Current Developments, Cases, Analysis, Planning Advice

FAMILY FOUNDATION Advisor

September/October 2007 • Volume 6 / No. 6 • ISSN 1537-9485

IN THIS ISSUE

When and How to Use the Conduit Foundation Election

By Laura H. Peebles, CPA/PFS*

[***Editor's Note:*** *One of the more obscure choices available to a family foundation is the election to be treated as a so-called "conduit foundation" for a particular taxable year. And yet that election can be very useful in certain planning situations. In this piece, Laura Peebles reviews some of the situations in which the conduit foundation election can be useful.*]

The Conduit Foundation

Most advisors would agree that charitable planning can be an unforgiving process, and mistakes can be easy to make. Rarely does one get a second chance. Once a donation has been made, there is usually little one can do to alter either the donation or the tax consequences that follow. One exception to this principle is the "conduit election" which a private foundation may make to allow its donors a full fair market value deduction for any capital assets donated. Neither the Code nor the Regulations use the phrase "conduit foundation," but it is certainly more succinct to describe it as such rather than using its full technical definition from IRC §170(b)(1)(F)(ii):

> any other private foundation (as defined in section 509(a)) which, 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 (as defined in section 4942(g), without regard to paragraph (3) thereof), which are treated, after the application of section 4942(g)(3), as distributions out of corpus (in accordance with section 4942(h)) in an amount equal to 100 percent of such contributions, and with respect to which the taxpayer obtains adequate records or other sufficient evidence from the foundation showing that

See CONDUIT FOUNDATION, next page

Foundations and Politics

Election-Year Guidance From IRS on Permissible Political Activity

By Jerry McCoy, LL.B, LL.M.

As anyone who has a television set or a newspaper subscription knows, the 2008 election season is already upon us, even though it's well over a year until the election. For IRC §501(c)(3) organizations, it's important to remember again that they are not permitted to participate in, or intervene in, any political campaign on behalf of (or in opposition to) any candidate for public office. For family foundations (and indeed all private foundations), there is also the parallel prohibition in IRC §4945(d)(2) forbidding expenditures to influence the outcome of any specific public election, or to carry on, directly or indirectly, any voter registration drive (except for the nonpartisan activities permitted under IRC §4945(f)).

See ELECTION GUIDANCE, page 13

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CONDUIT FOUNDATION, from page 1

the foundation made such qualifying distributions.

We refer here to such foundations as conduit foundations, but they are also referred to as pass-through foundations or distributing foundations. The term "conduit" is a shorthand description of the underlying concept. Contributions to public charities receive more favorable treatment than do contributions to private foundations as a general matter. The theory is that a public charity is usually more active in its operations, so that the contributions they receive pass more directly into the charitable stream than those of foundations, which customarily build up an endowment and make distributions out of income received. Of course, those are only generalizations, as many public charities use contributions to build up endowments and many foundations distribute the bulk of their contributions received, but that was the theory when the public charity/private foundation dichotomy was created in 1969.

Carrying that 1969 generalization to its logical conclusion, one can understand why Congress extended the contribution deduction benefits of the public charity to a private foundation that quickly distributed the contributions received to a public charity. The contributions to the conduit foundation end up in the hands of a public charity soon—within 2½ months after the close of the foundation's taxable year—so they are only slightly delayed in their passage to a public charity. Under these circumstances, Congress felt an exception was justified.

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Of course, this is something of a generalization, because the requirement for qualification as a conduit foundation is only that the timely distributions by the foundation be "qualifying distributions" for purposes of the minimum distribution requirement of IRC §4942. That definition requires only a distribution made to accomplish charitable purposes, a category that is not limited to grants to public charity. Nevertheless, it helps understand why this rule was enacted.

When the Election Is Useful

When may it be useful for a donor to consider having his or her private foundation make this election? The most common situation for the election is when donors discover, after they have irrevocably donated an asset to a private foundation, that the deduction will limited to the basis of the property by IRC §170(e)(1)(B)(ii). This mistake is often encountered when the donors own restricted stock or publicly traded partnership units that they thought would be appropriate for donation to a foundation. Unfortunately, IRC § 170(e)(5) allows a fair market value deduction only for "stock for which market quotations are readily available," and that necessarily excludes other publicly traded *securities*, such as bonds or partnership units. One potential source of this confusion may be the qualified appraisal rules for charitable donations. The definition in the exception to the required appraisal rules, Treasury Regulations §1.170A-13(c)(7)(xi), refers to publicly traded securities—which is certainly a broader category than "stock." Restricted stock would never qualify as

See CONDUIT FOUNDATION, page 11

FAMILY FOUNDATION *Advisor*

Family Foundation Adviser (ISSN: 1537-9485) is published bi-monthly by Civic Research Institute, Inc., 4478 U.S. Route 27, P.O. Box 585, Kingston, NJ 08528. Periodicals postage paid at Kingston, NJ and at additional mailing office (USPS # 0013-979). Subscriptions: $224.95 annually in the United States and Canada. $30 additional per year elsewhere. Vol. 6, No. 6, September/October 2007. POSTMASTER: Send address changes to Civic Research Institute, Inc., P.O. Box 585, Kingston, NJ 08528.

CONDUIT FOUNDATION, from page 2

"publicly traded" unless a special agreement is entered between the donor and the foundation in advance.[1]

Typically, by the time the problem is discovered, the donated property has been sold by the foundation. The donors will typically ask their advisor, "Well, is there anything we can do to save the deduction?" (The donors usually have something in mind like undoing the donation and giving the asset to another charity.)

Another characteristic setting for a conduit election is conduit foundation that is planned from the outset. This is often considered when a donor is about to incur substantial taxable income, such as from the sale of a business. He or she wants to make a significant donation, perhaps to his or her alma mater, but is so distracted by all the details of the sale that there is not sufficient time to negotiate the terms of the donation (i.e., name on building and terms of scholarship fund). The asset to be sold can be donated to the donor's family foundation, and the donation terms can be negotiated later, after the deal is done. As long as the distribution deadline is met, the tax deduction can be preserved.

Assuming that the donor's foundation is willing to part with the value of all property donated during the year, or has sufficient excess distribution carryforwards, the conduit election can preserve the fair market value deduction for the property donation, assuming the property donated is long-term capital gain property.[2] The election will also raise the level of deduction allowed for donations of property "other than long-term capital gain property" from 30% of adjusted gross income to 50% of adjusted gross income. Typically, this limitation applies to cash gifts, but it can also include short-term capital gain property, or property that would have been sold at a loss on the date of donation. Of course, if the permanent funding of the family's foundation is more important than the current income tax deduction, then the property should stay where it is, reduced tax deduction notwithstanding.

How Much to Distribute?

Assuming that the donor's foundation is willing, what amount has to be transferred out of the foundation, what are the deadlines for distributing it, and what type of charities qualify to receive the distribution?

To qualify for the conduit election, the foundation must have no undistributed minimum payments at the end of the election year.

An amount equivalent to the value of all property donated must be transferred no later than the 15th day of the third month after the close of the foundation's taxable year in which it received the donation.[3] No tracing of specific funds is required.[4] This amount may be reduced to the extent that the foundation already has excess distribution carryforwards, and it must be increased by the amount of any outstanding undistributed minimum distributions from prior years. For example, if a calendar-year foundation receives a donation of $500,000 of appreciated property in March 2007, has a minimum distribution requirement of $600,000 for 2007, and makes grants during 2007 to qualified charities of $900,000, it must make an additional $200,000 distribution by March 15, 2008, to qualify as a conduit foundation for 2007. If the foundation had an undistributed amount of $100,000 showing on its 2006 Form 990-PF, then it would need to distribute $300,000 by March 15 of 2008.

Could the foundation wait until 2008 and then distribute the entire required amount? No, because to qualify for the conduit election, the foundation must have no undistributed minimum payments at the end of the election year.[5] Thus, although any additional amounts can be distributed after the close of the year, the foundation must meet its minimum distribution requirements before the end of the year. In the example above, the foundation had a minimum requirement of $600,000, and that much must be distributed before December 31, 2007. However, the foundation may count excess amounts distributed in prior years toward that minimum. If the foundation had excess distributions of $150,000 on December 31, 2006, it could count that toward its minimum distribution for 2007. To qualify as a conduit foundation, the foundation would only have to distribute an additional $50,000 before March 15.[6]

What if the foundation had $1.5 million of excess distributions on December 31, 2006? Could it make an election to treat $500,000 of its prior excess distributions as "out of corpus," thereby qualifying as a conduit foundation without any distributions at all? Yes, it can.[7] It would reduce its carryover by $500,000 allocated to corpus and absorb $600,000 as the 2007 minimum distribution, leaving $400,000 excess distributions available for the future. No additional cash distributions by the foundation during the year would be required.

The election is made annually, so making the election once does not affect any future years. It is not possible to make a partial conduit foundation election with respect to only certain property donations. For example, if real estate and publicly traded stock were donated in the same year, the foundation cannot elect to distribute the value of the real estate and keep the value of the stock in the foundation. However, if the foundation received both cash and long-term capital gain property, it may distribute the value of the property, and not distribute the cash. The donor then may deduct the full value of the property donation, but the cash deduction limitation remains at 30% of his or her adjusted gross income.[8]

Because to qualify as a conduit foundation, the foundation must distribute all donations[9] received during the year, fiscal-year foundations can be a problem or can provide additional opportunities. A foundation cannot prove that it has met the criteria of distributing all donations received until after its year has ended. If a foundation has a November 2007 year-end and receives a contribution in December 2006, it will not be able to prove that it has distributed all contributions received until November 2007, which is too late for the filing of the donor's 2006 tax return. The donor will need to file an amended return after the close of the foundation's year.[10]

For newly established foundations, a fiscal year may be needed to achieve conduit

See CONDUIT FOUNDATION, next page

CONDUIT FOUNDATION, from page 11

status. If a foundation is established near calendar year-end, and the problem with the tax deduction is discovered during tax preparation the following spring, the foundation may select a fiscal year ending in a later month. This allows time to calculate the required minimum distribution plus the amount needed to satisfy the conduit requirement.

In determining the amount that must be distributed, "reasonable selling expenses" actually incurred may be deducted from the value of the property contributed when determining the amount. If the property donated is sold or transferred to charity within 30 days of the donation, the foundation may chose to treat the proceeds of the sale (or value on date of distribution) as if that were the value on date of donation.[11] Especially in the case of real estate, where selling expenses can be substantial, or assets with fluctuating value (such as traded option contracts), this choice allows the foundation to distribute the net value received rather than dipping into other funds to make the required distribution.

What Donees Qualify?

So now we know when the distributions must be made, and how much. What about donees? Can the foundation make grants to any charity to satisfy these requirements? Not quite. The recipient charity must be a public charity or a private operating foundation. Also, the recipient charity cannot be controlled by disqualified persons[12] with respect to the distributing foundation.[13] So, a redistribution to an operating foundation controlled by the same family as the distributing foundation cannot cure a mistaken donation—even though the original donation would have qualified for a fair value deduction if it had originally been made to the operating foundation.

At the time of this writing, there was no prohibition against the distribution being made to a donor-advised fund at a community foundation or elsewhere. Indeed, these have been very popular destinations for conduit funds. The conduit distribution may have to be made with very little notice if the deduction problem is discovered after the end of the foundation's tax year. Transfer to a donor-advised fund can give the foundation some breathing room to properly consider grant applications, but this should be used only in an emergency and not as a general operating policy. Congress in the Pension Protection Act of 2006 directed the Treasury Department to prepare a report on a number of donor-advised fund issues, with a view to possible future legislation in addition to the restrictions imposed on such funds in 2006. As critics of donor-advised funds had suggested that charitable contributions were sometimes improperly "parked" with donor-advised funds, some scrutiny of foundation distributions to such funds would not be unexpected.

The Pension Protection Act of 2006 made another change that affects the permissible donees of a conduit foundation. Effective August 17, 2006, distributions to certain supporting organizations (which are public charities pursuant to IRC §509(a)(3) are no longer treated as qualifying distributions under §4942. The affected categories are (1) non-functionally integrated Type III supporting organizations (as defined in IRC §4943(f)(5)); and (2) any other supporting organization if a disqualified person of the distributing private foundation directly or indirectly controls the supporting organization or one of its supported organizations or if the IRS issues regulations indicating that a distribution to the supporting organization is inappropriate. See IRC §§4942(g)(4)(A) and 4942(g)(4)(B).

How to Make the Election

Because the election is actually made on the foundation's return, not the donor's, it is important to get this right. The election is made by attaching a plain paper election to the 990-PF, referenced to Lines 4c or 7 of Part XIII and referring to the correct regulations section. If the foundation is treating current year distributions as corpus, then the election is attached to line 4c and refers to Treas. Reg. §53.4942(a)-3(d)(2). If the foundation is recharacterizing prior-year excess distributions as corpus, then the election is attached to line 7 and refers to Treas. Reg. §53.4942(a)-3(c)(2). Entering the amounts paid out of corpus on the correct lines of Part XIII is insufficient: The narrative election must be attached for it to be effective.[14]

The donor must obtain verification that the foundation has made the election, and must attach evidence of the qualifying distributions to their tax return.[15] The regulations do not specify the nature of the evidence to be attached. It is the author's practice to attach a copy of Part XIII of the Foundation's 990-PF, a copy of the election itself, and copies of canceled checks, brokerage statements, or other financial records showing the transfers to qualifying charities. If it is not clear on the attachments, of course, the name and identifying number of the foundation should be included. If the evidence is not available at the time the donor's return is due because the foundation's year has not yet ended, the donation and the evidence can be included on an amended return.[16]

Although not likely to be an everyday occurrence, the conduit election provides a means to maximize the tax benefit of a donation, and one of the rare times that the Code allows the taxpayers and their advisors the benefit of 20/20 hindsight.

Footnotes

[1] *See PLRs 9746050, 9734034, and 199915053.*

[2] *IRC §170(b)(1)(C)(iv).*

[3] *Treas. Reg. §1.170A-9(g)(1).*

[4] *Treas. Reg. §1.170A-9(g)(2)(iii).*

[5] *Treas. Reg. §1.170A-9(g)(1)(ii).*

[6] *$600,000 minimum distribution, reduced by $150,000 carryover leaves $450,000 to be distributed in 2006. $900,000 distributed is applied first to 2006 required distributions, with the remaining $450,000 applied toward the required distribution of corpus for the conduit election. As the donation was $500,000, the difference is only $50,000.*

[7] *Treas. Reg. §1.170A-9(g)(2)(v).*

[8] *Treas. Reg. §1.170A-9(g)(2)(i).*

[9] *"Donations" does not include bequests or similar transfers where no §70 deduction was allowed (Treas. Reg. §1.170A-9(g)(2)(i)).*

[10] *Treas. Reg. §1.170A-9(g)(4).*

[11] *Treas. Reg. §1.170A-9(g)(2)(iv).*

[12] *IRC §4946.*

[13] *Treas. Reg. §1.170A-9(g)(1).*

[14] *2006 Form 990-PF instructions, p. 27.*

[15] *Treas. Reg. §1.170A-9(g)(4).*

[16] *Id.* ■

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