



# Exempt Organizations Technical Guide

## TG 3-21: Private Operating Foundations – IRC Section 4942(j)(3)

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## I. Overview

- (1) Organizations that are exempt from taxation under Section 501(c)(3) of the Internal Revenue Code and that don't fall into any of the public charity categories under Section 509(a) are called private foundations. Private foundations raise complex and interrelated issues regarding the application of Chapter 42.

### A. Background / History

- (1) This section addresses private operating foundations. Private foundations are generally divided into two types: private operating foundations and private non-operating foundations (aka grant-making foundations). Private non-operating foundations engage in grant-making charitable activities and have assets mainly consisting of investments.
- (2) Private operating foundations (or operating foundations) are engaged mainly in direct charitable operations. Operating foundations, while subject to most of the rules for all private foundations (Sections 4941-4948), are sometimes treated like public charities for tax purposes under certain circumstances.

**Example:** Operating foundations are generally subject to an excise tax on their net investment income under Section 4940(a). However, Section 4942, which imposes an excise tax on all private foundations for their failure to distribute income, has a special exception for operating foundations. It states operating foundations that qualify under Section 4942(j)(3) won't be subject to excise tax under Section 4942.

- (3) The Pension Protection Act of 2006, P.L. 109-280 (PPA 2006), Section 1212, amended the IRS for Chapter 42 excise taxes. Most of the first tier excise tax rates, as well as the limits on foundation manager taxes, were doubled.
- (4) Regarding the filing requirements for private foundations, for tax years beginning on or after July 2, 2019, Section 3101 of P. L. 116-25 requires that returns by exempt organizations be filed electronically. If an organization is filing Form 990-PF, Return of Private Foundation or Section 4947(a)(1) Trust Treated as Private Foundation, for a tax year beginning on or after July 2, 2019, the organization must file the return electronically. Limited exceptions apply.
- (5) Electronic filing requirements haven't changed for Form 990-PF filers with tax years beginning before July 2, 2019 (which includes calendar year 2019 Forms 990-PF). Required electronic filing for calendar year filers will apply for tax years beginning in 2020 and later.
- (6) There are new reporting standards for net assets, and Part II of Form 990-PF was updated to reflect the Financial Accounting Standard Board's (FASB's) reclassification of net assets into two classes, net assets without donor restrictions and net assets with donor restrictions.

- (7) The Taxpayer Certainty and Disaster Tax Relief Act passed on December 20, 2019, included legislation that reduced the 2% excise tax on net investment income of private foundations to 1.39%. At the same time, the legislation repealed the 1% special rate that applied if the private foundation met certain distribution requirements. The changes are effective for taxable years beginning after December 20, 2019.
- (8) For tax years beginning in 2020, an individual liable for a Chapter 42 excise tax won't have the option to file jointly with the organization with respect to which the excise tax relates. Beginning with tax year 2020, Form 4720 has been revised to identify whether the filer is the organization or an individual.
- (9) Accordingly, for tax years after 2019, an agent preparing Form 4720 to report individual excise tax liability during an examination won't convert Form 4720 to "Form 4720-A." The revenue agent will, instead, complete Form 4720 identifying the filer as an individual as described in the instructions for Form 4720. Please see the instructions to the Form 4720 for further information.

## B. Relevant Terms

- (1) An **Operating Foundation** (also known as a **Private Operating Foundation**) is any private foundation which, in addition to satisfying the assets test, the endowment test or the support test makes qualifying distributions directly for the active conduct of activities constituting its charitable, educational, or other similar exempt purpose equal in value to:
  - a. For taxable years beginning before January 1, 1982, substantially all of the foundation's adjusted net income, and
  - b. For taxable years beginning after December 31, 1981, substantially all of the lesser of the foundation's adjusted net income or minimum investment return. See Treasury Regulation (Treas. Reg.) 53.4942(b)-1(a).
- (2) **Adjusted Net Income** is the excess of the gross income for the taxable year over the sum of the deductions which would be allowed to a corporation subject to the tax imposed by Section 11 for the taxable year, with certain modifications to income and deductions. Section 4942(f)(1) - (3).
- (3) A private foundation will satisfy the **Assets Test (first alternative test)** if substantially more than half of the fair market value of the foundation's assets:
  - a. Are devoted directly to the active conduct of activities constituting the foundation's charitable, educational, or other similar exempt purpose, or to functionally related businesses, or to any combination thereof;
  - b. Are stock of a corporation which is controlled by the foundation and substantially all the assets of which are so devoted; or
  - c. Are in part assets which are described in (a) and in part stock which is described in (b) above. See Treas. Reg. 53.4942(b)-2(a).

- (4) Qualifying distributions aren't made by a foundation "**directly for the active conduct of activities constituting its charitable, educational, or other similar exempt purpose**" unless such qualifying distributions are used by the foundation itself, rather than by or through one or more grantee organizations which receive such qualifying distributions directly or indirectly from such foundation. However, amounts paid to acquire or maintain assets which are used directly in the conduct of the foundation's exempt activities are considered direct expenditures for the active conduct of the foundation's exempt activities. Likewise, administrative expenses and other operating costs necessary to conduct the foundation's exempt activities shall be treated as qualifying distributions expended directly for the active conduct of such exempt activities if such expenses and costs are reasonable in amount. See Treas. Reg. 53.4942(b)-1(b)(1).
- (5) A foundation will satisfy the **Endowment Test (second alternative test)** if it normally makes qualifying distributions directly for the active conduct of activities constituting its charitable, educational, or other similar exempt purpose in an amount not less than two-thirds of its minimum investment return. See Treas. Reg. 53.4942(b)-2(b).
- (6) A **Functionally Related Business** is any trade or business that isn't unrelated under Section 513, or that is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors that is related to the foundation's exempt purposes. See Section 4942(j)(4) and Treas. Reg. 53.4942(a)-2(c)(3)(iii).
- (7) To meet the **Income Test**, a foundation must make qualifying distributions directly for the active conduct of the activities that comprise its exempt purpose equal to substantially all of the lesser of its adjusted net income or minimum investment return. See Treas. Reg. 53.4942(b)-1(a)(1).
- (8) **Minimum Investment Return** is defined in Section 4942(e) and generally means 5% of the excess of the aggregate fair market value of the foundation's assets (other than assets used or held for use directly in the foundation's exempt purposes) over the amount of the acquisition indebtedness with respect to such assets. See Section 4942(e).
- (9) **Program-related Investments** are investments for which the primary purposes are to accomplish one or more of the purposes described in Section 170(c)(2)(B) and no significant purpose of which is the production of income or the appreciation of property. See Section 4944(c).
- (10) **Qualifying Distributions** are amounts paid to accomplish exempt purposes or to acquire an asset used (or held for use) directly in carrying out an exempt purpose and amounts properly set aside for a specific project that is for an exempt purpose. See Section 4942(g) and Treas. Reg. 53.4942(a)-3(a)(2).
- (11) A foundation will be considered as maintaining a "**Significant Involvement**" in an exempt activity in connection with which grants, scholarships, or other payments are made or awarded if:

- a. An exempt purpose of the foundation is the relief of poverty or human distress, and its exempt activities are designed to improve conditions among a poor or distressed class of persons or in an area subject to poverty or national disaster, the making or awarding of the grants or other payments to accomplish such exempt purpose is direct and without the assistance of an intervening organization or agency, and the foundation maintains a salaried or voluntary staff of administrators, researchers, or other personnel who supervise and direct the activities described on a continuing basis; or
  - b. The foundation has developed some specialized skills, expertise or involvement in a substantive area, it maintains a salaried staff of administrators, researchers, or other personnel who supervise or conduct programs or activities which support and advance the foundation's work and, 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 foundation's particular area of interest and in some segment of the programs or activities carried on by the foundation. See Treas. Reg. 53.4942(b)-1(b)(2)(ii).
- (12) **Substantially All** means 85% or more, for operating foundation purposes. See Treas. Reg. 53.4942(b)-1(c).
- (13) **Substantially More Than Half** means 65% or more. See Treas. Reg. 53.4942(b)-2(a)(5).
- (14) A foundation satisfies the **Support Test** (third alternative test) if:
- a. Substantially all of its support (other than gross investment income as defined in Section 509(e)) is normally received from the general public and from five or more exempt organizations which are not described in Section 4946(a)(1)(H) with respect to each other or the recipient foundation;
  - b. Not more than 25% of its support (other than gross investment income) is normally received from any one such exempt organization; and
  - c. Not more than half of its support is normally received from gross investment income. See Treas. Reg. 53.4942(b)-2(c).

## C. Law / Authority

- (1) Section 4942(j)(3) and Treas. Reg. 53.4942(b)-1(a) define a private operating foundation as any organization which makes qualifying distributions directly for the conduct of the activities constituting the purpose or function for which it is organized and operated equal to substantially all of the lesser of its adjusted net income or its minimum investment return, and which satisfies one of the following.
  - a. Substantially more than half of the assets of which are devoted directly to such activities or to functionally related businesses or to both, or are stock



of a corporation which is controlled by the foundation and substantially all of the assets of which are so devoted (the Assets Test),

- b. Normally makes qualifying distributions directly for the active conduct of the activities constituting the purpose or function for which it is organized and operated in an amount not less than two-thirds of its minimum investment return (the Endowment Test), or
  - c. Substantially all of the support (other than gross investment income as defined in Section 509(e)) of which is normally received from the general public and from 5 or more exempt organizations which are not described in Section 4946(a)(1)(H) with respect to each other or the recipient foundation; not more than 25% of the support (other than gross investment income) of which is normally received from any one such exempt organization; and not more than half of the support of which is normally received from gross investment income (the Support Test).
- (2) Treas. Reg. 53.4942(b)-2 establishes the assets, endowment, and support tests.
- (3) Treas. Reg. 53.4942(b)-3 provides guidelines for determining compliance with the operating foundation tests.

## **II. Requirements**

- (1) 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.
- (2) These organizations are called private operating foundations because they're 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, and similar organizations.

### **A. Taxable Private Foundations**

- (1) To qualify as a private operating foundation, under Section 4942(j)(3), an organization must meet an income test and one of three alternative tests. The alternative tests include:
  - a. An assets test
  - b. An endowment test
  - c. A support test
- (2) The tests are applied each year. A private foundation could meet the requirements in one year and not in the next.
- (3) Different rules apply for satisfying the tests when an organization exists for less than one year, for more than one but less than four years, and for four or more years. See Treas. Reg. 53.4942(b)-3.

### **B. Income Test**

- (1) To meet the income test of Section 4942(j)(3)(A), a private foundation must make qualifying distributions directly for the active conduct of the activities constituting the purpose or function for which it is organized and operated equal to substantially all of the lesser of:
  - a. Its adjusted net income, or
  - b. Its minimum investment return.
- (2) Qualifying distributions are defined in Section 4942(g) and Treas. Reg. 53.4942(a)-3(a)(2). Qualifying distributions are amounts paid to accomplish exempt purposes or to acquire an asset used, or held for use, directly in carrying out an exempt purpose, and amounts properly set aside for a specific project that is for an exempt purpose.
- (3) If the foundation's qualifying distributions exceed the minimum investment return for the year but are less than the foundation's adjusted net income, then substantially all of the qualifying distributions must be made directly for the active conduct of activities constituting the foundation's exempt purpose. However, if the adjusted net income exceeds the minimum investment return

for the year, and the foundation's qualifying distributions equal or exceed its adjusted net income, then substantially all the foundation's qualifying distributions (except any in excess of adjusted net income) must be made directly for the active conduct of activities constituting its exempt purpose. See Section 4942(j)(3) and Treas. Reg. 53.4942(b)-1(a)(1).

- (4) Treas. Reg. 53.4942(b)-1(d) provides examples of qualifying distributions made by private operating foundations.

**Example:** An example of a private operating foundation is an exempt museum described in Section 501(c)(3) which was founded by an endowment gift from a single contributor and uses 90% of its adjusted net income to operate the museum. If the museum satisfies one of the three alternative tests, it may be classified as an operating foundation since substantially all of its qualifying distributions are used directly for the active conduct of its exempt activities. See Treas. Reg. 53.4942(b)-1(d), Example 1.

**Example:** M, an exempt organization described in Section 501(c)(3), was created to improve conditions in a particular distressed area. M receives its funds primarily from a limited number of wealthy contributors interested in helping carry out its exempt purpose. M's program consists of making a survey of the problems of the area to determine the areas in which its funds may be applied most effectively. Approximately 10% of M's adjusted net income is used to conduct this survey. The balance of its income is used to make grants to other nonprofit organizations doing work in the area in those areas determined to have the greatest likelihood of resulting in improved conditions. Under these circumstances, since only 10% of M's adjusted net income may be considered as constituting qualifying distributions made directly for the active conduct of M's exempt activities, M cannot qualify as an operating foundation. See Treas. Reg. 53.4942(b)-1(d), Example 2.

**Example:** Assume the facts, as stated in example (2), except that M uses the remaining 90% of its adjusted net income for the following purposes: (1) M maintains a salaried staff of social workers and researchers who analyze its surveys and make recommendations as to methods for improving conditions in the distressed area; (2) M makes grants to independent social scientists who assist in these analyses and recommendations; (3) M publishes periodic reports indicating the results of its surveys and recommendations; (4) M makes grants to social workers and others who act as advisers to nonprofit organizations, as well as small business enterprises, functioning in the community (these advisers acting under the general direction of M attempt to implement M's recommendations through their advice and assistance to the nonprofit organizations and small business enterprises); and (5) M makes grants to other social scientists who study and report on the success of the various enterprises which attempt to implement M's recommendations. Under these circumstances, M satisfies the requirements of Treas. Reg. 53.4942(b)-1(b)(2), and the various grants it makes constitute qualifying distributions made directly for the active conduct of its exempt activities. Thus, if M satisfies one of

the tests set forth in Section 53.4942(b)-2 it may be classified as an operating foundation. See Treas. Reg. 53.4942(b)-1(d), Example 3.

**Example:** P, an exempt educational organization described in Section 501(c)(3), was created for the purpose of training teachers for institutions of higher education. Each year P awards a substantial number of fellowships to students for graduate study leading toward their M.A. or Ph.D. degrees. The applicants for these fellowships are carefully screened by P's staff, and only those applicants who indicate a strong interest in teaching in colleges or universities are chosen. P publishes and circulates various pamphlets encouraging a development of interest in college teaching and describing its fellowships. P also conducts annual summer seminars which are attended by its fellowship recipients, its staff, consultants, and other interested parties. The purpose of these seminars is to foster and encourage the development of college teaching. P publishes a report of the seminar proceedings along with related studies written by those who attended. Despite the fact that a substantial portion of P's adjusted net income is devoted to granting fellowships, its commitment to encouraging individuals to become teachers at institutions of higher learning, its maintenance of a staff and programs designed to further this purpose, and the granting of fellowships to encourage involvement both in its own seminars and in its exempt purpose indicate a significant involvement by P beyond the mere granting of fellowships. Thus, the fellowship grants made by P constitute qualifying distributions made directly for the active conduct of P's exempt activities within the meaning of Treas. Reg. 53.4942(b)-1(b)(2). See Treas. Reg. 53.4942(b)-1(d), Example 4.

**Example:** Q, an exempt organization described in Section 501(c)(3), is composed of professional organizations interested in different branches of one academic discipline. Q trains its own professional staff, conducts its own program of research, selects research topics, screens, and investigates grant recipients, makes grants to those selected, and sets up and conducts conferences and seminars for the grantees. Q has particular knowledge and skill in the given discipline, carries on activities to advance its study of that discipline, and makes grants to individuals to enable them to participate in activities which it conducts in carrying out its exempt purpose. Under these circumstances, Q's grants constitute qualifying distributions made directly for the active conduct of Q's exempt activities within the meaning of Treas. Reg. 53.4942(b)-1(b)(2). See Treas. Reg. 53.4942(b)-1(d), Example 5.

**Example:** R, an exempt medical research organization described in Section 501(c)(3), was created to study and perform research concerning heart disease. R has its own research center in which it carries on a broad number of research projects in the field of heart disease with its own professional staff. Physicians and scientists who are interested in special projects in this area present the plans for their projects to R. The directors of R study these plans and decide if the project is feasible and will further the work being done by R. If it is, R makes a grant to the individual to enable him to carry out his project,

either at R's facilities or elsewhere. Reports of the progress of the project are made periodically to R, and R exercises a certain amount of supervision over the project. The resulting findings of these projects are usually published by R. Under these circumstances, the grants made by R constitute qualifying distributions made directly for the active conduct of R's exempt activities within the meaning of Treas. Reg. 53.4942(b)-1(b)(2). See Treas. Reg. 53.4942(b)-1(d), Example 6.

**Example:** S, an exempt organization described in Section 501(c)(3), maintains a large library of manuscripts and other historical reference material relating to the history and development of the region in which the collection is located. S makes a limited number of annual grants to enable post-doctoral scholars and doctoral candidates to use its library. Sometimes S obtains the right to publish the scholar's work, although this is not a prerequisite to the receipt of a grant. The primary criterion for selection of grant recipients is the usefulness of the library's resources to the applicant's field of study. Under these circumstances, the grants made by S constitute qualifying distributions made directly for the active conduct of S's exempt activities within the meaning of Treas. Reg. 53.4942(b)-1(b)(2). See Treas. Reg. 53.4942(b)-1(d), Example 7.

**Example:** T, an exempt charitable organization described in Section 501(c)(3), was created by the members of one family for the purpose of relieving poverty and human suffering. T has a large salaried staff of employees who operate offices in various areas throughout the country. Its employees make gifts of food and clothing to poor persons in the area serviced by each office. On occasion, T also provides temporary relief in the form of food and clothing to persons in areas stricken by natural disasters. If conditions improve in one poverty area, T transfers the resources of the office in that area to another poverty area. Under these circumstances, the gifts of food and clothing made by T constitute qualifying distributions made directly for the active conduct of T's exempt activities within the meaning of Treas. Reg. 53.4942(b)-1(b)(2). See Treas. Reg. 53.4942(b)-1(d), Example 8.

**Example:** U, an exempt scientific organization described in Section 501(c)(3), was created for the principal purpose of studying the effects of early childhood brain damage. U conducts an active and continuous research program in this area through a salaried staff of scientists and physicians. As part of its research program, U awards scholarships to young people suffering mild brain damage to enable them to attend special schools equipped to handle such problems. The recipients are periodically tested to determine the effect of such schooling upon them. Under these circumstances, the scholarships awarded by U constitute qualifying distributions made directly for the active conduct of U's exempt activities within the meaning of Treas. Reg. 53.4942(b)-1(b)(2). See Treas. Reg. 53.4942(b)-1(d), Example 9.

**Example:** O, an exempt charitable organization described in Section 501(c)(3), was created for the purpose of giving scholarships to children of the employees of X Corporation who meet the standards set by O. O not only screens and

investigates each applicant to make sure that he complies with the academic and financial requirements set for scholarship recipients, but also administers an examination which each applicant must take — 90% of O's adjusted net income is used in awarding these scholarships to the chosen applicants. O does not conduct any activities of an educational nature on its own. Under these circumstances, O is not using substantially all of its adjusted net income directly for the active conduct of its exempt activities within the meaning of Treas. Reg. 53.4942(b)-1(b). Thus, O is not an operating foundation because it fails to satisfy the income test set forth in Treas. Reg. 53.4942(b)-1(a). See Treas. Reg. 53.4942(b)-1(d), Example 10.

## **B.1. Distributions Made Directly for the Active Conduct of Exempt Activities**

- (1) The following standards in Treas. Reg. 53.4942(b)-1(b)(1) (unless otherwise noted), apply in determining whether a foundation has made a particular distribution directly for the active conduct of activities constituting its exempt purpose or function.
- (2) In general, such distributions must be used by the foundation itself. Grants to other organizations are generally considered an indirect rather than direct means of accomplishing exempt purposes. Payments to individual or corporate beneficiaries may qualify as distributions made directly for the active conduct of exempt activities.
- (3) 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, public park, or historic site are considered distributions made directly for the active conduct of exempt activities. However, the depreciation of such assets is not a qualifying distribution. See Rev. Rul. 74-560, 1974-2 C.B. 389.
- (4) Administrative expenses (such as staff salaries and traveling expenses) and other operating costs necessary to conduct the foundation's exempt activities (whether direct or indirect) are treated as distributions made directly for the active conduct of exempt activities if reasonable in amount. The administrative expenses of screening and investigating grant applicants may be treated as such distributions even if the grants themselves are not. See Treas. Reg. 53.4942(b)-1(b)(2)(i).
- (5) Reasonable legal fees paid to determine the proper beneficiary of a foundation are administrative expenses necessary to conduct the foundation's exempt activities. See Rev. Rul. 75-495, 1975-2 C.B. 449.
- (6) Administrative expenses and operating costs not attributable to exempt activities, such as expenses in connection with the production of investment income, aren't treated as distributions made directly for the active conduct of exempt activities.

- (7) Expenses attributable to both exempt activities and nonexempt activities must be allocated between them on a reasonable and consistently applied basis.
- (8) An amount set aside by a foundation for a specific project, such as the acquisition of a building which is to be used by the foundation directly for the active conduct of exempt activities, shall be deemed to be a distribution expended directly for the active conduct of exempt activities if the set-aside qualifies under Section 4942(g)(2) and Treas. Reg. 53.4942(a)-3(b).
- (9) Rev. Rul. 74-450, 1974-2 C.B. 388, held that renovation and construction with respect to a wildlife sanctuary and public park is a specific project, for which amounts set aside are qualifying distributions.
- (10) Payment of Section 4940 tax is deemed a distribution made directly for the active conduct of exempt activities. See Treas. Reg. 53.4942(b)-1(b)(3).

## **B.2. Payments to Individual or Corporate Beneficiaries**

- (1) Grants, scholarships, program-related investments, or other payments to individuals constitute distributions made directly for the active conduct of exempt activities only if the grantor foundation maintains some "significant involvement" in the active programs in support of which such grants are made. See Treas. Reg. 53.4942(b)-1(b)(2)(i).
- (2) Program-related investments per Section 4944(c) made to corporate enterprises as well as to individuals may qualify as distributions made directly for the active conduct of exempt activities if the significant involvement requirements of Treas. Reg. 53.4942(b)-1(b)(2)(ii)(A) or (B) are met (treating the corporate enterprises as individuals for such purposes). See Treas. Reg. 53.4942(b)-1(b)(2)(i).
- (3) Rev. Rul. 78-315, 1978-2 C.B. 271, held that where a trust's sole activity is operating a cultural center and the managing trustees form a corporation to operate the cultural center only as a corporate trustee of the trust, the trust's distributions to the corporation are distributions made directly for the active conduct of exempt activities rather than distributions to a grantee organization.
- (4) The determination of whether grants, scholarships, or other payments constitute distributions made directly for the active conduct of exempt activities depends on the facts and circumstances. See Treas. Reg. 53.4942(b)-1(b)(2)(i).
- (5) Individual grants may qualify as distributions made directly for the active conduct of exempt activities even if more of the foundation's funds are devoted to grants than to the active programs that such grants support. Treas. Reg. 53.4942(b)-1(b)(2)(i). However, the mere selection, screening, and investigation of grant applicants isn't treated as significant involvement. Treas. Reg. 53.4942(b)-1(b)(2)(i). See also Examples (2) and (10) of Treas. Reg. 53.4942(b)-1(d) for payments that do not qualify as such distributions.

## C. Adjusted Net Income

- (1) In determining whether a private foundation meets the income test of Section 4942(j)(3)(A), its adjusted net income may need to be calculated.
- (2) Adjusted net income is gross income less the deductions allowed to corporations subject to tax under Section 11, with certain modifications to income and deductions. See Section 4942(f).
- (3) Gross income includes all amounts derived from, or in connection with, property the foundation holds, including property used directly in an exempt function, in an unrelated trade or business, or otherwise. See Treas. Reg. 53.4942(a)-2(d)(1)(i) and (2)(viii).
- (4) In computing gross income and specific deductions, the principles of subtitle A of the IRC apply (except if they are inconsistent with Section 4942 or its regulations). But, exclusions, deductions, and credits aren't allowed unless expressly allowed per Section 4942 or its regulations. See Treas. Reg. 53.4942(a)-2(d)(1).
- (5) A foundation may deduct its amortizable bond premium to the extent deductible under Section 171. See Rev. Rul. 76-248, 1976-1 C.B. 353.

### C.1. Adjusted Net Income – Income Recapture Modifications

- (1) In general, amounts are included in income if they constitute the repayment of amounts previously claimed as qualifying distributions.
- (2) Amounts received or accrued as repayments of amounts which were taken into account as a qualifying distribution under Section 4942(g)(1)(A) for any taxable year are included in income. See Section 4942(f)(2)(C)(i).
- (3) If a foundation makes an interest-free loan to a public charity in a year in which its distribution requirements are met independently of the loan and doesn't use the loan to reduce its distributable amount in subsequent years, then the loan isn't considered a qualifying distribution. Such loan repayments aren't included in income in determining adjusted net income. See Rev. Rul. 77-252, 1977-2 C.B. 390.
- (4) Notwithstanding the general rule for capital gains in Section 4942(f)(2)(B), amounts received or accrued from the sale or other disposition of property are included in income to the extent that the amount paid to acquire the property was taken into account as a qualifying distribution under Section 4942(g)(1)(B) for any taxable year. See Section 4942(f)(2)(C)(ii).
- (5) Any amount set aside under Section 4942(g)(2) is included in income to the extent that the amount is determined not to be necessary for the purposes for which it was set aside. See Section 4942(f)(2)(C)(iii).
- (6) Amounts taken into account in a preceding taxable year as a qualifying distribution under Section 4942(g)(3), but which are not properly redistributed



by the close of the donee organization's succeeding taxable year, are included in the donor foundation's income for its taxable year beginning after the close of the donee organization's taxable year following the donee organization's taxable year of receipt. See Treas. Reg. 53.4942(a)-2(d)(2)(ix).

## **C.2. Adjusted Net Income – Other Income Modifications**

- (1) Gifts, grants, and contributions to the foundation are excluded from gross income. However, income from a functionally related business is included in gross income. See Treas. Reg. 53.4942(a)-2(d)(1).
- (2) A foundation that receives a bequest of a decedent's right to receive deferred compensation payments includes in income only the portion (if any) of each payment that exceeds the value of the right to receive the payment on the date of the decedent's death. The remainder will be treated as a gift to the foundation. See Rev. Rul. 75-442, 1975-2 C.B. 448.
- (3) Interest from exempt bonds is included in income. See Section 4942(f)(2)(A).
- (4) Capital gains and losses are not taken into account, except for any net short-term capital gain (which is any excess of short-term capital gain over short-term capital loss). See Section 4942(f)(2)(B).
  - a. Miller Charitable Fund v. Commissioner, 89 T.C. 1112 (1987), upheld this rule as applied to charitable trusts, and as against constitutional challenges.
  - b. Net short-term capital loss is not carried back or carried forward to other tax years. Treas. Reg. 53.4942(a)-2(d)(2)(ii).
  - c. Because the IRC treats a capital gain dividend from a regulated investment company as a gain from the sale or exchange of a long-term capital asset, such dividends are excluded from adjusted net income. Rev. Rul. 73-320, 1973-2 C.B. 386.
  - d. Similarly, net Section 1231 gains are not taken into account, but net Section 1231 losses (treated as ordinary income under Section 1231(a)(2)) are included in the computation of adjusted net income. Treas. Reg. 53.4942(a)-2(d)(2)(ii).
- (5) Certain distributions a private foundation received from a disqualified person in the redemption of stock held by the private foundation to avoid the excise tax for excess business holdings are treated as not essentially equivalent to a dividend under Section 302(b)(1) (and therefore, are amounts received in exchange for stock, giving rise to long-term capital gain or loss, if the conditions of Treas. Reg. 53.4942(a)-2(d)(2)(iv) are met). See also Rev. Rul. 75-336, 1975-2 C.B. 110.
- (6) If, as of the date of distribution of property for purposes described in Section 170(c)(1) or (2)(B), the fair market value of that property exceeds its adjusted

basis, the excess is not deemed an amount includible in gross income. See Treas. Reg. 53.4942(a)-2(d)(2)(v).

- (7) Income received from an estate during the period of administration of such estate is excluded from gross income unless, due to a prolonged period of administration, the estate is considered terminated under Treas. Reg. 1.641(b)-3(a). See Treas. Reg. 53.4942(a)-2(d)(2)(vi).
- (8) In general, distributions a private foundation received from a trust created and funded by someone other than the foundation itself are excluded from the foundation's gross income. See Treas. Reg. 53.4942(a)-2(d)(2)(vii).
  - a. The income portion of distributions received from Section 4947(a)(2) trusts (split-interest trusts) for amounts placed in trust after May 26, 1969 are included in income. See Treas. Reg. 53.4942(a)-2(d)(2)(vii), which cross references Treas. Reg. 53.4942(a)-2(b)(2).
  - b. While Treas. Reg. 53.4942(a)-2(b)(2) was held invalid as applied to the minimum investment return requirement of Section 4942(d) in *Ann Jackson Family Foundation v. Commissioner*, 15 F.3d 917 (9th Cir. 1994), aff'g 97 T.C. 534 (1991), the courts did not decide whether the regulation is invalid as applied to adjusted net income.
- (9) No interest is imputed under Section 483 in an installment sale of property per a binding contract (including an irrevocable written option) made in a taxable year beginning before January 1, 1970, unless a substantial change in the contract terms is made on or after January 1, 1970. See Section 4942(f)(2)(D) and Treas. Reg. 53.4942(a)-2(d)(2)(x). However, payments expressly designated as interest on loans made before 1970 are included in gross income in the year of payment. See Rev. Rul. 75-443, 1975-2 C.B. 449.

### **C.3. Adjusted Net Income – Deduction Modifications**

- (1) In general, no deduction is allowed other than all the 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 that income. See Section 4942(f)(3)(A).
  - a. Other deductions, such as the charitable contributions deduction under Sections 170 and 642(c), the net operating loss deduction under Section 172, and the special deductions under Section 241, are not allowed. See Treas. Reg. 53.4942(a)-2(d)(4)(i).
  - b. Special deductions under Sections 246, 246A, 247, 248 and 249, including the dividends received deductions under Sections 243, 245, and 245A are not allowed. See Treas. Reg. 53.4942(a)-2(d)(4)(i).
  - c. Deductions for depreciation and depletion are allowed as determined under Section 4940(c)(3)(B) (straight-line depreciation, cost depletion). See Section 4942(f)(3)(A).

- d. Deductions for expenses and interest relating to tax-exempt bond interest are allowed. See Section 4942(f)(3)(B); Section 265.
- (2) Where an expense relates partly to production of income and partly to the conduct of exempt functions (such as an officer's compensation or a maintenance expense for property part of which is used for production of income), the expense must be allocated between the two functions, and only the portion for production of income is deductible. See Treas. Reg. 53.4942(a)-2(d)(4)(i).

## D. Assets Test (First Alternative Test)

- (1) For a private foundation to meet the assets test of Section 4942(j)(3)(B)(i) and Treas. Reg. 53.4942(b)-2(a)(1), substantially more than half of the fair market value of its assets must be:
  - a. Devoted directly to the active conduct of activities constituting the foundation's exempt purpose, or to functionally related businesses,
  - b. Stock of a corporation which is controlled by the foundation and substantially all the assets of which are so devoted, or
  - c. Some combination of the above.
- (2) Any asset held for part of the taxable year is taken into account by multiplying the fair market value of such asset by the fraction of the number of days that the foundation held the asset, divided by the number of days in the taxable year. See Treas. Reg. 53.4942(b)-2(a)(3).
- (3) A functionally related business is any trade or business that is not an unrelated trade or business under Section 513, or an activity that is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors that is related to the exempt purposes of the organization. See Section 4942(j)(4) and Treas. Reg. 53.4942(a)-2(c)(3)(iii).
 

**Example:** A business in which substantially all the work is performed without compensation is a functionally related business. See Rev. Rul. 76-85, 1976-1 C.B. 357.
- (4) For an example of a subsidiary corporation controlled by a foundation and substantially all of whose assets are devoted to a functionally related business with respect to the parent foundation, see Example (1) of Treas. Reg. 53.4942(b)-2(a)(6) set forth in the next section.

### D.1. Devoted Directly to the Active Conduct of Exempt Activities

- (1) An asset is devoted directly to the active conduct of activities constituting the foundation's exempt purpose only if the foundation actually uses the asset directly for the active conduct of activities constituting its exempt purpose. Treas. Reg. 53.4942(b)-2(a)(2)(i). Treas. Reg. 53.4942(b)-2(a)(6) provides four examples of assets devoted directly to the active conduct of exempt activities

or to functionally related businesses. The regulation notes that it is assumed that none of the organizations described in these examples is described in Section 509(a)(1), (2), or (3).

**Example:** W, an exempt organization described in Section 501(c)(3), is devoted to the maintenance and operation of a historic area for the benefit of the general public. W has acquired and erected facilities for lodging and other visitor accommodations in such area, which W operates through a wholly owned, separately incorporated, taxable entity. These facilities comprise substantially all of the subsidiary's assets. The operation of such accommodations constitutes a functionally related business within the meaning of paragraph (c)(3)(iii) of Treas. Reg. 53.4942(a)-2. Under these circumstances, the stock of the subsidiary will be considered as part of W's assets which may be taken into account by W in determining whether it satisfies the assets test described in this paragraph. See Treas. Reg. 53.4942(b)-2(a)(6), Example 1.

**Example:** M, an exempt conservation organization described in Section 501(c)(3), is devoted to acquiring, preserving, and otherwise making available for public use geographically diversified areas of natural beauty. M has acquired and erected facilities for lodging and other visitor accommodations in national park areas. The operation of such accommodations constitutes a functionally related business within the meaning of paragraph (c)(3)(iii) of Treas. Reg. 53.4942(a)-2. Therefore, M's assets which are directly devoted to such visitor accommodations may be taken into account by M in determining whether it satisfies the assets test described in this paragraph. See Treas. Reg. 53.4942(b)-2(a)(6), Example 2.

**Example:** P, an exempt organization described in Section 501(c)(3), is devoted to acquiring and restoring historic houses. To ensure that the restored houses will be kept in the restored condition, and to make the houses more readily available for public display, P rents the houses rather than sells them once they have been restored. The rental income derived by P is substantially less than the amount which would be required to be charged in order to recover the cost of purchase, restoration, and maintenance of such houses. Therefore, such houses may be taken into account by P in determining whether it satisfies the assets test described in this paragraph. See Treas. Reg. 53.4942(b)-2(a)(6), Example 3.

**Example:** Z, an exempt organization described in Section 501(c)(3), is devoted to improving the public's understanding of Renaissance art. Z's principal assets are a number of paintings of this period which it circulates on an active and continuing basis to museums and schools for public display. These paintings constitute 80% of Z's assets. Under these circumstances, although Z does not have a building in which it displays these paintings, such paintings are devoted directly to the active conduct of activities constituting Z's exempt purpose. Therefore, Z has satisfied the assets test described in this paragraph. See Treas. Reg. 53.4942(b)-2(a)(6), Example 4.

- (2) Assets held for investment, the production of income, or similar use, are not devoted directly to the active conduct of exempt activities. Treas. Reg. 53.4942(b)-2(a)(2)(i).
- a. Whether an asset is held for such use is a question of fact. Treas. Reg. 53.4942(b)-2(a)(2)(i).
  - b. For example, an office building used to provide offices for a foundation's endowment fund managers is not devoted directly to the active conduct of the foundation's exempt activities. See Treas. Reg. 53.4942(b)-2(a)(2)(i).
  - c. While the leasing of property to others is generally not a direct exempt function, property acquired for use in carrying out the foundation's exempt purpose may be considered as devoted directly to the active conduct of such purpose even though it is leased (in whole or in part) for a limited and reasonable period (generally one year) during which the foundation arranges to use the property for the purpose acquired. See Treas. Reg. 53.4942(b)-2(a)(2)(i).
  - d. Property leased by a foundation in carrying out its exempt purpose is considered devoted directly to the active conduct of the foundation's exempt activities if the rental income is less than the amount which would be required to be charged to recover the cost of purchase and maintenance of the property (taking into account the deductions permitted in calculating adjusted net income, such as straight-line depreciation). See Treas. Reg. 53.4942(b)-2(a)(2)(i) and -2(a)(6), Example (3).
- (3) Property is considered to be used exclusively for exempt functions if that use is 95% or more of the total use. If property is used only partly for exempt functions, allocation of the uses must be made. See Treas. Reg. 53.4942(b)-2(a)(2)(i).
- a. Where a portion of a building is used directly for exempt functions and the remainder is leased to commercial tenants, the basis of the allocation of the fair market value of the building is on the rental values of the two portions rather than the square footage. See Rev. Rul. 82-137, 1982-2 C.B. 303.
- (4) For purposes of the assets test, amounts set aside aren't treated as devoted directly to the active conduct of the foundation's exempt activities. See Treas. Reg. 53.4942(b)-2(a)(2)(ii)(B).
- a. Similarly, assets held to extend credit or make funds available to members of a charitable class (for example, assets set aside to guarantee student loans made by banks) aren't considered as devoted directly to the active conduct of exempt activities. See Treas. Reg. 53.4942(b)-2(a)(2)(ii)(A).
  - b. A foundation's program-related investment isn't considered as devoted directly to the active conduct of exempt activities unless the foundation meets the "significant involvement" requirement in Treas. Reg. 53.4942(b)-1(b)(2). See Treas. Reg. 53.4942(b)-2(a)(2)(ii)(A).

- (5) Section 4942(e)(1)(A) (regarding assets excluded from calculating minimum investment return) and Treas. Reg. 53.4942(a)-2(c)(3), and related authorities offer guidance on whether a foundation uses an asset directly for exempt functions or in a functionally related business. These rules also include assets "held for use" within a reasonable period of time even if they are not actually used for those purposes in the tax year at issue.
- a. Rev. Rul. 74-498, 1974-2 C.B. 387, held that a foundation's paintings loaned to museums are assets used directly for its exempt functions.
  - b. Rev. Rul. 75-207, 1975-1 C.B. 361, held that a foundation's island used as a wildlife and archeological preserve, to which access is limited to invited researchers, is used directly for its exempt functions.

## **E. Endowment Test (Second Alternative Test)**

- (1) To meet the endowment test of Section 4942(j)(3)(B)(ii), a private foundation must normally make qualifying distributions directly for the active conduct of activities constituting its exempt purpose in an amount not less than two-thirds of its minimum investment return.
- (2) In effect, the endowment test requires qualifying direct exempt-function distributions of  $3\frac{1}{3}\%$  ( $\frac{2}{3}$  of 5%) of the excess of the fair market value of the foundation's assets (other than assets used or held for use directly in carrying out the foundation's exempt purposes), over the amount of acquisition indebtedness with respect to such assets. Usually a foundation with a minimum investment return that is less than its adjusted net income will satisfy the endowment test if it satisfies the income test.
- (3) Congress added the endowment test alternative for the benefit of foundations that actively conduct charitable activities but need large endowments to fund their personal services. However, the Tax Court in "Miss Elizabeth" D. Leckie Scholarship Fund v. Commissioner, 87 T.C. 251 (1986) reasoned that the test applies to all foundations and held that the foundation satisfied the test under the circumstances of that case.
- (4) See the example at Treas. Reg. 53.4942(b)-2(b)(3) for another application of the test. Note that this example has not been updated to reflect the Tax Reform Act of 1976 (P.L. 94-455), which reduced the percentage used to calculate minimum investment return to 5%.
- (5) In most cases, the foundation satisfies the endowment test if it satisfies the income test. Only where the minimum investment return is markedly higher than adjusted net income does the endowment test (and thus the other alternative tests as well) have independent significance.
- (6) In determining whether the amount of such qualifying distributions is not less than an amount equal to two-thirds of the foundation's minimum investment return, the foundation isn't required to trace the source of such expenditures to

determine whether they were derived from investment income or from contributions. See Treas. Reg. 53.4942(b)-2(b)(1).

## **F. Support Test (Third Alternative Test)**

- (1) A private foundation must satisfy three requirements to meet the support test in Section 4942(j)(3)(B)(iii):
  - a. Substantially all of its support (other than gross investment income as defined in Section 509(e)) must normally be received from the public and from five or more exempt organizations that are not related to each other or to the recipient foundation per Section 4946(a)(1)(H);
  - b. Not more than 25% of its support other than gross investment income may normally be received from any one exempt organization; and
  - c. Not more than half of its support may normally be received from gross investment income.
- (2) Section 509(d) provides that for the purposes of Chapter 42, the term “support” includes (but is not limited to):
  - a. Gifts, grants, contributions, or membership fees,
  - b. Gross receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities in any activity which is not an unrelated trade or business within the meaning of Section 513,
  - c. Net income from unrelated business activities, whether or not such activities are carried on regularly as a trade or business,
  - d. Gross investment income,
  - e. Tax revenues levied for the benefit of an organization and either paid to or expended on behalf of such organization, and
  - f. The value of services or facilities (exclusive of services or facilities generally furnished to the public without charge) furnished by a governmental unit referred to in Section 170(c)(1) to an organization without charge.
- (3) The support received from any one exempt organization may not be counted toward satisfaction of the support test unless the foundation receives support from at least five exempt organizations. See Treas. Reg. 53.4942(b)-2(c)(2)(iii).
- (4) Support received from any individual or nonexempt organization (other than a governmental unit) is considered as support from the public only to the extent that it does not exceed 1% of the foundation’s total support (other than gross investment income). See Treas. Reg. 53.4942(b)-2(c)(2)(iv).
- (5) Support from two or more persons related to one another as described in Section 4946(a)(1)(C)-(G) is treated as support from one person. See Treas. Reg. 53.4942(b)-2(c)(2)(iv).



- (6) Support from a governmental unit described in Section 170(c)(1) is treated as support from the public but is not subject to the 1% limitation. See Treas. Reg. 53.4942(b)-2(c)(2)(iv).
- (7) Congress added the support test alternative primarily for the benefit of special-purpose foundations with expertise in specialized substantive areas, but it applies to any foundation meeting the standard. The support test is described in Treas. Reg. 53.4942(b)-2(c).

## **G. Certain Long-Term Care Facilities**

- (1) For Section 4942 (but no other IRC provision), an operating foundation includes a foundation that meets the following three requirements (Section 4942(j)(5) and Treas. Reg. 53.4942(b)-1(a)(2)):
  - a. The foundation operates and maintains (as its principal functional purpose) residential facilities for the long-term care, comfort, maintenance, or education of permanently and totally disabled persons, elderly persons, needy widows, or children,
  - b. The foundation has operated and maintained such facilities continuously from May 26, 1969, to the close of the taxable year, and
  - c. The foundation meets the endowment test of Section 4942(j)(3)(B)(ii).
- (2) To meet the "principal functional purpose" requirement, a foundation must be organized for the principal purpose of operating and maintaining such residential facilities and must directly operate and maintain such facilities as its primary activity. See Treas. Reg. 53.4942(b)-1(a)(2)(ii).
- (3) Operating and maintaining such facilities is treated as a foundation's primary activity if at least 50% of its qualifying distributions are normally made to operate and maintain those facilities. See Treas. Reg. 53.4942(b)-1(a)(2)(ii).
- (4) Congress enacted Section 4942(j)(5) to relax the income test for those foundations. Those foundations are not precluded from satisfying the income and alternative tests under Section 4942(j)(3).

## **H. Periods and Methods for Calculating the Tests**

- (1) To qualify for private operating foundation status, a foundation must satisfy the income test and either the assets, endowment, or support test, in one of two methods:
  - a. The first is the three-out-of-four-year method, which requires meeting the income test and one of the alternative 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 (the four-year period). This method considers each year separately.



- b. The second method is the aggregation method which aggregates all pertinent amounts of income or assets held, received, or distributed during the four-year period including the taxable year in question. Treas. Reg. 53.4942(b)-3(a).
- (2) An organization in existence for four or more tax years cannot claim operating foundation status for a particular year unless it has met the income and alternative tests for at least two years before the year in question (using the three-out-of-four-year method) or the four tax-year period ending on the year in question (using the aggregation method).
- (3) A foundation must use the same method for both the income test and the alternative test in its three-year or four-year calculations on Form 990-PF, Return of Private Foundation or Section 4947(a)(1) Trust Treated as a Private Foundation ("Form 990-PF"), for a given year but may use the other method for the two tests the following year. See Treas. Reg. 53.4942(b)-3(a).
- (4) A foundation may not qualify as an operating foundation in one year and qualify in the following year, but the qualification in the latter year will not serve to retroactively qualify the foundation in the former year. See Treas. Reg. 53.4942(b)-3(a).

## **I. Special Rules for New Organizations**

- (1) An organization that satisfies the income test and one of the alternative tests for its first taxable year of existence is treated as a private operating foundation from the beginning of its first taxable year. The organization will be treated as an operating foundation for its second and third taxable years only if it satisfies the tests by the aggregation method for all taxable years it has existed. See Treas. Reg. 53.4942(b)-3(b)(1).
- (2) An organization that has not yet completed its first taxable year is treated as an operating foundation if the organization has made a good faith determination that it is likely to satisfy the income test and one of the alternative tests for its first taxable year. A good faith determination will be considered to be made where the determination is based on an affidavit or opinion of counsel of the organization that the requirements will be satisfied. The affidavit or opinion must set forth sufficient facts about the operations and support of the organization for the IRS to be able to determine that the organization is likely to satisfy the requirements. See Treas. Reg. 53.4942(b)-3(b)(2).
- (3) An organization may ask to be classified as a private operating foundation as part of its Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code. Otherwise, an organization seeking operating foundation status must submit Form 8940, Request for Miscellaneous Determination, along with all information, documentation, and other materials required by Form 8940 and its instructions.

- (4) A foundation that is treated as an operating foundation for its first tax year based on a good-faith determination but actually fails to qualify will be treated as a non-operating foundation as of the beginning of its second tax year for all Code purposes, unless the foundation establishes to the IRS's satisfaction that it is likely to qualify as an operating foundation on the basis of its second, third, and fourth tax years. See Treas. Reg. 53.4942(b)-3(b)(2).
  - a. If the foundation actually fails to qualify in its second, third, or fourth year, then it will be treated as a non-operating foundation as of the beginning of the year in which it fails to qualify and until it qualifies for a particular year on the basis of the aggregation method (for a full four tax years) or the three-out-of-four-year method. Treas. Reg. 53.4942(b)-3(b)(2).

## **J. Recognition of Operating Foundation Status**

- (1) An organization determined to be a private foundation may request a foundation status change by submitting Form 8940, Request for Miscellaneous Determination. Treas. Reg. 1.508-1(b)(5) and Revenue Procedure (Rev. Proc.) 2024-5, 2024-1 I.R.B. 262, (updated annually) list procedures for applying for and issuing, modifying, and revoking rulings and determination letters for private operating foundation status.
- (2) A grant to a foreign organization that hasn't received a ruling on operating foundation status may be treated as a grant to an operating foundation if the grantor foundation makes a "good faith determination," also known as an "equivalency determination," that the grantee is an operating foundation. Treas. Reg. 53.4942(a)-3(a)(6). In general, a determination will be considered a "good faith determination" if it's based on current written advice from a qualified tax practitioner and if the foundation reasonably relies in good faith on the written advice in accordance with the requirements of Treas. Reg. 1.6664-4(c)(1). The written advice must set forth sufficient facts concerning the operations and support of the donee organization for the IRS to determine that the donee organization would be likely to qualify as a private operating foundation. Rev. Proc. 2017-53, 2017-40 I.R.B. 263, has a procedure for private foundations to make the good faith/equivalency determination.
- (3) Although rulings and determinations relating solely to operating foundation status and other non-disclosable matters (and not part of the organization's application for tax-exempt status) aren't subject to public disclosure under Sections 6104 or 6110, organizations recognized as operating foundations under Section 4942(j)(3) are listed as such in the IRS's databases.
- (4) All private foundations claiming operating foundation status must fill out the relevant schedule of Form 990-PF, which is subject to public disclosure.

## **K. Reliance by Contributors**

- (1) Under Treas. Reg. 53.4942(b)-3(d), contributors per Section 170, and grantors, per Section 4942 ("contributors"), may rely on a foundation's operating foundation classification by the IRS if all the following circumstances exist:
- a. The IRS has not published notice of the foundation's change in status (such as in the Internal Revenue Bulletin);
  - b. The contributor has no knowledge that the IRS has given notice to the foundation that it would be classified as a non-operating foundation; and
  - c. The contributor is neither responsible for nor aware of any act or failure to act resulting in the foundation's inability to satisfy the requirements of operating foundation status. A contributor will not be considered responsible for or aware of such an act or failure to act if the contributor makes his contribution in reliance on a written statement, described in Treas. Reg. 53.4942(b)-3(d)(2), by the grantee foundation.

**Note:** See also Treas. Reg. 1.508-1(b)(5) and (6) and Rev. Proc. 2018-32, 2018-23 I.R.B. 739.

### **III. Other Considerations**

- (1) There are other considerations when examining a private operating foundation.

#### **A. Classification of Private Operating Status**

- (1) Being classified as a private operating foundation described in Section 4942(j)(3) rather than as a private non-operating foundation has certain advantages including:
  - a. Operating foundations aren't subject to the excise tax imposed on the undistributed income of a private foundation under Sections 4942(a) and 4942(b).
  - b. A private foundation generally can satisfy its Section 4942 distribution requirement by making distributions directly for exempt functions or to operating foundations or public charities. An operating foundation is eligible to receive a qualifying distribution from a private non-operating foundation like a public charity if the private foundation doesn't control it. A private foundation may not make distributions to another private non-operating foundation unless the non-operating foundation makes a qualifying distribution of the grant within a certain period. See Sections 4942(g)(1)(A) and (g)(3).
  - c. Contributions by individuals to private operating foundations described in Section 4942(j)(3) are deductible by the donors to the extent of 50% for non-cash assets and 60% for cash contributions of the donors' adjusted gross income, whereas contributions to most other private foundations are generally limited to 30% of a donor's adjusted gross income. The Tax Cuts and Jobs Act, P. L. 115-97 distinguished and added the deduction limit of 60% for cash contributions effective for tax years beginning after December 31, 2017 and before January 1, 2026. See Section 170(b)(1)(G).
  - d. Operating foundations are treated like organizations described in Section 509(a)(1), (2), or (3) for estate and gift tax purposes for certain transactions involving works of art. See Sections 2055(e)(4); 2503(g).
  - e. Certain operating foundations may qualify as exempt operating foundations under Section 4940(d). Exempt operating foundations are exempt from excise tax under Section 4940, and private foundations are not required to exercise expenditure responsibility under Section 4945(d)(4) for grants they make to exempt operating foundations.

#### **B. Fair Market Value**

- (1) Fair market value is generally determined under the rules in Treas. Reg. 53.4942(b)-2(a)(4) (which cross-reference to the rules in Treas. Reg. 53.4942(a)-2(c)(4))

- a. For assets devoted directly to the active conduct of the foundation's exempt activities and for which neither a ready market nor standard valuation methods exist (such as historical objects or buildings, certain works of art, and botanical gardens), the historical cost, unadjusted for depreciation, is considered fair market value unless the foundation demonstrates a different value (the substituted valuation).
  - b. The foundation may use the substituted valuation on a five-year basis if it follows the procedures under Treas. Reg. 53.4942(a)-2(c)(4)(iv)(b). See Treas. Reg. 53.4942(b)-2(a)(4).
- (2) The alternative tests apply to all foundations. See "Miss Elizabeth" D. Leckie Scholarship Fund v. Commissioner, above.

## IV. Examination Techniques

- (1) This section focuses on how to calculate and assert excise tax once it has been determined that a Chapter 42 excise tax applies to the private operating foundation. It also contains information pertaining to examinations of private foundations in general.

### A. Introduction

- (1) Private operating foundations, except as noted above, are subject to the excise taxes like a non-operating foundation regarding the application of Chapter 42.

### B. Chapter 42 First Tier Excise Taxes Table

- (1) The table below identifies the parties subject to the Chapter 42 excise taxes, the applicable tax rates before and after the implementation of PPA 2006, and what limit, if any, applies to the tax, and if so, how much.
- (2) The Taxpayer Certainty and Disaster Tax Relief Act (TCA) passed on December 20, 2019, included legislation that reduced the 2% excise tax on net investment income of private foundations to 1.39%. At the same time, the legislation repealed the 1% special rate that applied if the private foundation met certain distribution requirements (former Section 4940(e)). The changes are effective for taxable years beginning after December 20, 2019.

Code Section	Liable party	Tax Rate (PPA 2006*)		Limit (PPA 2006*)		TCA
		Before	After	Before	After	After
4940(a)	PF	up to 2%	up to 2%	None	None	1.39%**
4941(a)(1)	Self-dealer	5%	10%	None	None	No change
4941(a)(2)	FM	2.5%	5%	\$10,000 per act	\$20,000 per act	No change
4942(a)	PF	15%	30%	None	None	No change
4943(a)(1)	PF	5%	10%	None	None	No change
4944(a)(1)	PF	5%	10%	None	None	No change
4944(a)(2)	FM	5%	10%	\$5,000 per act	\$10,000 per act	No change
4945(a)(1)	PF	10%	20%	None	None	No change
4945(a)(2)	FM	2.5%	5%	\$5,000 per act	\$10,000 per act	No change

\*The tax rate changes are effective for full tax years that begin after August 17, 2006.

\*\*The tax rate changes are effective for full tax years after December 20, 2019.

- (3) If an organization or individual incurs an excise tax under Section 4941, 4942, 4943, or 4944 in a given year, then the first tier tax is imposed that year and each subsequent tax year or partial year in the taxable period (but under Section 4943, only for tax years that end within the taxable period). For Section 4941, 4943, and 4944, the taxable period doesn't end until the earliest of:
- Full correction (in the case of Section 4943 when the excess business holding is eliminated, or in the case of Section 4944, when the amount invested is removed from jeopardy),
  - Assessment, or
  - Issuance of a notice of deficiency.
- Note:** If a foundation has undistributed income under Section 4942 for its first taxable year that remains undistributed as of the end of its second taxable year, then the Form 4720 instructions treat the Section 4942 tax on the undistributed income as imposed at the end of its second taxable year and reportable on Form 4720 for its second taxable year (normally due May 15 of its third taxable year for a calendar year filer).
- (4) For Sections 4942 and 4945, the taxable period ends on the earliest of:
- Issuance of a notice of deficiency, or
  - Assessment.
- Note:** the notice of deficiency should reflect the taxes owed for all years and partial years up to the date of the notice, as a second notice of deficiency might not be allowed for taxes on the same act or failure to act. See Section 6212(c).
- (5) Under Section 4945, there is only one first tier tax in the taxable period (unlike Sections 4941 - 4944).
- (6) Use the tax year of the disqualified person for tax paid by the disqualified person under Section 4941 (Rev. Rul. 75-391, 1975-2 C.B. 446). Similarly, use the tax year of the private foundation for tax paid by the private foundation under Section 4940 or Sections 4942-4945, and the tax year of the foundation manager for foundation manager taxes under Sections 4941, 4944 and 4945.
- (7) Except for Section 4940, excise taxes are reported on Form 4720, Return of Certain Excise Taxes Under Chapters 41 and 42 of the Internal Revenue Code. Previously, for years prior to 2020, if the taxpayer was a self-dealer, disqualified person, organization or foundation manager, donor or donor advisor, or related person, the taxpayer completed Part II of the Form 4720 to report the tax. When Part II was processed, the Form 4720 was designated as Form 4720-A. Alternatively, such taxpayer (described above) had the option to

report liability for excise tax on the return filed by the organization, assuming that both had the same taxable year. For tax years beginning in 2020, each taxpayer must file a separate Form 4720. Form 4720 has been revised to identify whether the filer is the organization or another taxpayer subject to the Chapter 42 excise taxes. Accordingly, for tax years after 2019, an agent preparing the Form 4720 under substitute for return (SFR) procedures to report a taxpayer's excise tax liability during an examination will no longer convert Form 4720 to "Form 4720-A." The revenue agent will, instead, complete a Form 4720 identifying the filer as described in the instructions for Form 4720. Please see the instructions for Form 4720 and Notice 2021-01, 2021-2 I.R.B. 315, for further information.

**Note:** Electronic filing of the Form 4720 is required for private foundations for Form 4720 returns due on or after July 15, 2021. A limited exception applies for 2020 Form 4720 returns with a due date on or after July 15, 2021, that are submitted on paper and bear a postmark date on or before June 16, 2021. Organizations other than private foundations are encouraged, but not required, to file Form 4720 electronically.

- (8) To calculate Section 4940 and Section 4942 taxes, complete the Form 990-PF, Return of Private Foundation or Section 4947(a)(1) Trust Treated as Private Foundation. Reclassify expenditures as necessary to determine the qualifying distributions.
- (9) The applicable report forms are:
  - a. Form 4621, Exempt Organizations - Report of Examination
  - b. Form 4883, Exempt Organizations Excise Tax Audit Changes
  - c. Form 886-A, Explanation of Items
  - d. Form 870-E, Waiver of Restrictions on Assessment and Collection of Deficiency and Acceptance of Overassessment

## C. Qualifying Distributions

- (1) Qualifying distributions are made to achieve Section 170(c)(2)(B) purposes.
- (2) If a distribution doesn't serve a Section 170(c)(2)(B) purpose, and doesn't meet an exception in Section 4942 or in Treas. Reg. 53.4942(a)-3, then redo the Form 990-PF Parts X, XI, XII, and XIII for the year(s) under examination. If operating under a six-year statute memo from Area Counsel, redo the form for each year under examination.

**Note:** Some transactions that constitute self-dealing transactions and/or taxable expenditures aren't qualifying distributions. Look at each transaction/expenditure on a case by case basis.

- (3) A taxpayer generally can't make any elections with respect to qualifying distributions during the examination. Taxpayers must make the elections before they file the Form 990-PF. If the taxpayer properly made a pre-filing



election, verify it. If there is a valid election, consider that when revising Part XIII. (You may find the election in another part of the form.)

**Note:** To incur the Section 4942 excise tax requires two years of failing to distribute; in other words, a foundation has until the end of Year 2 to make qualifying distributions of its distributable amount for Year 1. Consider opening all periods with open statutes when dealing with possible disqualified distributions. See TG 59 Taxes on Foundation Failure to Distribute Income – IRC Section 4942 for more information.

(4) Refer to the Correction section for a discussion of acceptable correction.

(5) Complete Forms 4883, 4621, 886-A and 870-E.

**Note:** Form 870-E is used with respect to the taxes that a taxpayer agrees to pay in full, suspends interest from continuing to accrue, and facilitates closure. See IRM 8.6.4, Reaching Settlement and Securing an Appeals Agreement Form, and IRM 4.70.14, Resolving the Examination. List separately the tax for each act or taxable event (and for each year within the taxable period) and prepare a separate Form 870-E for each taxpayer as applicable.

(6) The tax is reported on Form 4720 and assessed against the private foundation. See IRM 4.70.13, Executing the Examination, to set up a substitute for return if no Form 4720 is filed or to secure a delinquent return.

#### **D. One Act/Failure to Act, Multiple Violations**

(1) The structure of Chapter 42 permits the assessment of excise taxes under different statutes for the same transaction. For instance, a self-dealing transaction (Section 4941) is frequently also a taxable expenditure (Section 4945), that may also affect the net investment income (Section 4940) and the qualifying distributions (Section 4942). See Treas. Reg. 53.4944-1(a)(2)(iv); Rev. Rul. 77-161, 1977-1 C.B. 358; *Kermit Fisher Foundation v. Commissioner*, T.C. Memo. 1990-300.

(2) Section 4940 and Section 4942 are closely related. Expenses must be allocated between Section 4940 (investment activities) and Section 4942 (charitable activities). See Treas. Reg. 53.4940-1(e)(1); Rev. Rul. 75-410, 1975-2 C.B. 446; *Julia R. & Estelle L. Foundation, Inc. v. Commissioner*, 598 F.2d 755 (2d Cir. 1979); *Kermit Fisher Foundation v. Commissioner*, above. Also, a deduction for expenses paid or incurred in any taxable year for the production of gross investment income earned as an incident to a charitable function may not be greater than the income earned from such charitable function which is includible in gross investment income for such year. See Treas. Reg. 53.4940-1(e)(2)(iv). However, deductions with respect to property used for an exempt purpose in excess of the income derived from the property may be treated as a qualifying distribution. See Treas. Reg. 53.4942(a)-2(d)(4)(i).

- (3) For taxable years beginning before December 21, 2019, Section 4940(e) and Section 4942 were especially inseparable. Adjustments to the net value of non-charitable use assets impact the investment tax calculations (under former Section 4940(e)) and the minimum investment return (Section 4942). Both taxes rely on determining qualifying distributions; Section 4942 applies them against undistributed income to compute the tax liability. The following examples illustrate several outcomes when changes are made to the first page of the Form 990-PF.
- (4) Note that the examples below regarding Section 4940, which imposes an excise tax on the net investment income of most domestic tax-exempt private foundations, including private operating foundations, are for tax years beginning on or before December 20, 2019. For those tax years, the excise tax is 2% of net investment income, but is reduced to 1% in certain cases. For tax years beginning after December 20, 2019, the excise tax is 1.39% of net investment income, and there is no reduced 1% tax rate.

**Example 1:** The foundation engages in self-dealing expenditures. The foundation reported these amounts in Part I Column d as charitable disbursements. The IRS later disallows these amounts and the Part XII Line 1a amount is reduced. This in turn reduces the qualifying distributions. When the qualifying distributions for the year are less than: the sum of 1% of the net investment income and the product of 1) the 5-year average distribution ratio and 2) the net value of the non-charitable use assets, the foundation can't use the Section 4940(e) 1% tax rate. For Section 4942 purposes, undistributed income is offset by qualifying distributions. When the qualifying distributions are reduced or disallowed, the potential for tax on undistributed income arises. This flow of actions is demonstrated as follows:

Form 990-PF line adjustment	Increase or decrease
Part I Line 26 Column (d)	Decrease
Part XII Line 1(a)	Decrease
Part XII Line 4	Decrease
Part V Line 8	Decrease
Part XIII Line 4	Decrease

**Note:** Part V of the Form 990-PF will no longer be used for taxable years beginning after December 20, 2019, because the Taxpayer Certainty and Disaster Tax Relief Act passed on December 20, 2019, included legislation that reduced the 2% excise tax on the net investment income of a private foundation to 1.39%. The legislation also repealed the 1% special rate that applied if the private foundation met certain distribution requirements.

If Part V Line 8 is less than Part V Line 7, use the 2% tax rate for Section 4940. A decrease in qualifying distributions results in Section 4942 tax if Part XIII Line 6(e) is greater than zero.

**Example 2:** The foundation understates the net investment income (either understating investment revenues or over-allocating/overstating investment expenses or both). This directly increases the Section 4940 tax. Also, this decreases the distributable amount (Part XI). This decreases the amount of undistributed income to be offset by qualifying distributions in Part XIII. This flow of actions is demonstrated as follows:

Form 990-PF line adjustment	Increase or decrease
Part I Line 27(b)	Increase
Part VI Line 5	Increase
Part XI Line 2(a)	Increase
Part XI Line 7	Decrease
Part XIII Line 1	Decrease

If the amount on Part XIII Line 1 is greater than the sum of Part XIII Lines 4(d) and 5, there will be an amount in Part XIII Line 6f. This amount is then reported on the subsequent year's Form 990-PF Part XIII Line 2a.

**Example 3:** The foundation overstates the net investment income. The Section 4940 tax is reduced, and the distributable amount in turn is increased, increasing any possible Section 4942 tax.

**Example 4:** The foundation understates the non-charitable use assets. (This frequently occurs when the return preparer averages the beginning and end of year bank/brokerage balances in lieu of the month end balances.) The non-charitable use assets net value and the minimum investment return (Part X Lines 5 and 6) increases. In addition to affecting the subsequent year's distribution ratio, it raises the threshold for meeting the Section 4940(e) reduced tax rate. For Section 4942 purposes, the distributable amount increases, thus increasing the chance for tax two years down the road.

**Example 5:** The foundation overstates the non-charitable use assets. The net value of non-charitable use assets decreases, as do the minimum investment return and distributable amount. This lowers the Section 4940(e) threshold, and the chance for a possible Section 4942 tax is reduced.

- (5) Section 4941 and Section 4945 excise tax liability can commonly occur for the same transaction. Many self-dealing transactions aren't considered to be for Section 170(c)(2)(B) purposes, thus becoming taxable expenditures. On the

other hand, a taxable expenditure isn't necessarily a self-dealing transaction and vice-versa. See Rev. Rul. 77-161, 1977-1 C.B. 358. Remember to apply the appropriate IRC section and regulations when analyzing each transaction.

**Example 1:** A foundation manager uses foundation funds to go on a vacation in the Bahamas. This transaction is both a self-dealing transaction and a taxable expenditure.

**Example 2:** The same foundation manager is a member of Church X congregation. The manager uses the funds to pay for a "recuperation retreat" for the church's pastor and the pastor's family in the Bahamas. The manager isn't related to the pastor by blood or marriage, and the pastor and family aren't otherwise disqualified persons with respect to the foundation. The foundation doesn't have advance approval under Section 4945(g) to make grants to individuals. Due to lack of advance approval of the grant procedures under Section 4945(g), the transaction constitutes a taxable expenditure but not a self-dealing expenditure.

- (6) An act subject to Section 4943 may also trigger other taxes in certain situations.

**Example:** A foundation purchases stock of a disqualified person's wholly owned corporation directly from the disqualified person. The purchase of the stock constitutes a self-dealing transaction. If the foundation owns more than 2% of the total stock of the corporation, the purchase may trigger Section 4943. A donation of the stock won't constitute a self-dealing transaction but may trigger Section 4943.

- (7) As with Section 4943, an act subject to Section 4944 may also trigger other taxes in certain situations.

**Example:** The foundation bought stock of a disqualified person's wholly owned corporation from the disqualified person. The corporation is a corporate sole entity used to shelter the disqualified person's income and assets. The disqualified person isn't a minister of a church and thus the entity constitutes a sham corporation. The purchase constitutes a jeopardizing investment and a self-dealing transaction. As with the previous example, if the foundation owns more than 2% of the total stock of the corporation, the transaction may also trigger Section 4943.

## E. Information Regarding Correction

- (1) Each Chapter 42 excise tax (except for Section 4940) requires correction of the taxable event that triggers the excise tax. (Sections 4942, 4943, and 4944 generally don't refer to "correction," but effectively require correcting the violation to avoid multiple taxes and second tier taxes.) Failure to make correction can result in the imposition of second tier taxes. When one transaction triggers multiple excise taxes, the correction for one tax may possibly also satisfy correction for the other taxes. Refer to the specific

Technical Guides and Regulations for directions on the appropriate correction methods for each IRC subsection.

- (2) The immediately following table identifies the IRC subsection requiring correction and the actions required to make it. There is no correction for Section 4940, as it has no second tier excise tax. Section 4940 is an excise tax that is computed like an income tax, except that certain deductions aren't allowed, such as the net operating loss deduction under Section 172. Treas. Reg. 53.4940-1(e).

Code Section	Correction
4941(e)(3)	Undo the transaction to the extent possible. Restore the foundation to the same or better financial position that it would have been in had the transaction not occurred. Treas. Reg. 53.4941(e)-1(c)
4942(h)(2) and 4963(d)(2)	Reduce the amount of undistributed income to zero. Can elect to treat qualifying distributions as made from a prior year's undistributed income. Treas. Reg. 53.4942(a)–3(b)(6), relating to failure to distribute minimum amounts under the cash distribution test for set-asides, allows for correction (by distribution of cash or cash equivalent only) within the correction period if the failure to distribute was not willful and was due to reasonable cause.
4943(c)	Depending on when and how the business holding was received, the organization may have a transition period in which to dispose of the excess holding. Correction is made when no excess holdings remain. Treas. Reg. 53.4943-9(c)
4944(e)(2)	Remove the investment from jeopardy by either selling it or disposing of it (other than exchanging it for another jeopardizing investment). Treas. Reg. 53.4944-5(b)
4945(i)(1)	Recover as much of the expenditure as possible, and any other correction the IRS may prescribe if unable to recover the whole expenditure. In certain situations, obtain or make a report on the use of a grant, or obtain approval of grantmaking procedures. Treas. Reg. 53.4945-1(d)

- (3) The correction amount isn't necessarily the same as the amount involved in a particular transaction. Compute the correction amount and the taxable amount involved separately. Refer to the specific Exempt Organizations Technical Guides and regulations for directions on the appropriate correction methods.

**Note:** When two or more excise taxes are involved, verify that correction has been made for each tax code section under which liability arises. What may constitute correction for one section may not be sufficient correction under another code section.

- (4) When correction is made, obtain verification. See the following list (not all-inclusive) for acceptable proof of correction. Discuss with the manager and Area Counsel as to appropriate methods of correction and proof, if desired:
  - a. Copies of cancelled check(s) to the foundation and bank statement(s) showing the deposit(s).
  - b. New title documents for returned real property.
  - c. Copies of cancelled check(s) and bank statement(s) showing appropriate distributions.
  - d. Brokerage/financial institution statement(s) showing that a foundation no longer owns an asset or stock.
  - e. Copies of reports secured concerning the uses of grants made.
- (5) Be alert for attempts to circumvent the correction requirement. At a minimum, ensure that the parties don't:
  - a. Deposit the correction amount and then issue a new check back to the party making correction.
  - b. Obtain new title documents for returned property and then change title back to the party that returned the property.
  - c. Redeposit amounts distributed to satisfy Section 4942 (such as voided checks, circular transactions).
  - d. Transfer assets or stocks to other financial institutions or to disqualified parties for which statements aren't provided.
  - e. Engage in an act of self-dealing when attempting to make correction.
- (6) If revoking or involuntarily terminating the foundation, request and verify that correction is made to a governmental agency or other Section 501(c)(3) organization that isn't itself at risk of revocation.
- (7) In the event that requests to extend the correction period (See Section 4963(e)(1)(B)) are received, under Delegation Order 7-4 (IRM 1.2.2.8.4, Delegation Order 7-4), Area Managers may authorize extensions of the correction period, or delegate the authority to the group manager. Consult the group manager if considering granting an extension of time to make correction. It is recommended that the appropriate TE/GE Division Counsel also be consulted per the group manager's authorization.
- (8) Extensions of the correction period aren't ordinarily granted unless these factors are present:
  - a. The taxpayer is actively seeking in good faith to correct the taxable event.

- b. Adequate correction is unavailable or can't reasonably be expected to occur during the original correction period.
- c. The taxable event appears to be an isolated occurrence, and it appears unlikely that similar taxable events will occur in the future.

See Treas. Reg. 53.4963-1(e)(3).

**Note:** An extension of the correction period also extends the period in which the taxpayer may petition the Tax Court for the deficiency. Treas. Reg. 301.6213-1(e).

- (9) A taxpayer paying the full amount of the first tier tax during the original correction period extends the correction period to the later of:

- a. 90 days after paying the first tier tax, or
- b. The last day of the original correction period.

**Note:** If the taxpayer pays the first tier tax after the IRS mails a statutory notice of deficiency and before the 90-day period of the notice has expired, the taxpayer has 90 days from the payment date to make correction. See Treas. Reg. 53.4963-1(e)(4). If the taxpayer petitions the Tax Court regarding the second tier taxes, before the correction period (including extensions) expires, the correction period runs until the decision is final. See Treas. Reg. 53.4963-1(e)(2).

- (10) If prior to the expiration of the correction period (including extensions) a claim for refund is filed with respect to payment of the full amount of the first tier tax imposed with respect to the taxable event, the IRS shall extend the correction period during the pendency of the claim plus an additional 90 days. If within that time a suit with respect to the claim is filed, the IRS shall extend the correction period until the determination in the suit for refund. See Treas. Reg. 53.4963-1(e)(5).

- (11) If there has been a waiver of the restrictions on assessment and collection of the deficiency or if the deficiency is paid, and therefore no notice of deficiency is mailed, the correction period will end with the end of the collection prohibition period described in Treas. Reg. 53.4961-2(e)(5). See Treas. Reg. 53.4963-1(e)(6).

## F. Correction Period

- (1) Under Section 4963(e), the correction period is the period beginning on the first day on which the taxable event occurs and ending 90 days after the date of mailing under Section 6212 of a notice of deficiency with respect to the second tier tax imposed on such taxable event, extended by:
  - a. Any period in which a deficiency cannot be assessed under Section 6213(a) (determined without regard to the supplemental proceeding provided for under Section 4961(b)), and



- b. Any other period which the IRS determines is reasonable and necessary to bring about correction.
- (2) See Section 4963(e)(2), which sets forth special rules for when the taxable event occurs.

## **G. Advance Approval of Proposed Correction**

- (1) Taxpayers may request advance approval of a proposed correction. If granted, the advance approval provides assurance to taxpayers and organizations that IRS will view an intended remedial action favorably as correction.
- (2) Advance approval is **only** available when:
  - a. The only barrier is the reluctance to correct because the taxpayer is uncertain of final IRS approval, and
  - b. The other aspects of the issue aren't disputed.
- (3) For all other cases, treat the case as unagreed if the taxpayer is unwilling to make correction.
- (4) To grant advance approval, all the following conditions must be met:
  - a. The taxpayer indicates acceptance of initial tax liability (Sections 4941 through 4945).
  - b. Correction will be very difficult or costly, requiring the exercise of sound judgment on a broad scale.
  - c. The taxpayer should be able to complete the proposed correction within 90 days from the date of approval.
  - d. The taxpayer submits a written request for advance approval, attention of the Area Manager.
- (5) The written request must:
  - a. Fully describe the surrounding circumstances giving rise to the initial tax liability.
  - b. Outline in detail the nature and method of the proposed correction.
  - c. Accept an initial tax liability for the act or failure to act in question.
  - d. Include the date by which the taxpayer will complete the correction.
- (6) When such a written request is received, suspend further action on the issue, and continue all other aspects of the examination. Send a copy of the request to the Area Manager (scanned and secured e-mail if possible). Consult with Area Counsel if complex correction situations arise from the written request. Schedule and hold a conference call with the Group and Area Managers.
- (7) If the Area Manager approves the request, prepare, and issue a draft correction approval letter. See Letter 5305, Private Foundation Correction Approval Letter. The letter must:



- a. Explain in detail the proposed corrective action.
- b. Specify the due date for correction completion.
- c. Require the taxpayer to notify the area manager upon completion.
- d. Clarify that the taxpayer's reliance on the letter is conditioned on it meeting the conditions specified for correction.

**Reminder:** Monitor the time remaining on the statute of limitations. Consider requesting a statute extension as needed.

- (8) If the Area Manager denies the request, prepare, and issue a draft correction rejection letter. See Letter 5306, Private Foundation Correction Rejection Letter. In the letter:
  - a. Outline the taxpayer's proposal.
  - b. Explain why it doesn't constitute correction.
  - c. Clarify that other methods of correction are still available.
  - d. Suggest a correction action (or actions) that would be acceptable.
- (9) If the Area Manager accepts the request, keep the case in the group, and continue to work other issues on the case. When the Area Manager provides notification that the taxpayer corrected, secure proof. Secure the taxpayer's agreement to the first tier tax on Form 870-E. Collect the first tier tax or secure an installment agreement request (Form 9465, Installment Agreement Request).
- (10) If notification or proof isn't received by the due date for correction, contact the taxpayer to confirm correction. Ask the taxpayer to send proof right away (via express mail, or fax).
- (11) If proof of correction is not promptly received after contacting the taxpayer, close the case as unagreed. See IRM 4.70.14, Resolving the Examination, for closing procedures.

## H. All Chapter 42 Second Tier Excise Taxes

- (1) See the following table for the additional/second tier taxes generally applicable to private foundations under subchapter A for each code section.

Code Section	Liable Party	Tax Rate	Limit? (PPA 2006*)	
			Before	After
4941(b)(1)	Self-dealer	200%	None	None
4941(b)(2)	FM	50%	\$10,000 per act	\$20,000 per act

4942(b)	PF	100%	None	None
4943(b)	PF	200%	None	None
4944(b)(1)	PF	25%	None	None
4944(b)(2)	FM	5%	\$10,000 per act	\$20,000 per act
4945(b)(1)	PF	100%	None	None
4945(b)(2)	FM	50%	\$10,000 per act	\$20,000 per act
*The limit changes are effective for the first full tax years that begin after August 17, 2006.				

(2) Second tier taxes are:

- a. Triggered by the failure to make correction,
- b. Imposed at the same time as first tier taxes for assessment or when a notice of deficiency is issued, and
- c. Abated if correction is made within the correction period.
- d. Indicate in the report of examination (Forms 4883, 4621, 886-A) the amount of potential second tier taxes if the taxpayer doesn't make correction. With Area Manager approval, the closing of an agreed first tier tax case can be delayed for a reasonable period to permit correction, depending on the facts and circumstances.

(3) Before granting the above extension, ensure that the taxpayer has:

- a. Signed the Form 870-E.
- b. Paid the first tier tax.
- c. Granted a statute extension, if necessary.

**Note:** Obtain the Area Manager's approval due to the additional case cycle time.

- (4) All second tier taxes are imposed once per act/failure to act or taxable event. Refer to the specific IRC section and the regulations for how to determine the amount of the second tier tax calculation. Under Sections 4942 and 4943, if the taxpayer partially corrects (reduces but doesn't eliminate undistributed income or excess business holdings), the second tier tax is on the uncorrected remaining amount.

**Example:** M, a private foundation which uses the calendar year as its taxable year, has at the end of 1981, \$50,000 of undistributed income for 1981. As of

January 1, 1983, \$40,000 is still undistributed. On August 15, 1983, a notice of deficiency with respect to the excise taxes imposed by Section 4942(a) and (b) is mailed to M under Section 6212(a) and the taxable period ends. Thus, under these facts, an initial excise tax of \$12,000 (30% of \$40,000) is imposed upon M. An additional excise tax of \$40,000 (100% of \$40,000) is imposed by Section 4942(b). Under Section 4961(a), however, if the undistributed income is reduced to zero during the correction period, this latter tax won't be assessed, and if assessed, it will be abated, and if collected, it will be credited or refunded as an overpayment.

- (5) See IRM 4.70.14, Resolving the Examination, for additional information for the necessary letters and forms to complete. For a proposed second tier tax liability, show the second tier tax on the last year which shows an adjustment for the first tier tax, noting in the examination report that the additional tax will be imposed at the end of the taxable period if the act/failure to act or taxable event is not corrected. Before issuing a 30-day letter to a foundation manager asserting second tier taxes, the examiner must issue a Thorne letter requesting that the foundation manager agree to correction.
- (6) If the taxpayer doesn't agree to the tax or fails to make correction, the case is unagreed. See IRM 4.70.14, Resolving the Examination, for case closing procedures.

## I. Termination Tax

- (1) This section focuses on those situations when tax is due under Section 507 for termination of private foundation status. The termination tax acts like a third tier excise tax. The phrase "termination" has several different meanings in the context of private foundations. The term is ordinarily used when an entity dissolves or goes out of business. For a private foundation, however, termination of foundation status doesn't necessarily mean dissolution has occurred. Termination for Section 507 purposes means any of the following:
  - a. The foundation notifies the IRS and pays the Section 507(c) tax (if any) (Section 507(a)(1)).
  - b. The IRS involuntarily terminates the foundation and imposes Section 507(c) tax (Section 507(a)(2)).
  - c. The foundation transfers all of its net assets to certain public charities (Section 507(b)(1)(A)).
  - d. The foundation becomes a public charity (Section 507(b)(1)(B)).

**Note:** Transfer under Section 507(b)(2) of all of a foundation's net assets to one or more other foundations does not, by itself, terminate private foundation status. The foundation must separately terminate, whether voluntarily (Sections 507(a)(1), 507(b)(1)(A), or 507(b)(1)(B)) or involuntarily (Section 507(a)(2)).
- (2) If the foundation hasn't engaged in repeated willful acts or one flagrant, willful act triggering Chapter 42 taxes, the foundation may opt for termination under

Section 507(b)(1)(A) or (b)(1)(B). If terminated under Section 507(b)(1), the foundation pays \$0 in termination taxes.

- (3) If the foundation voluntarily terminates under Section 507(a)(1), the foundation submits its final Form 990-PF and pays a termination tax (\$0 tax if the foundation distributes all of its net assets before providing notice of termination). The foundation follows the instructions to the Form 990-PF as to the method of notification.
- (4) Consider a Section 507(a)(2) involuntary termination when there have been multiple willful repeated acts committed under Chapter 42. Also consider Section 507(a)(2) if there has been one willful and flagrant act committed triggering Chapter 42 treatment. If proposing involuntary termination, you can propose revocation at the same time.

**Note:** If a private foundation's Section 501(c)(3) status is revoked but its private foundation status isn't terminated under Section 507, then the foundation becomes a taxable private foundation; it's no longer tax-exempt but still subject to Chapter 42 taxes as a private foundation. See Section 509(b) and Treas. Reg. 1.509(b)-1(b).

**Note:** As a practical matter, termination tax assessments are more likely to occur during a subsequent examination. Once Chapter 42 taxes have been assessed, any new violations identified in a later examination will provide proof of willfulness.

- (5) Computing the termination tax requires multiple smaller computations normally provided by the foundation:

The Termination Tax is the Smaller of:	
A) The aggregate tax benefit - the sum of:	
1.	<p>The increase in income, estate, and gift taxes** on substantial contributors that would result from the disallowance of their contributions. The taxes are computed from the later of the foundation inception date or March 1, 1913. Section 507(d)(1)(A))</p>
B) The value of the net assets as of the date the foundation first committed a Chapter 42 violation that culminates in its Section 507 termination, or the effective termination date, whichever amount is higher. See Section 507(e)(1). Default to this amount unless the "aggregate tax benefit" is calculated.	

2.	The income taxes of the foundation, had the foundation filed Forms 1120, U.S. Corporation Income Tax Return, or Forms 1041, U.S. Income Tax Return for Estates and Trusts, in lieu of Forms 990-PF. The taxes are computed from the later of the foundation inception date or January 1, 1913.* (Section 507(d)(1)(B))
3.	The aggregate tax benefit from other private foundations in Section 507(b)(2) transfers. (Treas. Regs. 1.507-5(a)(3) and 1.507-3(a)(2))
4.	The accumulated interest on the above amounts as computed via Report Generated System NT (RGS NT) or Integrated Data Retrieval System (IDRS) command code INTST. (Section 507(d)(1)(C))
<p>*For purposes of this calculation, the charitable contribution deduction allowed a trust is deemed to have been limited to 20% of taxable income. Section 507(d)(1)(B)(ii).</p> <p>** For any year in which a gift tax would be due if a charitable deduction were not available, refer to the Instructions to Form 709, United States Gift (and Generation - Skipping Transfer) Tax Return, for that particular year for assistance in calculating the appropriate amount of deemed gift tax.</p>	

- (6) Aggregate tax benefit is used as the amount of the termination tax only if the foundation substantiates the amount by adequate records or other corroborating evidence. See Section 507(c)(1). As the IRS retains records for a limited period, it may not be feasible to compute the tax from the date of inception. Obtain what information is available via IDRS, return requests, and Online Statistics of Income EO Image Net (SEIN). Establish Audit Information Management System (AIMS) controls via the Reporting Compliance and Case Management System (RCCMS) using source code 45 to retrieve the returns of the substantial contributors.
- (7) See IRM 4.70.14, Resolving the Examination, for guidance on converting the Form 990-PF to Forms 1120 or 1041. Use the RGS NT to determine the increase in income tax from the disallowance of charitable contributions deductions.
- (8) Propose the tax using Forms 4883 and 4621. Use Form 990-PF to assess the tax in lieu of Form 4720.

- (9) Imposition of the termination tax doesn't eliminate liability for the underlying Chapter 42 taxes that initiated the termination process. See Treas. Reg. 1.507-1(b)(2).
- (10) When you close the case as a termination, prepare Form 2363-A, Request for IDRS Input for BMF/EO Entity Change, to update the status code, indicating the effective date in YYYYMM format:
  - a. Status 23: 507(a)
  - b. Status 24: 507(b)(1)(A) (no termination tax applies)
  - c. Status 25: 507(b)(1)(B) (no termination tax applies)
- (11) Termination of private foundation status under Section 507 results in the foundation being treated as an organization created on the day after termination. See Section 509(c).

## **J. Revocation**

- (1) Propose to revoke exemption if the foundation ceases to be operated exclusively for exempt purposes but the circumstances don't warrant involuntary termination of private foundation status under Section 507(a)(2). A Section 501(c)(3) foundation must engage primarily in activities that accomplish Section 501(c)(3) purposes. If more than an insubstantial part of its activities does not further an exempt purpose, propose revocation. A private foundation is subject to the auto-revocation process of Section 6033(j). (See IRM 4.70.14, Resolving the Examination.)
- (2) Foundations are subject to similar restrictions as other Section 501(c)(3) organizations:
  - a. Absolute prohibition for political campaigning.
  - b. Limitation on lobbying (subject to Section 4945(d) which functions as a virtual ban on lobbying).
  - c. Prohibition on inurement.
  - d. Prohibition on operating for the benefit of private interests.
  - e. Limitation on UBI activities (less than primary purpose).
  - f. Limitation on commercial-type insurance (Section 501(m)).
  - g. Prohibition on illegal activities/purposes that violate public policy.
- (3) If the foundation violates any of the prohibitions and/or restrictions listed above, propose revocation. Private foundations are subject to declaratory judgement under Section 7428 when proposing revocation. An administrative record and administrative record index are required for all proposed revocations and should be prepared in accordance with IRM 4.70.14, Resolving the Examination. Additionally, when proposing revocation, follow the information in

IRM 4.70.14, Resolving the Examination. Upon revocation, the foundation becomes a taxable private foundation.

- (4) In many revocations, the foundation, disqualified persons, and foundation managers may also be subject to Chapter 42 excise taxes. If there are willful repeated acts or a single willful and flagrant act triggering Chapter 42 taxes, propose the termination tax in addition to revocation. You may include the basic report forms with Letter 3614, 30-day letter package for Chapter 42 excise taxes. Form 870-E shows all tax deficiencies of the foundation.
- (5) In revocations of private foundations, the foundation becomes a taxable foundation and must file an income tax return as well as Form 990-PF. See Section 509(b) and Treas. Reg. 1.509(b)-1(b). Use status codes 18 (for trusts) and 19 (for corporations) in lieu of status code 22. Status codes 18 and 19 set the Form 990-PF and Form 1041 or Form 1120 filing requirements. Prepare Form 2363-A with status code change and indicate the effective date of revocation in YYYYMM format. Leave the Form 2363-A in the case file for processing following review.
- (6) All revocations are subject to Mandatory Review.

## K. Statute of Limitations

- (1) The Form 990-PF initially controls all statutory limitations periods for assessment and collection of taxes (or “statutes”) with respect to the excise taxes. (See Section 6501(l)(1) and Treas. Reg. 301.6501(n)-1(a).) The following table identifies the Code section, the taxable party, the return used to report the tax, and the year in which the tax is imposed.

Code Section	Liable Party	Tax Form	Tax year
4940(a)	PF	990-PF	On the same form, same year.
4941(a)(1)	Self-dealer	*4720	<p>If individual: Year of Form 1040, U.S. Individual Income Tax Return, in which transaction occurs.</p> <p>All others: Year of Form 1041 (trust), 1065 (partnership), or 1120 (corporation) in which transaction falls. *</p>
4941(a)(2)	FM	*4720	Form 1040 year in which transaction occurs.
4942(a)	PF	4720	Same year of Form 990-PF

4943(a)(1)	PF	4720	Same year of Form 990-PF
4944(a)(1)	PF	4720	Same year of Form 990-PF
4944(a)(2)	FM	*4720	Form 1040 year in which transaction occurs.
4945(a)(1)	PF	4720	Same year of Form 990-PF
4945(a)(2)	FM	*4720	Form 1040 year in which transaction occurs.
*Contact Area Counsel if considering asserting tax on indirect self-dealing against a disqualified person partner or other owner of the disqualified person entity (in addition to asserting tax on self-dealing against the entity).			

(2) The rules for the length of statutory period for assessing Chapter 42 taxes are:

Length of statute	Requirements	Code Section
3 years	Form 990-PF filed disclosing the transaction (must adequately identify existence and nature of transaction). See Cline v. Commissioner, T.C. Memo. 1988-144.	6501(a) and (e)(3)
6 years	Section 4940, 4948: Exceeds 25% of amount reported on return.  Section 4941 - 4945: Transaction not disclosed on the return.  Requires Area Counsel memo.	6501(e)(3)
Open ended	False or fraudulent return with intent to evade tax.  Form 990-PF not filed (SFR).  Requires Area Counsel memo for false or fraudulent returns.	6501(c)(1) and (c)(3), 6020(b)

(3) See table below for Section 4942 statute modifications:



4942 Subsection	Additional Time	Code Section Reference
4942(g)(3) Failure to distribute deficiency	+1 year to statute date	6501(l)(2)
4942(g)(2)(B)(ii) Failure to set aside deficiency	+2 years to statute date	6501(l)(3)

- (4) Prepare and obtain statute extensions for all parties to an excise tax. This entails extensions on the foundation, disqualified persons, and foundation managers, if applicable. Use Form 872, Consent to Extend the Time to Assess Tax, to secure the extension.

**Note:** A statute extension for the foundation's return doesn't extend the statute for a disqualified person or foundation manager. Separate statute extensions must be secured for all parties. Refer to IRM 25.6.22, Extension of Assessment Statute of Limitations by Consent, for further information regarding statute extensions.

**Caution:** You may use Form 872-A, Special Consent to Extend the Time to Assess Tax, as an alternative to allow an open-ended extension, until terminated by the submission of Form 872-T, Notice of Termination of Special Consent to Extend the Time to Assess Tax. Use Form 872-A only for cases with valid formal protests to Appeals.

- (5) The statutory limitations period for Chapter 42 taxes reportable on Form 4720 ordinarily begins with the filing of Form 990-PF, whether or not Form 4720 is filed. If there are multiple acts/failures to act or taxable events over a period of years, the Forms 4720 will have separate statutes for each transaction. When extending the statute for the Form 4720, extend the statute for all the transactions.

**Note:** The filing of Form 990-PF for the year of the initial taxable act ordinarily starts the limitations period (or periods, if multiple acts during the tax year) for second tier tax as well as first tier tax, even though second tier tax does not arise until the end of the taxable period. See the example in Treas. Reg. 301.6501(n)-1(c) regarding an act of self-dealing. Similarly, the second tier tax payable by a foundation manager is essentially on refusal to agree to correct, which does not arise until after a Thorne letter is sent.

- (6) For discrete acts, if the statute expired for the year the act occurred, no assessment can be made for any subsequent year. However, for continuing transactions under Section 4941, even if the statute expired for the year in

which the original transaction occurred, tax for each open year may be asserted (because a new act is deemed to occur every year within the taxable period). Similarly, an excess business holding acquired in a closed year of the foundation that is still held by the foundation in one or more open years is subject to Section 4943 tax for an open year, assuming the holding is still an excess business holding.

- (7) When preparing the extensions, reference the specific IRC section in the type of tax. Use “excise (Section 494X)”. If extending multiple excise tax code sections, state “excise (Sections 494X and 494Y)”. If extending both income and excise taxes, state “income and/or excise (Section 494X)”. It’s recommended that a consent for both income and excise tax be used only when a private foundation may be liable for both excise tax under Section 4940 on its investment income and income tax (such as unrelated business income tax). This is because a regular Form 872 is used to extend the statute for these taxes, based on the foundation’s taxable year and not taxable periods arising from taxable events (which require using a modified Form 872).
- (8) Extensions for Section 4941 through Section 4945 taxes require a modification of the Form 872. Replace the phrase “on any returns made by or for the above taxpayer(s) for the period(s) ended” with “from the above taxpayer(s) for the years that are fully or partially within the taxable period(s) that began.” Use the date of the first act or failure to act (or taxable event) for the start of the taxable period.
- (9) If there are multiple acts in a single tax year that trigger Chapter 42 taxes, you may list them on the modified Form 872.
- (10) For each year in which acts or failures to act occur which give rise to Chapter 42 taxes, including for deemed or continuing transactions (such as loan transactions in which each year the loan is outstanding, a new or separate transaction is created), secure a modified Form 872. Separate consents for each year in which new or continuing transactions occurred should be obtained.
- (11) As the Section 4940 tax is assessed on the Form 990-PF, prepare any statute extensions for Section 4940 taxes using the regular Form 872. Associate the statute extension with the appropriate Form 990-PF.

## **L. Applicable Penalties**

- (1) For a complete overview of the penalties that apply to private foundations, see IRM 20.1.8, Employee Plans and Exempt Organizations Miscellaneous Civil Penalties.
- (2) As the Form 990-PF is both an information return and an excise tax return for purposes of Section 4940, foundations are subject to several sets of penalties:

- a. Section 6652(c) - daily delinquencies (Section 6652(c)(1)(A) - failure to file return or show correct information), public inspections (Section 6652(c)(1)(C) and (D)) and prohibited tax shelters (Section 6652(c)(3)).
- b. Section 6651(a), Section 6655, and Section 6662(c) - failure to file, failure to pay, estimated tax (Section 6655(g)(3)(B)), and accuracy-related due to negligence penalties. See IRM 20.1.2, Failure To File/Failure To Pay Penalties, IRM 20.1.3, Estimated Tax Penalties and IRM 20.1.5, Return Related Penalties.

**Note:** The daily delinquency penalty of Section 6652(c)(1)(A) is computed on the number of days late. The failure to file penalty of Section 6651(a) is computed as a percentage of the Section 4940 tax due. A late filed Form 990-PF can be subject to both penalties. Both are normally automatically computed and assessed when the return is posted to BMF.

- (3) Foundations can also be subject to the criminal penalties of Section 7203, Section 7206, and Section 7207, as well as the civil fraud penalty of Section 6663. See IRM 9.1.3, Criminal Statutory Provisions and Common Law, and IRM 20.1.5, Return Related Penalties.
- (4) Foundations, individuals, and taxable entities who file (or are required to file but do not file) Form 4720 may be subject to failure to file, failure to pay, negligence, and civil fraud penalties.
- (5) Any entity or individual previously liable for a Chapter 42 tax may be subject to a 100% penalty. See Section 6684. This penalty may also be imposed where the act or failure to act is both willful and flagrant. In both circumstances, the act or failure to act must not be due to reasonable cause. Under Section 6684 if a person becomes liable for tax under any section of Chapter 42 and meets the criteria, then such person is liable for a penalty equal to the amount of such tax. Thus, this penalty can be imposed with respect to both first tier and second tier taxes.

**Note:** The IRS bears the burden of proof on whether an act or failure to act was willful and flagrant. See *Thorne v. Commissioner*, 99 T.C. 67 (1992); *Moody v. Commissioner*, 69 T.C.M. (CCH) 2517 (1995).

- (6) Foundations that file Form 990-T, Exempt Organization Business Income Tax Return, may be subject to failure to file, failure to pay, estimated tax, accuracy, and civil fraud penalties.
- (7) The officers, directors, trustees, and employees of a foundation may be subject to the public inspection compliance penalty of Section 6685 on the responsible party. See IRM 20.1.8, Employee Plans and Exempt Organizations Miscellaneous Civil Penalties.
- (8) When computing penalties under Section 6651(a)(1) and (2), 6651(f), 6662, or 6663, use the first tier tax amounts for the computations. Because the second tier taxes aren't taxes that are reported (or required to be reported) on any tax return, they are not subject to those penalties. Imposition of the penalties under

Sections 6662 and 6663 requires that the taxpayer file a return. If the taxpayer didn't file a return, those penalties don't apply. An SFR doesn't constitute a return for the purpose of applying penalties under Section 6662 and 6663.

**Example:** In a report of examination issued to a disqualified person for self-dealing transactions, the agent proposes \$15,000 in tax on a \$150,000 payment. The agent prepared a substitute for return package (IRM 4.70.13, Executing the Examination), because the taxpayer didn't file the late Form 4720. The agent proposes the failure to file and pay penalties. The 201312 return was due on May 15, 2014. The agent issued the report October 15, 2016. The failure to file penalty is at a 22.5% rate (4.5% x 5 months), for \$3,375. The failure to pay penalty rate is at 14.5% (.5% x 29 months late), for \$2,175. See Section 6651(a)(1), (a)(2), and (c)(1) (which reduces the penalty amount under Section 6651(a)(1) when both the failure to file and failure to pay penalties apply).

**Note:** The examination report should explain that the failure to pay computation is merely an estimate because the penalty will continue to accrue, until the initial tax is fully paid, up to a maximum rate of 25%.

- (9) If proposing or recommending a failure to pay penalty for a non-filer under a substitute for return package, the failure to pay determination must be included in the examination report. See IRM 4.70.13, Executing the Examination. In addition, the failure to pay penalty may only be asserted on a certified substitute for return. Examiners should follow the instructions on Form 13496.
- (10) Be aware that with some exceptions, Section 6751(b)(1) requires written supervisory approval for penalty assessment which must be obtained prior to issuing any written communication of penalties to a taxpayer that offers the taxpayer an opportunity to sign an agreement or consent to assessment or proposal of the penalty. See IRM 20.1.5, Return Related Penalties, which outlines the requirements for securing written supervisory approval and describes the documentation required for the case file. Section 6751(b)(2) provides exceptions to this requirement for additions to tax and penalties under 6651, 6654, 6655, or 6662 (but only with respect to an addition to tax by reason of subsection (b)(9)), and any penalties automatically calculated through electronic means. See IRM 20.1.1, Introduction and Penalty Relief, and IRM 20.1.11, Excise Tax and Estate and Gift Tax Penalties.
- (11) For examples of penalty computations, see the Example Worksheet/Exhibits section in TG 62 Excise Taxes on Taxable Expenditures – IRC Section 4945.

## **M. Domestic Taxable Private Foundations**

- (1) Taxable private foundations are former tax-exempt private foundations whose exemptions were revoked. Unless terminated under Section 507, they remain private foundations, and under TE/GE jurisdiction. See Section 509(b) and Treas. Reg. 1.509(b)-1(b).

- (2) Taxable private foundations are required to file Form 990-PF in addition to either the Form 1120 or Form 1041.
- (3) Taxable foundations remain subject to Chapter 42 taxes.
- (4) A taxable foundation owes Section 4940 tax to the extent that this tax (plus unrelated business income tax, computed as if it were still exempt), exceeds its income tax liability. See Section 4940(b). The foundation isn't subject to the Form 990-T filing requirement, but may attach the Form 990-T, Exempt Organization Business Income Tax Return, to the Form 990-PF to show the computations.
- (5) When computing the Section 4940 tax:
  - a. Compute the 1.39% tax via Form 990-PF.
  - b. Add the tax computed via Form 990-T.
  - c. Subtract the tax determined via Form 1120 or Form 1041.
- (6) Taxable foundations are subject to the penalty of Section 6710 for not making required disclosures under Section 6113 of non-deductibility of contributions for the first five years after revocation. See IRM 20.1.8, Employee Plans and Exempt Organizations Miscellaneous Civil Penalties.
- (7) If you find acts/failures to act that give rise to Chapter 42 taxes, consider proposing involuntary termination under Section 507(a)(2).

## N. Abatement of Excise Taxes

- (1) Under Sections 4961 and 4962, abatement is available for the following taxes:

Code Section	First Tier	Second Tier
4941	No	Yes
4942	Yes	Yes
4943	Yes	Yes
4944	Yes	Yes
4945	Yes	Yes

- (2) To qualify for abatement of second tier tax, the taxable event must be corrected within the correction period. See Section 4961(a). The taxpayer qualifies for abatement of first tier tax if the taxpayer establishes to the IRS' satisfaction that the taxable event:
  - a. Was due to reasonable cause,
  - b. Wasn't due to willful neglect, and
  - c. Was corrected within the correction period. See Section 4962(a).

- (3) The correction period begins on the date the event occurs and ends 90 days after the mailing date of a notice of deficiency in connection with the second tier tax imposed on that taxable event (Section 4963(e) and Section 6212). That time is extended by:

- a. Any period in which a petition to the Tax Court for redetermination of the deficiency is pending. See Section 6213(a).
- b. Any other period the IRS determines is reasonable and necessary to correct the taxable event.

- (4) If correction hasn't occurred or doesn't occur, abatement is unavailable. If correction is made, consider whether abatement is applicable for the first tier tax (other than Section 4941 tax, for which abatement is not available). Correction within the correction period requires abatement of the second tier tax.

**Note:** In practice, assessment of the tax is on hold until after the 90-day period (plus any court time) has elapsed. If correction is made, Mandatory Review and the EO Closing Unit adjust the assessment amount to reflect only the first tier tax.

- (5) If correction is made before a statutory notice of deficiency is issued, don't propose the second tier tax. Any subsequent statutory notice will exclude consideration of the second tier tax.
- (6) If correction is made after the correction period has expired, abatement isn't available under Section 4962.

**Note:** If a request for abatement or claim for refund is received, verify whether the second tier tax was assessed via an examination. If needed, request a copy of a previous examination report via RCCMS using source code 45.

- (7) If the taxpayer requests abatement during the examination, verify correction first. If the facts don't warrant abatement, document the willful neglect and failure to establish reasonable cause. If the facts warrant abatement, don't propose the tax. Address the issue in an advisory closing letter. See IRM 4.70.14, Resolving the Examination.
- (8) See the lists below for examples of abatement/non-abatement of the first tier tax.
- (9) Possible abatement:

**Example:** The foundation incurred a Section 4942(a) liability when it incorrectly valued its assets in a manner which was not willful and was due to reasonable cause. As a result of the incorrect valuation of assets, the foundation did not properly distribute all of its required distributable amount. A notice of deficiency with respect to the excise taxes imposed by Section 4942(a) and (b) is mailed to the foundation under Section 6212(a). Subsequently, the foundation makes the appropriate qualifying distribution (within the allowable distribution period). In addition, the foundation

submitted a written document requesting abatement of the excise taxes due to reasonable cause. The examining agent concurred that the foundation's written request for abatement has met the threshold for reasonable cause. Based upon these facts, the initial excise tax under Section 4942(a) can be abated since all the requirements of such subparagraph have been satisfied.

**Example:** The foundation incurred a Section 4943(a) liability when an unrelated third party exercised its property rights on an ownership interest in a jointly owned business enterprise. This was done at a time, and in a manner that made it difficult for the foundation to identify its risk in a timely manner despite prudent precautions.

**Example:** The foundation incurred a Section 4945(a) liability when it gave scholarships for the first time without obtaining advance approval of its scholarship procedures. Upon review of its procedures, an EO specialist determined that the procedures met the criteria for advance approval at the time the scholarships were originally given.

**Example:** The foundation relied, in good faith, on the written, reasoned advice of an attorney or accountant (dated before the transaction) that the transaction wasn't subject to Chapter 42.

(10) Likely non-abatement (though pertinent facts must be considered):

**Example:** The foundation's officers, directors, and representatives state they were ignorant of the provisions of the law.

**Example:** The Form 990-PF return for the tax period was prepared by a compensated attorney, accountant, or enrolled agent. The return gave no notice that a specifically identified questionable transaction had occurred.

**Example:** The foundation, a related foundation, or a predecessor foundation had a previous Chapter 42 tax amount abated under Section 4962 for the same type of taxable event.

**Example:** The taxable transaction wasn't identified as a potential violation of Chapter 42 by any party until an examination began.

(11) See IRM 4.70.17, Claims and Abatements, for information to work abatement requests.

## O. Pre-Examination Considerations

- (1) If a copy of the determination file isn't already in the file, follow the requirements in IRM 4.70.12, Planning the Examinations, to request and review a copy. You may receive a copy on disk, via secure e-mail, or via Teams. For private foundations, focus additional attention on:
  - a. Who are the founders, initial substantial contributors, and foundation managers?



- b. What is the purpose of the foundation (actively operating, grant-making, and so forth)?
  - c. Did the organization request advance approval of individual grant-making under 4945(g)?
  - d. If grant-making, what criteria were provided, and what constitutes the applicant pool?
  - e. What assets were donated to form the corpus of the foundation?
  - f. Who contributed the assets?
- (2) Make note of whether the articles of incorporation, association, or trust document contains the Section 508 language. See Publication (Pub.) 557. Note that most states now incorporate the language into state law, thus eliminating the requirement to have the language in the document. See Treas. Reg. 1.508-3(d). If the language is present, note all who signed the document.
- Note:** When encountering a Chapter 42 violation, be sure to incorporate this information into the report of examination, if relevant to the party committing the transaction (self-dealers, foundation managers). This helps establish that at a minimum the founders acknowledged these restrictions in the governing instruments at the time the foundation was formed.
- (3) If the application and/or tax return list a website address for the foundation, visit the website and determine whether the information matches the information in the application. Note any changes from the application materials. Compare contact information provided to the tax return and the application.
- (4) Obtain copies of prior and subsequent Forms 990-PF and Forms 990-T via Online SEIN.
- a. Review the Forms 990-T to determine the sources of income reported.
  - b. Using the Forms 990-T as a guide, add to the initial Information Document Request (IDR) any items on the Form 990-T that merit review.
  - c. Match the income and expenses reported on the Form 990-PF to the Form 990-T. Note any differences. Note whether there may be allocation issues.
  - d. Perform the standard risk analysis, identifying the large, unusual, and questionable items for inclusion on the IDR.
- Reminder:** Private foundations can be subject to the Form 990-T filing requirement for the same reasons as a public charity. The foundation is permitted to generate income within the limitations set by Chapter 42. An unrelated business directly conducted by a foundation, however, may constitute an excess business holding as a “sole proprietorship” business enterprise. See Section 4943(c)(3)(B) and Treas. Reg. 53.4943-10(e). Exceptions apply to a proprietorship described in Section 4943(d)(3).
- (5) Obtain IDRS transcripts for the foundation and the disqualified persons. Perform Accurint research on the disqualified persons. Review the completed



research for possible compliance issues (such as missing returns, prior Chapter 42 liabilities, same disqualified person and foundation addresses, foundation vehicles registered under disqualified persons, payments to disqualified person businesses listed on the Form 990-PF).

- (6) Review the Form 990-PF for the period(s) under examination in the following sequence:

<b>Review Form 990-PF:</b>	
<b>Verify the Statute of Limitations</b>	
1	Find the date stamped received.
2	Determine the date mailed, if possible.
3	Apply the rules of IRC Section 7502 (timely mailing treated as timely filing).
<b>Analyze the first page, Letters A through J (in the top third of the page)</b>	
1	Note the accounting method.
2	Note whether this is an initial, amended, or final return.
3	Determine whether there has been a name or address change.
4	Check whether a foreign foundation and percentage of foreign support (for purposes of Section 4948(b)).
5	Check for unusual events: prospective exemption, 507(b)(1)(A) termination, 507(b)(1)(B) conversion.
6	Note the type of entity.
<b>Review Parts VII-A and VII-B, Statements Regarding Activities</b>	
1	Verify the presence of all required schedules. Note any missing documents.
2	Check for an FBAR, if indicated.
3	Determine the liability for Form 4720.
4	Note any private benefit disclosures.
<b>Review Part VIII, Information About Officers, Directors, Trustees, Foundation Managers, Highly Paid Employees, and Contractors</b>	
1	Match the amounts reported to the Forms W-2. (Use command code IRPTRR to retrieve the Forms W-2.)
2	Note the top paid individuals and contractors. Match to the list of founders, substantial contributors, and foundation managers reported in the determination application and in Part XV. (May be subject to IRC Section 4941.)

<b>Review XVII, Information Regarding Transfers to and Transactions and Relationships With Noncharitable Exempt Organizations</b>	
1	Identify any large, unusual, or questionable items.
2	Verify the non-charitable entities exemptions on IDRS.
3	Print the INOLES/BMFOLO information for each non-charitable entity.
4	Use Online SEIN to obtain copies of the Forms 990 or 990-EZ for each entity.
5	Check EO Select Check for electronic postcard information.
6	See if there are any related parties on the board of each entity.
<b>Review Part XV, Supplementary Information</b>	
1	Identify any large, unusual, or questionable items.
2	Compare any entries to information from the determination application.
<b>Review Part IV, Capital Gains and Losses for Tax on Investment Income</b>	
1	Verify the math. Note any errors.
2	Identify any large, unusual, or questionable items.
3	Note the type of asset(s) for future reference in the interview and IDR.
<b>Review Part I, Analysis of Revenue and Expenses</b>	
1	Verify the math. Note any errors.
2	Identify any large, unusual, or questionable items.
<b>Review Part XVI-A, Analysis of Income-Producing Activities and Part XVI-B, Relationship of Activities to the Accomplishment of Exempt Purposes</b>	
1	Verify the math. Note any errors.
2	Identify any large, unusual, or questionable items.
3	Compare to Part I. Note any differences.
4	Compare to any filed Forms 990-T. Note any differences.
<b>Review Part II, Balance Sheets **</b>	
1	Verify the math. Note any errors.
2	Identify any large, unusual, or questionable items.
3	Check for any attached schedules. Note any missing schedules.

4	Compare any amounts on the attached schedules to Part II. Note any differences.
**There are new reporting standards for net assets, and Part II of Form 990-PF was updated to reflect the Financial Accounting Standards Board's (FASB's) reclassification of net assets into two classes, net assets without donor restrictions and net assets with donor restrictions.	
<b>Review Part III, Analysis of Changes in Net Assets or Fund Balances</b>	
1	Verify the math. Note any errors.
2	Note any increases or decreases not included in Part I, Line 27a. Determine whether such amounts should be included in Part I.
<b>Review Part IX, Summary of Direct Charitable Activities, Summary of Program-Related Investments</b>	
1	Identify any large, unusual, or questionable items.
2	Compare the expenses reported to the amounts listed in Part I.
3	If applicable, compare the investment amounts to the amounts listed in Part II.
<b>Review Part X, Minimum Investment Return</b>	
1	Verify the math. Note any errors.
2	Note the existence of any acquisition indebtedness for IRC Section 514 purposes.
<b>Review Part XI, Distributable Amount</b>	
1	Verify the math. Note any errors.
2	Note whether there was any income tax. Check the amount against Form 990-T (or Form 1120/Form 1041 if a taxable foundation).
3	Note any recoveries of qualifying distributions for inclusion in the IDR.
<b>Review Part XII, Qualifying Distributions</b>	
1	Verify the math. Note any errors.
2	For set asides, note whether claiming prior IRS approval or look for an attached schedule. If prior approval, or schedule is missing, note for inclusion in the IDR.
<b>Review Part XIII, Undistributed Income</b>	
1	Verify the math. Note any errors.
2	Note any excess distributions. Compare the amounts reported to the prior years' Forms 990-PF.
3	For entries indicating election required, check for the attached statement. If none present, include in the IDR a request of the election.

4	Verify that the foundation has not elected to treat a qualifying distribution as made out of corpus in an attempt to “refresh” an expiring excess distribution “carryover.”
<b>Review Part V, Qualification Under Section 4940(e) for Reduced Tax on Net Investment Income (for taxable years beginning on or before December 20, 2019)</b>	
1	Verify the math. Note any errors.
2	Compare the entries in Line 1 to the prior years' Forms 990-PF Parts X through XII. Note any differences.
<b>Review Part VI, Excise Tax Based on Investment Income</b>	
1	Verify the math. Note any errors.
2	Note the tax rate used. Verify whether the correct rate was used.
3	Note any additional taxes reported. Verify whether properly entered. (If tax-exempt, UBTI isn't included, and deductions taken into account in determining UBTI are not taken into account in determining Section 4940 tax either. If taxable, UBIT and regular income tax are included.)
<b>Review Part XIV, Private Operating Foundations</b>	
1	Verify the math.
2	Note which operating foundation status was claimed. (Section 4942(j)(3) vs. Section 4942(j)(5)). If Section 4942(j)(5), compare the charitable activities to the Code and regulation requirements. See Instructions to the Form 990-PF.
3	Note the letter date. Request a copy via the initial IDR.

**Note:** The above method of reviewing the Form 990-PF is based on the sequencing chart for completing the Form 990-PF (Instructions for Form 990-PF).

- (7) Review any information in the case file from Classification. Prepare to start an administrative record if there are indicators of potential exemption issues. See IRM 4.70.14, Resolving the Examination.
- (8) Modify the initial interview/questionnaire to incorporate any items identified during the review of the application and tax returns. Additional questions to ask:
  - a. Please describe the relationship, if any, between the foundation manager(s), founder(s), and any substantial contributor(s). (If all the same person, don't ask.)
  - b. Please explain your understanding of the Chapter 42 provisions/prohibitions.

- (9) Incorporate the items noted from analyzing the application and the tax returns. When asking for financial information, you can ask for the supporting source documents, such as bank statements and cancelled checks, for up to five years back. For private operating foundations, Form 990-PF Part XIV supports the request of records for the three prior years.

**Note:** When asking for the records, indicate the basis for the request. (For example, “Please provide the bank statements and cancelled checks for the years XXXX through YYYY to support the amounts reported on the Form 990-PF.”)

**Caution:** If you identify any self-dealing transactions or taxable expenditures in prior years, ensure that the statute is still open before pursuing the issue. Discuss with your manager regarding requesting a Counsel memo on a six-year statute, if applicable.

- (10) Consider requesting these additional items in the IDR:

- a. A list of all disqualified persons with respect to the foundation, including government officials with which the foundation had any interactions, and a brief explanation of why each is a disqualified person (for example “daughter of substantial contributor (Mr. X)”).
- b. A list of all business enterprises owned in whole or in part by the foundation and percentage of ownership for the foundation and disqualified persons. See Form 990-PF.
- c. The list of all scholarship and grant recipients who were awarded a grant or received a payment.
- d. Relationship information of the scholarship/grant recipients to the founder(s), substantial contributor(s), foundation manager(s) and any other disqualified persons.
- e. Copies of the scholarship/grant criteria and any application forms.
- f. Copies of any such applications and other grant request forms received.
- g. Title documents to any foundation-owned real property.
- h. Compensation contracts for the foundation manager(s).
- i. Notes and other loan documents involving disqualified persons.
- j. Review of the general ledger and bank statements for transactions with disqualified persons.
- k. Leases, partnership agreements, and all contracts between the foundation and disqualified persons.
- l. Credit card statements of the foundation as well as credit card statements of the disqualified persons, if applicable.
- m. Travel expenses incurred by the foundation on behalf of disqualified persons.

## P. Field/Office Correspondence Exam Information

- (1) Review any revised organizing documents. Verify that any Section 508 language is included, if not covered by state law. Determine whether any changes have modified the exempt purpose or jeopardize the exemption.
- (2) Perform the foundation status test. Verify whether the entity continues to fail to qualify under Section 509(a) as a public charity.

**Note:** If the foundation satisfies the test for public charity status, inform the organization of the possibility of a Section 507(b)(1)(B) termination. To apply for an advance ruling the foundation must file Form 8940 with EO Determinations.

- (3) Examine the financial statements and financial records. At a minimum, do the following:

Financial Statement and Financial Record Analysis:	
1	Compute the average fair market value of the securities using the twelve monthly ending values.
2	Do the same for the bank statements.
3	Compare the amounts to Form 990-PF Part X Line 1.
4	Identify the program-related investments, if reported on Form 990-PF Part IX-B and determine whether they qualify as such.
5	Determine if there is any overlap between program-related investments and non-charitable use investments.
6	Identify any assets purchased in the year(s) under examination.
7	Compare the asset purchase amounts to the amount reported in Part XII Line 2.
8	Determine any differences, verify whether any amounts are for non-charitable use.
9	Identify any amounts listed as set aside.
10	Verify that the set aside was appropriate.
11	Identify any acquisition indebtedness.
12	Determine whether Section 514 applies. If so, verify that a Form 990-T was filed and that it included the debt financed income.
13	Determine whether the acquisition indebtedness triggers Section 4941 as a loan with a disqualified person (or as a deemed sale or exchange with a disqualified person because the foundation received property subject to a mortgage or similar lien as described in Section 4941(d)(2)(A)).
14	Determine whether any of the asset purchases trigger Section 4941 as a sale with a disqualified person.

15	Review the other assets of the organization.
16	Look at the title documents. Review for any questionable elements involving disqualified persons.
17	Inquire and verify whether the assets are being used by any disqualified persons.
18	Review the cancelled checks and check registers. Request explanations for questionable expenditures.
19	Inspect any receipts provided for the questionable expenditures.
20	Identify all payments that are grants or scholarships to disqualified persons.
21	Determine whether the payments meet the exceptions to Section 4941 and Section 4945.
22	Compare the Forms W-2/1099 to the amounts reported on Form 990-PF Part VIII and to the amounts reported in the register.
23	Determine whether there are any missing or incorrectly reported Forms W-2/1099.

- (4) Determine how assets were used. Verify the relationship of the asset to the exempt purposes of the foundation. Tour all foundation facilities. If the foundation has real estate investment property, tour those properties as well. Be aware of potential self-dealing acts such as DPs having offices in the building or using the land. Does the foundation have artwork? Where is it located?

**Note:** Keep in mind that at times, potential self-dealing transactions may not show up in the books of the organization. For instance, the foundation may own property for investment purposes, such as ranch land. Do the disqualified persons use the land for recreation such as fishing or hunting?

- (5) Using a blank Form 990-PF, revise the amounts reported according to the exam findings. Changes to the return impact the Section 4940 tax and may trigger the Section 4942 tax. If you have reviewed the financial records from prior years, revise the prior year Forms 990-PF as needed. Use the modified information from the prior years to revise Parts V (as pertinent to years ending prior to December 20, 2019) and XIII of the exam year Form 990-PF.
- (6) If you determine that amounts reported in Part I Column d are not charitable expenditures, remove the amounts in your revised Form 990-PF. Remove self-dealing transactions and taxable expenditures from Part I Column d if previously reported as such. This in turn modifies Part XII, directly impacting the computations in Part XIII.
- (7) Determine whether the foundation has:
- Engaged in any self-dealing transactions.
  - Failed to make qualifying distributions.

- c. Held or acquired excess business holdings.
  - d. Made jeopardizing investments.
  - e. Made taxable expenditures.
- (8) If there are any acts/failures to act giving rise to Chapter 42 taxes, ensure that the statute of limitations is protected. Request extensions from the foundation and from each disqualified person party to an act/failure to act. Open AIMS controls on BMF for the foundation and any business entities and on NMF for any individuals.

**Note:** For tax years beginning in 2020, an individual liable for a Chapter 42 excise tax will not have the option to file jointly with the organization with respect to which the excise tax relates. Beginning with tax year 2020, Form 4720 has been revised to identify whether the filer is the organization or an individual. Therefore, for tax years after 2019, an agent preparing Form 4720 to report individual excise tax liability during an examination will no longer convert Form 4720 to “Form 4720-A.” The revenue agent will, instead, complete Form 4720 identifying the filer as an individual as described in the instructions for Form 4720. See the instructions to the Form 4720 for further information.

- (9) For any Chapter 42 taxes, prepare a report of examination for each liable party. Ensure that there are no disclosure violations. See IRM 4.70.14, Resolving the Examination, for the report letter and attachments. All excise tax reports include Forms 4621, 4883, 886-A and 870-E.
- (10) If an act requires correction, verify that correction is made before closing an agreed case. See IRM 4.70.14, Resolving the Examination, for the initial report, formal report, protest to Appeals, and rebuttal information.
- (11) See IRM 4.70.14, Resolving the Examination, for information on the necessary letters and forms to complete. However, before issuing a 30-day letter to a foundation manager proposing the second tier tax, you must first issue a Thorne letter. For help in drafting a Thorne letter, with your manager’s authorization, contact Area Counsel. A sample Thorne letter can be found in other Technical Guides, such as those for Sections 4941 and 4945.
- (12) For egregious cases, consider involuntary termination and revocation. Discuss these possibilities with your group manager and Area Counsel before pursuing these actions. See IRM 4.70.14, Resolving the Examination, for information on preparing an administrative record.

## **Q. Exam Case Closing Information**

- (1) Resolve the following types of related cases:
- a. Employment tax cases such as worker reclassification, fringe benefit treatment, and unreported amounts.



- b. Income tax cases (Forms 990-T for tax-exempt foundations, Forms 1120 or 1041 for taxable foundations).
  - c. Excise tax cases (gaming and/or Chapter 42 taxes).
- (2) Discuss with your group manager whether to close the related cases separately from the Form 990-PF.
- (3) Close Form 990-PF as a no change/no change with advisory if there is no modification to the Section 4940 tax, foundation status, or exempt status. See IRM 4.70.14, Resolving the Examination, for case file assembly and other common closing information.
- (4) For agreed cases involving employment, income, or gaming excise taxes:
  - a. Issue report of examination.

**Note:** Remember if a disqualified person is involved, there will be a separate case file and report for that taxpayer, and disclosure rules will be applicable.
  - b. Secure the agreement.
  - c. Collect payment or complete a request for an installment agreement. See IRM 4.70.14, Resolving the Examination.
  - d. Prepare the appropriate closing letter. See IRM 4.70.14, Resolving the Examination.
  - e. Close the case to your manager, who in turn closes it to the EO Closing Unit.
- (5) For agreed cases involving Chapter 42 taxes:
  - a. Request correction.

**Note:** No correction for Section 4940 adjustments
  - b. Obtain verification of correction.
  - c. Correction made: Issue report of examination.
  - d. Correction not made: Treat as unagreed.
  - e. Secure the agreement on Form 870-E.
  - f. Collect payment and/or complete the installment agreement request.
  - g. Prepare the appropriate closing letter.
  - h. Close the case to your manager, who in turn closes it to the EO Closing Unit.

**Note:** Before asserting excise taxes on the foundation manager(s), issue a Thorne letter, before issuing the 30-day letter. Consult your manager and Area Counsel for pre-issuance review of the Thorne letter.
- (6) For cases requiring correction, follow the information below:

- a. If correction is acceptable, issue the acceptance letter. See Letter 5305.
  - b. If correction is inadequate or unacceptable, issue the rejection letter. See Letter 5306.
  - c. If uncorrected, determine whether additional time is needed for correction.
  - d. Grant an extension of time with managerial approval for the correction to be made.
  - e. If uncorrected as of the end of the extension date, **close as unagreed**, even if the taxpayer previously signed an agreement to the first tier tax on Form 870-E.
- (7) For agreed cases involving revocation or foundation status modification:
- a. Secure Form 6018, Consent to Proposed Action.
  - b. Obtain a statute extension, if less than 270 days remaining on the statute of limitations.
  - c. Prepare a Form 3198-A, completing the Mandatory Review/Operations, Planning & Review section.
  - d. Close the case to your manager, who closes the case to Mandatory Review.
- (8) For unagreed cases, regardless of the type of tax or action (revocation, termination, foundation status modification):
- a. Issue a Thorne letter before issuing the 30-day letter if proposing second tier excise taxes on the foundation manager(s).
  - b. Obtain a full copy of the tax form under protest showing the date received, if not already in the file or on RCCMS. Use Online SEIN if obtaining a Form 990-PF or a filed Form 4720.
  - c. Issue a formal report of examination with the appropriate waiver/agreement form(s).
  - d. Ensure that there are 425 days remaining on the statute of limitations when closed from the group.
- Note:** All cases received in Appeals require 365 days remaining on the assessment statute of limitations.
- e. Prepare a Form 3198-A, completing the applicable sections.
  - f. Verify that a formal protest to Appeals is valid. If invalid, secure a valid protest.
  - g. Prepare and issue a full rebuttal to any protests.
  - h. Close the case to your manager as unagreed (with or without protest).
- Note:** If applicable, consider offering a Fast Track Settlement before issuing the formal report of examination. Both agent and manager must

approve a request to enter fast track negotiations. See IRM 4.70.14, Resolving the Examination, for Fast Track Settlement information.

(9) A valid protest contains the following elements:

- a. The taxpayer's name, address, Employer Identification Number (EIN) and a daytime phone number.
- b. A statement that the taxpayer wants to protest the proposed determination.
- c. A copy of the 30-day letter showing the findings that the taxpayer disagrees with (or the date and IRS office symbols from the letter).

**Note:** If a copy of the 30-day letter is the only item missing from a protest, the case can be closed using the copy in the file without returning the protest to the taxpayer to perfect. See IRM 4.10.8, Report Writing.

- d. An explanation of the taxpayer's reasons for disagreeing, including any supporting documents.
- e. The law or authority, if any, on which the taxpayer is relying.

(10) The protest must also contain a valid jurat statement: "Under penalties of perjury, I declare that I have examined this protest statement, including accompanying documents, and to the best of my knowledge and belief, the statement contains all relevant facts, and such facts are true, correct and complete."

(11) Representatives submitting the protest must also include a substitute declaration stating that the representative prepared the protest and any accompanying documents, and personally knows (or does not know) that the statement of facts in the protest and any accompanying documents are true and correct. Organization officers or representatives may sign the protest. (See Pub. 892, How to Appeal an IRS Decision on Tax Exempt Status.)

(12) For cases subject to Section 7428 declaratory judgment, prepare an administrative record. See IRM 4.70.14, Resolving the Examination.

## **V. Issue Indicators and Examination Tips**

- (1) This section provides for possible issue indicators and examination tips when examining a private foundation, particularly with respect to private operating foundations.

### **A. Issue Indicators**

- (1) Foreign foundations can qualify as both Section 4942(j)(3) private operating foundations and Section 4940(d) exempt operating foundations. Classification as an exempt operating foundation is a moot issue for Section 4940 as foreign foundations aren't subject to Section 4940 (see Section 4948(a)), though it may matter for Section 4945(d)(4). Foreign foundations can apply for reclassification as a public charity by filing Form 8940. If a foreign foundation claims to be an operating foundation, it is required to complete Part X of the Form 990-PF.
- (2) Operating foundations aren't subject to the excise tax on failure to distribute income (Section 4942). Also, contributions to private operating foundations described in Section 4942(j)(3) are, in general, deductible by the donors to the extent of 50% of the donor's adjusted gross income (60% in the case of cash contributions to a qualified charity), whereas contributions to other private foundations (except those described as Private Pass-through Foundations in Section 170(b)(1)(F)(ii)) are generally limited to 30% of the donor's adjusted gross income. However, for calendar years 2020 and 2021, individuals may deduct up to 100% of adjusted gross income for cash contributions to qualified charities, including private operating foundations. In addition, a private operating foundation may receive qualifying distributions from a private foundation if the private foundation does not control it.

### **B. Examination Tips**

- (1) Private operating foundations submit information to calculate their ongoing qualification based on their qualifying distributions, income, and assets. Review Form 990-PF, Part XIV computations to ensure the organization meets private operating foundation status.
- (2) If a private foundation isn't an operating foundation, then consider whether it has distributed enough in qualifying distributions. If not, then seek to impose the Section 4942 excise tax for failure to distribute income.
- (3) Check the organization's application for exemption, since any organization that is applying for recognition of exemption under Section 501(c)(3) may submit information that it's a private operating foundation, on the Form 1023. If the foundation has existed for one year or more, it must provide information that demonstrates it meets the requirements to be classified as a private operating foundation including the income test and either the endowment test, the assets test, or the support test. If the foundation has existed for less than one year, it

must sufficiently describe how it's likely to meet these requirements and tests. The foundation may also submit an affidavit or opinion of counsel giving enough facts about its operations and support to enable the IRS to determine that it's likely to meet these requirements.

- (4) Determine whether the income test and one of the three remaining tests are met. This depends on whether the tests are met in a foundation's normal and regular operation over a period of years, rather than on a given day during the year or on a year-by-year basis.
- (5) If a foundation fails to satisfy the income test and either the assets, endowment, or support test for a particular year under either the three-out-of-four year method or the combination method, treat it as a non-operating foundation for the tax year and all later tax years until it satisfies the tests.
- (6) Private operating foundations submit information to calculate their ongoing qualification based on their qualifying distributions, income, and assets. Review and substantiate Form 990-PF, Part XIV computations to ensure the organization meets private operating foundation status.