to the foundation's exempt purpose.

the production of income (including offices for employees engaged in the management of the foundation's endowment funds) are not considered devoted directly to the foundation's exempt purpose. If property is used for both exempt and non-exempt purposes, and if the exempt use represents 95% or more of the total use, the property will be considered as used exclusively for an exempt purpose.²⁹

Caution: Assets that are held for purposes of extending credit or making funds available for a charitable class are not considered assets devoted directly to the active conduct of activities constituting the foundation's exempt purpose.³⁰

Example 5: The hypothetical Hand-Up Foundation maintains a reserve account used to guarantee student loans made by a lending institution. The funds in the reserve account are not devoted directly to the active conduct of Hand-Up Foundation's exempt purpose. While this amount might constitute a "program related investment," such that it is not taken into account for purposes of calculating the foundation's minimum investment return, it does not count toward the requirements of the Assets Test.

Further, an amount that is set aside by a

Income Test will also meet the Endowment Test.³² Put simply, the Endowment Test requires that a foundation normally make qualifying distributions directly for the active conduct of its exempt purpose in an amount not less than two-thirds of its minimum investment return.

As stated earlier, the mandatory income test requires a foundation to make qualifying distributions directly for the active conduct of its exempt purpose in an amount equal to at least 85% of the lesser of adjusted net income or minimum investment return. Because the Income Test is more stringent than the Endowment Test, so long as a foundation's adjusted net income is higher than its minimum investment return, the Endowment Test automatically will be satisfied if the Income Test is satisfied and the minimum investment return is less than, equal to, or no more than 27.5% greater than the foundation's adjusted net income. Only where a foundation's adjusted net income is significantly less than its minimum investment return does the Endowment Test have independent significance.³³

The Support Test. The Support Test is met if the following three requirements are satisfied:

INS AND OUTS, from page 8

gross investment income) during that period.

In applying the 1% limitation, all support received by the foundation from any one source, and from any other person that is a disqualified person under IRC §§4946(a)(1)(C) through 4946(a)(1)(G) are treated as received from one source. Support received from a governmental unit is treated as support from the general public but is not subject to the 1% limitation.³⁷

Practice Point: A private foundation that satisfies the Support Test is likely to qualify as a public charity under IRC §501(a)(1)/IRC §170(b)(1)(A)(vi) or IRC §509(a)(2). In such case, the foundation might be better served by filing Form 8940, Request for Miscellaneous Determination, to terminate its private foundation status under IRC §507(b)(1)(B) and become a public charity.

Application of the Operating Foundation Tests to New Organizations

Any organization that is applying for recognition of exemption under IRC §501(c)(3) may submit information that it is a private operating foundation. In accordance with Part X of Form 1023, the foundation should include supporting information needed to confirm the determination, along with 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 a private 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.³⁸

A new foundation ordinarily will be treated as a private operating foundation only if it has satisfied the Income Test and one of the three alternative 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. But it will continue to be treated as an operating foundation for its second and third years only if it satisfies the tests by the combination method (taking all three years into account) for the first three years.³⁹

In the alternative, a foundation will be treated as an operating foundation before the end of its first tax year if it makes a good-faith determination that it is likely to meet the Income Test and one of the three alternative tests for its first taxable year. A good faith determination ordinarily will be treated as made if it is based on an affidavit or opinion of counsel that the requirements will be satisfied. The affidavit or opinion must set forth sufficient facts concerning the foundation's operations and support for the IRS to be able to determine that the foundation is likely to satisfy the requirements.

If an organization that has been treated as a private operating foundation for its first tax year ultimately fails to meet the requirements for its first tax year, it will be treated as a private non-operating foundation as of the first day of its second taxable year, unless it can establish that it is likely to qualify as an operating foundation on the basis of its second, third, and fourth taxable 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 three-out-of-four-year method or the four-years-combined method.⁴⁰

Conclusion

Private operating foundation status requires a meaningful departure from the activities of a typical grant-making family foundation, as well as vigilance to ensure continued compliance with the Income Test and one of the three alternative tests. However, the tax benefits—and the satisfaction that comes from performing exempt activities in a more direct manner—may justify the investment for some family foundations.

Endnotes

1. IRC §170(b)(1)(A)(vii).
2. IRC §170(b)(1)(C).
3. IRC §170(e)(1)(B).
4. IRC §4942(a)(1).
5. IRC §4942(g)(1)(A)(ii).
6. IRC §4942(j)(3).

7. Treas. Reg. §53.4942(b)-3(a).

8. IRC §4942(d).

9. IRC §4942(j)(3)(A).

10. See Internal Revenue Service, "Private Operating Foundations," 1984 EO CPE Text. Available at www.irs.gov/pub/irs-tege/eotopicn84.pdf.

11. IRC §4942(j)(3).

12. Treas. Reg. §53.4942(b)-1(a)(1)(ii).

13. See Internal Revenue Service "Private Operating Foundations," *supra* note 10.

14. Treas. Reg. §53.4942(a)-2(d)(1).

15. See Internal Revenue Service, "Adjusted Net Income Defined." Available at www.irs.gov/charities-non-profits/private-foundations/adjusted-net-income-defined.

16. See Treas. Reg. §53.4942(b)-1(a)(1)(ii).

17. Treas. Reg. §53.4942(a)-2(c).

18. See Rev. Rul. 74-498, 1974-2 C.B. 387.

19. See Rev. Rul. 75-207, 1975-1 C.B. 361.

20. Treas. Reg. §53.4942(b)-1(b)(1).

21. *Id.*

22. Treas. Reg. §53.4942(b)-1(b)(3).

23. Treas. Reg. §53.4942(b)-1(b)(2).

24. See Treas. Reg. §53.4942(b)-1(d), Example (10).

25. Treas. Reg. §53.4942(b)-1(b)(2)(ii)(A).

26. Treas. Reg. §53.4942(b)-1(b)(2)(ii)(B).

27. Treas. Reg. §53.4942(b)-1(b)(2)(i).

28. Treas. Reg. §53.4942(b)-2(a)(1).

29. See Treas. Reg. §53.4942(b)-2(a)(2); Internal Revenue Service "Private Operating Foundations," *supra* note 10.

30. Treas. Reg. §53.4942(b)-1(b)(2)(ii).

31. *Id.*

32. Internal Revenue Service "Private Operating Foundations," *supra* note 10.

33. See Treas. Reg. §53.4942(b)-2(b); Internal Revenue Service "Private Operating Foundations," *supra* note 10.

34. Treas. Reg. §53.4942(b)-2(c)(1).

35. See Internal Revenue Service, "Private Operating Foundation—Support Test." Available at www.irs.gov/charities-non-profits/private-foundations/private-operating-foundation-support-test.

36. Treas. Reg. §53.4942(b)-2(c)(2)(iii).

37. Treas. Reg. §53.4942(b)-2(c)(2)(iv).

38. See IRS, "Private Operating Foundations—New Organizations." Available at www.irs.gov/charities-non-profits/private-foundations/private-operating-foundations-new-organizations.

39. Treas. Reg. §53.4942(b)-3(b)(1).

40. Treas. Reg. §53.4942(b)-3(b)(2). ■



Authorized Electronic Copy

This electronic copy was prepared for and is authorized solely for the use of the purchaser/subscriber. This material may not be photocopied, e-mailed, or otherwise reproduced or distributed without permission, and any such reproduction or redistribution is a violation of copyright law.

For permissions, contact the [Copyright Clearance Center](http://www.copyright.com/) at <http://www.copyright.com/>

You may also fax your request to 1-978-646-8700 or contact CCC with your permission request via email at info@copyright.com. If you have any questions or concerns about this process you can reach a customer relations representative at 1-978-646-2600 from the hours of 8:00 - 5:30 eastern time.