N. PRIVATE OPERATING FOUNDATIONS

1. Introduction

In the Tax Reform Act of 1969, Congress not only created a number of distinctions between public charities and private foundations, it also introduced the subclassification private "operating foundation". A private operating foundation is a foundation that enjoys certain advantages available to public charities, but in all other respects is treated as a private foundation.

These organizations are called private operating foundations because they are private foundations that actively conduct their own charitable, educational, or other exempt programs and activities. Examples of operating foundations include museums, zoos, research facilities, libraries, etc. In contrast, a private foundation that principally provides grants to other entities or to individuals for charitable or other exempt purposes would not qualify as an operating foundation, and instead would be called a "nonoperating foundation".

This topic describes private operating foundations as they currently exist. The proposed Tax Reform Act of 1983 (H.R. 4170) may significantly change the rules governing these organizations. For a discussion of the proposed legislation, see page 301.

2. Advantages of Operating Foundation Status

Operating foundations are subject to all rules applicable to nonoperating foundations except as specifically provided in the Internal Revenue Code and applicable regulations. Thus, the taxes and requirements of IRC 4940, 4941, 4943, 4944, and 4945 are fully applicable to operating foundations as well as nonoperating foundations. The differences in treatment are outlined below.

A. An operating foundation is not subject to the IRC 4942 taxes on failure to distribute income.

Congress enacted IRC 4942 in order to provide an objective formula by which private foundations would be required to distribute an ascertainable minimum amount of their income for charitable or other exempt purposes. Prior to 1969, only subjective distribution requirements existed and some organizations exempt under IRC 501(c)(3) transferred little, if any, of their income to charitable causes.

Under the provisions of IRC 4942(a)(1) and IRC 4942(b), operating foundations are not subject to the initial and additional taxes under IRC 4942 for failure to distribute income to which nonoperating foundations are subject. Operating foundations, however, must continue to meet other distribution requirements in order to maintain their status as operating foundations. While these requirements will be discussed later, the significant advantage for operating foundations is that their distributions may be used internally to finance their own charitable programs and activities, while a nonoperating foundation must make its distributions outside the organization.

B. <u>Contributions to operating foundations are deductible to taxpayers on the same basis as contributions to public charities.</u>

Under IRC 170(b)(1)(A)(vii) and IRC 170(b)(1)(D)(i), contributions by individuals to operating foundations are deductible up to 50% of the taxpayer's adjusted gross income for the taxable year. Unused deductions for contributions in excess of the 50% limitation can be carried forward to succeeding taxable years under IRC 170(d)(1). In these respects, operating foundations are on an equal footing with public charities. On the other hand, except in the very narrow circumstances described in IRC 170(b)(1)(D)(ii) and (iii), contributions by individuals to nonoperating foundations are subject to a 20% limitation under IRC 170(b)(1)(B). Further, deductions for contributions of amounts in excess of the 20% limitation cannot be carried forward to subsequent years.

Likewise, deductions for contributions of capital gain property to nonoperating foundations by individuals or corporations are subject to a reduction under IRC 170(e)(1)(B)(ii). A deduction for the same contribution to an operating foundation or to a public charity would not be reduced under that provision.

Many of these contribution provisions may be modified upon passage of the Tax Reform Act of 1983.

C. <u>An operating foundation may receive qualifying distributions from other private foundations</u>

Under the minimum distribution formula of IRC 4942, a nonoperating foundation must make "qualifying distributions" in an amount that equals or exceeds a certain minimum distributable amount. IRC 4942(g)(1)(A) provides that a distribution is not a qualifying distribution if it is made to a nonoperating foundation (except in the narrow circumstances described in IRC 4942(g)(3)). By contrast, operating foundations and public charities are permissible recipients of qualifying distributions from all private foundations, both operating and nonoperating.

3. Qualification for Private Operating Foundation Status

A. In General

In order to qualify as an operating foundation, a private foundation must satisfy:

(1) The Income Test (Reg. 53. 4942(b)-1(a)), and

(2) One of the following alternative tests:
(a) The Assets Test (Reg. 53.4942(b)-2(a));
(b) The Endowment Test (Reg. 53.4942(b)-2(b)); or
(c) The Support Test (Reg. 53.4942(b)-2(c)).

B. The Income Test

All operating foundations must meet the Income Test, which ensures that the foundations make minimum distributions for the direct conduct of their charitable or other exempt activities. The Economic Recovery Tax Act of 1981 liberalized the Income Test for taxable years beginning after December 31, 1981, and these changes have been incorporated in final regulations published in March, 1983 (T.D. 7878, 1983-17 I.R.B. 48). Under current requirements, an operating foundation must make qualifying distributions directly for the active conduct of activities constituting the basis for its exemption, equal in value to:

(1) For taxable years beginning before January 1, 1982, substantially all of the foundation's adjusted net income; and

(2) For taxable years beginning after December 31, 1981 substantially all of the lesser of:
(a) its adjusted net income; or
(b) its minimum investment return.

The underlined words above have the following meanings:

1. Substantially all.
   For all purposes under the operating foundation regulations, "substantially all" means 85% or more. Reg. 53.4942(b)-1(c).

2. Qualifying distributions.
   (a) Any amount paid to accomplish purposes listed in IRC 170(c)(1) or (2)(B). These include contributions to the United States, its possessions, a State or political subdivision, or for charitable, educational, religious, literary, or other exempt purposes. A qualifying distribution may be made in the form of program-related investment under IRC 4944(c), but may not be made to a nonoperating foundation or to an organization controlled by a disqualified person with respect to the foundation, except in narrow circumstances. Reg. 53.4942(a)-3(a)(2)(i).

   (b) Any amount paid to acquire an asset used or held for use directly in carrying out one or more of the exempt purposes listed in IRC 170(c)(1) or (2)(B).

   (c) Any amount set aside under Reg. 53.4942(a)-3(b).

3. Minimum Investment Return.
   A standard by which a minimum expected return on foundation investment assets is computed whether or not such a return is actually received by the foundation. Under IRC 4942(e), the minimum investment return is 5 percent of the excess of the aggregate fair market value of all foundation assets (other than those used or held for use directly in the active conduct of the foundation's exempt purpose) over the acquisition indebtedness with respect to such assets. Reg. 53.4942(a)-2(c). The issue of whether an asset is used or held for use directly in the active conduct of a foundation's exempt purposes has been considered in several revenue rulings. See Rev. Rul. 74-498, 1974-2 C.B. 387 (a collection of paintings loaned to museums by the foundation was held to be used directly in the active conduct

of the foundation's exempt purposes); and Rev. Rul. 75-207, 1975-1 C.B. 361 (an island held by a foundation to preserve the island's ecological system and archeological remains was considered to be used directly in the active conduct of the foundation's exempt purposes).

4. Adjusted Net Income.
   Gross income for the taxable year less the sum of the deductions that would be allowed to a taxable corporation, subject to the income and deduction modifications of IRC 4942(f)(2) and (3). Reg. 53.4942(a)-2(d).

As in the case of the minimum distribution requirements for a nonoperating foundation under IRC 4942(a), the Income Test ensures a minimum level of charitable or other exempt activities by an operating foundation. Both operating and nonoperating foundations are required to make qualifying distributions. Operating foundations, however, must make direct qualifying distributions to be used for the operating foundation's own programs or activities rather than giving the money to another organization to use in the second organization's program. Reg. 53.4942(b)-1(b)(1). Grants made to governments, public charities, or other operating foundations, although permissible, are not considered direct qualifying distributions and are not acceptable distributions for purposes of meeting the Income Test.

The regulations list several types of expenses that are considered a direct means of carrying out an operating foundation's exempt activities. These include:

1. Payment of the tax imposed by IRC 4940.

2. Amounts paid to acquire or maintain assets used directly in the conduct of the foundation's exempt activities; for example, the operating assets of a museum, park, or historic site;

3. Administrative expenses (such as staff salaries) and other operating costs necessary to conduct the exempt activities regardless of whether they are "directly for the active conduct" of the activities, if such expenses are reasonable in amount. Administrative expenses not attributable to exempt activities, such as expenses for the production of investment income, are not

treated as distributions directly for the active conduct of exempt activities.

4. Amounts set aside for specific projects to be used directly for the active conduct of the exempt activities, if the set-aside meets the standards of Reg. 53.4942(a)-3(b); and

5. Grants to individuals under certain circumstances. Reg. 53.4942(b)-1(b)(2). Grants, awards, scholarships, or similar payments made to individuals to support active programs to carry out the foundation's exempt purposes will be treated as qualifying distributions directly for the active conduct of the foundation's exempt activities only if the foundation otherwise maintains a significant involvement in the active programs in support of which the grants or other payments are made. The regulations list two categories of such significant involvement:

    (a) The exempt purpose is to eliminate hunger or poverty, or to relieve human distress, and the foundation makes distributions of aid without the assistance of an intervening organization or agency, and it maintains a salaried or volunteer staff to supervise and direct its activities on a continuing basis, or

    (b) The foundation has specialized expertise or involvement in a particular discipline, maintains a salaried staff that supervises or conducts its programs and activities, and awards grants or scholarships to further the recipient's involvement in the foundation's area of expertise and in the foundation's activities.

An organization providing scholarships to individuals without otherwise conducting educational activities of its own is not an operating foundation. See Reg. 53.4942(b)-1(d), Example (10).

Under the Income Test, an operating foundation has a somewhat more flexible distribution standard than that imposed by IRC 4942 on nonoperating foundations. A nonoperating foundation is required to make qualifying distributions that equal the foundation's minimum investment return, less certain taxes paid. An operating foundation's distribution requirement, however, is keyed to the lesser of its minimum investment return or its adjusted net income. Thus, a nonoperating foundation with no adjusted net income would still have to make qualifying distributions based upon its minimum investment return, while an operating foundation with no adjusted net income for a taxable year would not be required to make distributions for that year (unless it is relying on the Endowment Test, discussed below).

IRC 4942(j)(3) provides an additional refinement for the Income Test in cases where a foundation's minimum investment return is less than adjusted net income. Where a foundation's total qualifying distributions exceed the minimum investment return but are less than the adjusted net income, substantially all (85% or more) of the qualifying distributions must be made directly for the active conduct of the foundation's exempt activities.

Example:	Minimum Investment Return	= $ 80
	Adjusted Net Income	= $ 100

Under normal circumstances, an operating foundation must make qualifying distributions directly for the active conduct of its exempt activities equal in amount to 85% of the lesser of its minimum investment return and its adjusted net income. In this case, such direct distributions must equal 85% of $ 80, or $ 68. However, if total qualifying distributions (direct and indirect) equal $ 90 in this example, 85% of those distributions (85% x $ 90 = $ 76.50) must be directly for the active conduct of the foundation's exempt activities. In no case would it be necessary, however, to make qualifying distributions directly for the active conduct of the foundation's exempt activities in an amount greater than 85% of its adjusted net income (85% x $ 100 = $85).

C. The Alternative Tests

In addition to the Income Test, an operating foundation must meet either the Assets Test, the Endowment Test, or the Support Test. Only one of these three tests needs to be satisfied.

1. The Assets Test

A foundation will meet the Assets Test if substantially more than half (65% or more) of the foundation's assets are either:

(a) Assets devoted to the active conduct of activities constituting the foundation's charitable or other exempt purpose, or to functionally related business. A functionally related business is one that is not an unrelated trade or business under IRC 513; or is an activity carried on with a larger complex of other endeavors related to the exempt purpose.

(b) Stock of a corporation controlled by the foundation and 85% or more of the assets of the corporation are directly devoted to the active conduct of the foundation's exempt activities.

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. Generally, however, assets held for the production of income (e.g., stocks, bonds, endowment funds) will not be considered directly devoted to a foundation's exempt purposes. See Reg. 53.4942(b)-2(a)(2)(i).

Also, amounts set aside for specific projects are <u>not</u> considered assets devoted directly to the active conduct of the foundation's exempt activities for purposes of the Assets Test.

2. The Endowment Test

The Endowment Test is similar to the mandatory Income Test and many organizations meeting the Income Test will also meet the Endowment Test. Simply stated, the Endowment Test requires that a foundation normally make qualifying distributions directly for the active conduct of the activities constituting its exempt purpose in an amount not less than two-thirds of the minimum investment return.

The Income Test, by comparison, now requires qualifying distributions directly for the active conduct of the activities constituting a foundation's exempt purpose in the amount of 85% or more of the lesser of the minimum investment return and the adjusted net income of the foundation. Because this is a more stringent requirement than the Endowment Test whenever a foundation's adjusted net income is higher than its minimum investment return, the Endowment Test will automatically be satisfied whenever the Income Test is met 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 markedly less than its minimum investment return does the Endowment Test, and thus the other two alternative tests as well, have independent significance.

3. The Support Test

The Support Test is met if:

(1) 85% or more the foundation's support (other than IRC 509(e) gross investment income) is normally received from the general public and from five or more exempt organizations that are not described in IRC 4946(a)(1)(H) with respect to each other or to the recipient foundation;

(2) not more than 25% of its support (other than gross investment income) is normally received from any one such exempt organization; and

(3) not more than half its support is normally received from gross investment income.

There are some peculiarities in the application of this test that would tend to restrict it to a very limited number of foundations. First, at least five exempt organizations (that are not commonly controlled or otherwise related to each other under IRC 4946(a)(1)(H)) <u>must</u> be contributors to the foundation; without the requisite five exempt organizations, no amount of support from the general public or from exempt organizations can be taken into account. Also, support from an individual, taxable trust, or taxable corporation, can be considered only to the extent that such support does not exceed one percent of the foundation's total support for the applicable period. Support from governmental units is not subject to the one percent limitation, but otherwise is considered support from the general public. Finally, an organization receiving substantial public support may be eligible for public charity status under IRC 509(a)(1) or (2), thus rendering qualification as a private operating foundation unnecessary.

D. Certain Elderly Care Facilities

In IRC 4942(j)(5), Congress allowed certain elderly care facilities to be treated as operating foundations for certain purposes. The facilities that qualify under this section are not subject to the IRC 4942 distribution requirements to which nonoperating foundations are subject. However, deductions for taxpayers contributing to these elderly care facilities are subject to the same limitations as deductions for gifts to nonoperating foundations.

To qualify as an organization described in IRC 4942(j)(5), an organization:

(1) must operate residential facilities for the long-term care, comfort, maintenance, or education of permanently or totally disabled persons, the elderly, needy widows, or children;

(2) must make at least 50% of its qualifying distributions for the operation and maintenance of its facilities;

(3) must have been in existence on or before May 26, 1969, and have met the above requirements continuously since that date; and

(4) must satisfy the Endowment Test.

4. Compliance with Operating Foundation Requirements

A. Established Organizations. The Four-Year Test. Reg. 53.4942-3(a)

A private foundation that has been in existence for at least four years and has not heretofore qualified for operating foundation status may satisfy the operating foundation requirements by showing that it has met the Income Test and one of the three alternative tests over a four-year period. This may be done either by:

1. aggregating all income, assets held, and distributions over the four-year period; or

2. separately satisfying the tests during each of three of the four years.

An organization may select either method; however, it may not use one method to satisfy the Income Test and the other to satisfy one of the three alternative tests. It must use the same method for all computations used to qualify for operating foundation status at a particular time.

A private foundation that meets the operating foundation requirements under either method will be considered an operating foundation effective the final year of the four-year period.

B. New Organizations in Existence for at Least One Taxable Year. Reg. 53.4942(b)-3(b)(i).

When one taxable year has been completed, an organization seeking operating foundation status that has satisfied the Income Test and one of the alternative tests for its first year will be treated as an operating foundation for that year. To be treated as an operating foundation for its second and third year, it must satisfy the tests by the aggregation method (described above) for the two or three years that it has been in existence.

C. Special Rule for Organizations Within Their First Taxable Year. Advance Rulings.

An organization in its first taxable year may submit an affidavit or opinion of counsel that the operating foundation requirements will be satisfied, accompanied by sufficient facts to allow the Service to determine that the organization is in fact likely to qualify as an operating foundation. At that time the Service may issue an advance ruling that the organization will be treated as an operating foundation for its first year.

An organization that has received an advance ruling that it will be treated as an operating foundation for its first year, and subsequently fails to meet the applicable tests for its first year, will be treated as a nonoperating foundation at the beginning of its second taxable year unless it can demonstrate to the Service that it will qualify as an operating foundation for its second, third, and fourth years. If it does make a successful demonstration to the Service, and then subsequently fails to satisfy the operating foundation tests in its second, third, or fourth year, it will not again be treated as an operating foundation until it meets the four-year test for established organizations, outlined above.

5. IRC 6110 and 7428

A determination that an organization is, or is not, a private foundation is not subject to the public disclosure requirements of IRC 6110.

Section 7428(a)(1)(C), however, is specifically applicable to determinations involving private operating foundations. In the case of an adverse operating foundation determination, or a failure to make such a determination, the affected organization may seek a declaratory judgment in accordance with the provisions of IRC 7428.