



Exempt Organizations Technical Guide

TG 57: Taxes on Net Investment Income – IRC Section 4940

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I. Overview

- (1) Organizations that are exempt from taxation under Section 501(c)(3) of the Internal Revenue Code and do not 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.
- (2) This Technical Guide discusses the tax imposed on the net investment income of tax exempt and taxable private foundations under Internal Revenue Code Section 4940.

A. Background / History

- (1) Before the Tax Reform Act of 1969, the investment income of private foundations, similar to public charities, wasn't subject to tax. According to the legislative history of Section 4940, the purpose of a tax on the investment income of private foundations was to:
 - a. Ensure private foundations would bear part of the cost of government, and
 - b. Function as a user fee that would help pay the cost of administering the private foundation provisions.
- (2) The tax imposed under Section 4940(a) is an excise tax and not an income tax. Unless an income tax treaty provides that a tax other than an income tax is covered for purposes of the tax treaty, excise taxes, and the Section 4940 excise tax in particular, will not be treated as a covered tax under that United States income tax treaty. See Revenue Ruling (Rev. Rul.) 84-169, 1984-2 C.B. 216.
- (3) The Pension Protection Act of 2006, Public Law 109-280 ("PPA 2006"), redefined gross investment income and capital gain net income for purposes of Section 4940(c). The Act also amended the Code 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 Public Law 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 have not 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. Accordingly, 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. Please see the Form 4720 instructions for further information.

B. Relevant Terms

- (1) **Disqualified Individual:** Section 4940(d)(3)(B) provides that the term "disqualified individual" means, with respect to any private foundation, an individual who is:
 - a. A substantial contributor to the foundation,
 - b. An owner of more than 20% of (i) the total combined voting power of a corporation, (ii) the profits interest of a partnership, or (iii) the beneficial interest of a trust or unincorporated enterprise, which is a substantial contributor to the foundation, or
 - c. A member of the family of any individual described in (a) or (b) above.

For purposes of this provision, the term "family " includes only an individual's spouse, ancestors, children, grandchildren, great grandchildren, and spouses of children, grandchildren, great grandchildren. The constructive ownership rules (Section 4946(a)(3) and (4)) apply in determining ownership in a corporation, partnership and trust for the purpose of defining "disqualified individual."
- (2) **Exempt Operating Foundation:** Section 4940(d)(2) provides that the term "exempt operating foundation" means, with respect to any taxable year, any private foundation if:
 - a. Such foundation is an operating foundation, as defined in Section 4942(j)(3),
 - b. Such foundation has been publicly supported for at least 10 taxable years,

- c. At all times during the taxable year, the governing body of such foundation (i) consists of individuals at least 75% of whom are not disqualified individuals, and (ii) is broadly representative of the general public, and
- d. At no time during the taxable year does such foundation have an officer who is a disqualified individual.

Note: Section 4940 does not impose tax on exempt operating foundations. See Section 4940(d). An organization must obtain a determination letter from the IRS recognizing its status as an exempt operating foundation to be exempt from the Section 4940 excise tax. See Revenue Procedure (Rev. Proc.) 2024-5, 2024-1 I.R.B. 262 (updated annually).

- (3) **Gross Investment Income:** Section 4940(c)(2) states that the term “gross investment income” means the gross amount of income from interest, dividends, rents, payments with respect to securities loans (as defined in Section 512(a)(5)), and royalties, but not including any such income to the extent included in computing the tax imposed by Section 511. Such term shall also include income from sources similar to those in the preceding sentence.
- (4) **Net Investment Income:** Section 4940(c)(1) states the net investment income is the amount by which (A) the sum of the gross investment income and the capital gain net income exceeds (B) the deductions allowed. Except to the extent inconsistent with the provisions of this section, net investment income shall be determined under the principles of subtitle A.

C. Law / Authority

- (1) For tax years beginning after December 20, 2019, Section 4940(a) imposes on each private foundation which is exempt from taxation under Section 501(a) for the taxable year, with respect to the carrying on of its activities, a tax equal to 1.39% of the net investment income of such foundation for the taxable year.

Note: On December 20, 2019, new legislation was signed that changed the excise tax rates of net investment income for most domestic tax-exempt private foundations, including private operating foundations. For tax years beginning January 1, 1985, through December 20, 2019, the excise tax was 2% of net investment income, but was reduced to 1% in certain cases (Section 4940(e)). Effective for tax years beginning after December 20, 2019, Section 4940(a) was amended to use a single tax rate of 1.39% on net investment income and Section 4940(e) was repealed.
- (2) The tax is reported on the form the foundation is required to file under Section 6033 and is paid annually at the time prescribed for filing its annual return regardless of whether any extension for filing is granted. See Treasury Regulation (Treas. Reg.) 53.4940-1(a).
- (3) Section 4940(b) imposes on each private foundation which is not exempt from taxation under Section 501(a) for the taxable year, with respect to the carrying on of its activities, a tax equal to:

- a. The amount (if any) by which the sum of (A) the tax imposed under subsection (a) (computed as if such subsection applied to such private foundation for the taxable year), plus (B) the amount of the tax which would have been imposed under Section 511 for the taxable year if such private foundation had been exempt from taxation under Section 501(a), exceeds
- b. The tax imposed under subtitle A on such private foundation for the taxable year.

II. Requirements

- (1) Section 4940 imposes an excise tax on the net investment income of most domestic tax-exempt private foundations, including private operating foundations.

A. Taxable Private Foundations

- (1) The Section 4940 excise tax is also imposed on taxable private foundations. A taxable private foundation is simply a private foundation that doesn't have tax-exempt status.

Example: A private foundation which fails to take the necessary steps to reform its governing instrument as required by Section 508(e) would lose exempt status and become a taxable private foundation.

- (2) Also, a Section 4947(a)(1) trust treated as a private foundation is subject to this tax. See Treas. Reg. 53.4947-1.

A.1. Computing Section 4940 Tax on Taxable Private Foundations

- (1) The tax on taxable private foundations is equal to the amount, if any, by which the sum of the 1.39% tax on investment income, computed as if the foundation were exempt from taxation under Section 501(a) for the taxable year, plus the amount of unrelated business income tax which would have been imposed for such taxable year if the foundation had been exempt from taxation under Section 501(a), exceeds the tax imposed under subtitle A on such foundation for the taxable year.
- (2) Stated otherwise, if the sum of the 1.39% excise tax on investment income and the tax on unrelated business income (applied to a taxable private foundation as if it were exempt) exceeds the regular income tax, then the taxable private foundation must pay the amount of this excess. This ensures a private foundation can't reduce its tax liability by losing its exempt status. The tax is paid annually at the time the organization is required to pay income taxes imposed under subtitle A.

B. Examples of Tax on Taxable Private Foundations

- (1) Assume that the tax liability under subtitle A for private foundation X, which is not exempt from taxation under Section 501(a) for 1970, is \$10,000. Had X been exempt under Section 501(a) for 1970, the tax imposed under Section 4940(a) would have been \$4,000 and the tax imposed under Section 511 would have been \$7,000. The excess of the sum of the taxes which would have been imposed under Sections 4940(a) and 511 (\$11,000) over the tax that was imposed under subtitle A (\$10,000) is \$1,000, the amount of the tax imposed on such organization under Section 4940(b). See Treas. Reg. 53.4940-1(b)(2) Example 1.

- (2) Assume the facts stated in Example (1), except that the tax liability under subtitle A is \$15,000 rather than \$10,000. Because the sum of the taxes which would have been imposed under Sections 4940(a) and 511 (\$11,000) does not exceed the tax that was imposed under subtitle A (\$15,000), there is no tax imposed under Section 4940(b) with respect to such foundation. See Treas. Reg. 53.4940-1(b)(2) Example 2.

III. Other Considerations

- (1) There are other considerations that should be analyzed when examining net investment income that may fall within the definition of Section 4940.

A. Prior Law: Reductions in Section 4940 Tax

- (1) For tax years beginning January 1, 1985, through December 20, 2019, the excise tax was 2% of net investment income, but was reduced to 1% in certain cases. The reduction in tax to 1% was for private foundations meeting certain distribution requirements of prior Section 4940(e).
- (2) The Deficit Reduction Act of 1984, as amended by the Tax Reform Act of 1986, added Section 4940(e) which, effective for taxable years beginning after December 31, 1984, reduces the excise tax on net investment income of a private foundation from 2% to 1% if the amount of the qualifying distributions made by the foundation during such taxable year equals or exceeds the sum of:
 - a. An amount equal to the foundation's assets for such taxable year multiplied by the average percentage payout for the base period; plus
 - b. 1% of the foundation's net investment income for such year. In addition, the rate reduction is not available if the foundation was liable for tax under Section 4942 with respect to any year in the base period.

A.1. Foundation's Assets

- (1) The amount of a foundation's assets is determined under Section 4942(e)(1) and shall be treated as the excess of the:
 - a. Aggregate fair market value of all assets of the foundation other than those that are used (or held for use) directly in carrying out the foundation's exempt purposes, over
 - b. Acquisition indebtedness with respect to such assets (determined under Section 514(c)(1) without regard to the taxable year in which the indebtedness was incurred).

A.2. Percentage Payout

- (1) Percentage Payout: A foundation's percentage payout for a taxable year is determined by dividing:
 - a. The amount of the foundation's qualifying distributions made during the taxable year, by
 - b. the foundation's assets for the taxable year.
- (2) The average percentage payout for the base period is the average of the percentage payouts for each of the taxable years in the base period. Section 4940(e)(3).

A.3. Base Period

- (1) The base period for any taxable year generally consists of the five taxable years preceding such taxable year. If an organization hasn't been a private foundation for five years, its base period consists of the taxable years during which the foundation has existed.

A.4. Qualifying Distribution

- (1) The term "qualifying distribution" has the meaning given such term by Section 4942(g). For any base period year in which the Section 4940 tax was reduced under the provisions of Section 4940(e), the amount of qualifying distributions to be taken into consideration for that base period year must be reduced by the amount of the tax reduction for that year.

A.5. Successor Organizations

- (1) When a private foundation is a successor to another foundation, it must consider the experience of its predecessor in applying these provisions.

A.6. Example of Section 4940(e) Eligibility Determination

- (1) A private nonoperating foundation has assets of \$100,000 in the taxable year in question. Qualifying distributions for the taxable year equal \$5,500, and net investment income is \$10,000. The data for the base period years are:

Year	Qualifying Distribution	4940(e) Tax Reduction	Assets	4942 Tax
Year 1	\$5,000	\$0	\$100,000	\$0
Year 2	\$7,000	\$0	\$140,000	\$0
Year 3	\$6,100	\$100	\$100,000	\$0
Year 4	\$8,000	\$0	\$120,000	\$0
Year 5	\$4,000	\$0	\$100,000	\$0

- (2) Step 1: Determine if there was liability for tax under Section 4942 for any year in the base period. Although the percentage for year 5 is less than 5%, no liability was incurred because the foundation carried over excess qualifying distributions under Section 4942(i).
- (3) Step 2: Since there was no liability, compute the percentage payout for each year, as follows:

$$\text{Year 1: } \$5000/\$100,000 = 5\%$$

Year 2: $\$7,000/\$140,000 = 5\%$

Year 3: $(\$6100-\$100)/\$100,000 = 6\%$

Year 4: $\$8000/\$120,000 = 6\frac{2}{3}\%$

Year 5: $\$4000/\$100,000 = 4\%$

- (4) Step 3: Average the percentage payout figures, with the result in this case being 5.333%.
- (5) Step 4: Multiply the 5.333% average payout by the foundation's assets for the current year. $\$100,000 \times 5.333\% = \$5,333$.
- (6) Step 5: Add 1% of the net investment income for the taxable year to this figure. $1\% \times \$10,000 = \100 ; $\$100 + \$5,333 = \$5,433$.
- (7) Solution: Because qualifying distributions for the taxable year (\$5,500) exceed \$5,433, the foundation qualifies for the Section 4940(e) reduction.

B. Net Investment Income

- (1) The net investment income of a private foundation is defined as the amount by which its gross investment income plus capital gain net income exceeds allowable deductions. In computing net investment income, no exclusions or deductions from gross investment income or credits against the Section 4940 tax are allowable except those provided in Section 4940 and the applicable regulations. Net investment income must be determined under the principles of Subtitle A, except to the extent inconsistent with the provisions of Section 4940.
- (2) Tax-exempt income and the expenses and interest related to such income are excluded in computing the base of the excise tax. In computing net investment income, the IRS has held that a private foundation:
 - a. Must include in the year received any capital gain dividend from a regulated investment company described in Section 851. See Rev. Rul. 73-320, 1973-2 C.B. 385.
 - b. Must apportion the audit fees it paid between its investment and exempt activities to deduct the former expense in computing net investment income. See Rev. Rul. 75-410, 1975-2 C.B. 446.
 - c. May deduct its amortizable bond premium to the extent that it would be deductible under Section 171 in computing its net investment income. See Rev. Rul. 76-248, 1976-1 C.B. 353.

C. Gross Investment Income

- (1) Section 4940(c)(2) defines gross investment income as the gross amount of income (other than unrelated business taxable income) from, and from sources similar to:
 - a. Interest

- b. Dividends
- c. Rents
- d. Payments with respect to securities loans (Section 512(a)(5))
- e. Royalties (including overriding royalties)

Example: Rents taxable as unrelated business taxable income pursuant to Section 512(b)(3) wouldn't be subject to Section 4940 excise tax. Interest, dividends, rents and royalties derived from assets devoted to charitable activities are included in gross investment income. Therefore, interest received on a student loan would be included in the gross investment income of a private foundation making such loan.

- (2) In computing gross investment income, unrelated business income taxable under Section 641(a) isn't includible in the gross investment income of a Section 4947(a)(1) nonexempt charitable trust. See Rev. Rul. 74-497, 1974-2 C.B. 383.
- (3) A private foundation includes in gross investment income the entire amount of interest income derived from the redemption of Series E U.S. Savings Bonds received from the estate of the purchaser, when neither the estate nor the purchaser elected to report as income the periodic increases in bond value. See Rev. Rul. 80-118, 1980-1 C.B. 254.

C.1. Subpart F Controlled Foreign Corporations - Section 965 Regulations Touch on Section 4940 Calculations

- (1) An inclusion under Section 951(a)(1) (inclusion of subpart F income from a controlled foreign corporation), including a Section 965(a) inclusion, generally is included in the calculation of gross investment income of a private foundation for purposes of determining the excise tax imposed under Section 4940. Gross investment income under Section 4940 doesn't include an inclusion under Section 951(a)(1), including a Section 965(a) inclusion, to the extent the amount is included in computing the unrelated business income tax imposed by Section 511. See Section 4940(c)(2). Section 4940(c)(3) allows as a deduction all the ordinary and necessary expenses paid or incurred for the production or collection of gross investment income or for the management, conservation, or maintenance of property held to produce income.
- (2) Under final regulations issued February 5, 2019, a Section 965(c) deduction is not treated as an ordinary and necessary expense paid or incurred for the production or collection of gross investment income for purposes of section 4940(c)(3)(A). See Treas. Reg. 1.965-3(f)(4).

C.2. Exclusion of Income from Section 4947 Trusts

- (1) Distributions received from a non-exempt charitable trust described in Section 4947(a)(1) or from an estate are excluded from a private foundation's gross investment income for purposes of Section 4940 tax. See Treas. Reg. 53.4940-

1(d)(2). Such trusts are treated as organizations described in Section 501(c)(3) and are themselves subject to Section 4940 excise tax unless they qualify as other than private foundations under Section 509.

- (2) Also excluded from a private foundation's income for purposes of the Section 4940 tax are distributions received from split-interest (charitable and noncharitable beneficiaries) trusts unless the distributions are attributable to transfers in trust made by a split-interest trust after May 26, 1969. See Treas. Reg. 53.4940-1(d)(2). This exception for distributions from post-May 26, 1969, transfers in trust prevents use of the split-interest trust to shelter investment income from the Section 4940 tax. However, Notice 2004-35 provides that until further guidance is promulgated, income from a trust or an estate is not included in a foundation's net investment income. See Notice 2004-35, 2004-19 IRB 889.

C.3. Non-Dividend Treatment of Certain Distributions in Redeeming Stock

- (1) Distributions made to a private foundation by a disqualified person (as defined in Section 4946(a)) in redemption of foundation-owned stock aren't treated as dividends.
- (2) Any distribution by a corporation that is classified as a disqualified person in redemption of stock held by a private foundation in a business enterprise will be treated as not essentially equivalent to a dividend if all the following conditions are met:
 - a. The stock was owned by the private foundation on May 26, 1969.
 - b. The foundation is required to dispose of the stock in order not to be liable for the Section 4943 tax on excess business holdings.
 - c. The foundation receives in return an amount that equals or exceeds the fair market value of the stock at the time of disposition (or at the time a contract for the disposition was previously executed) in a transaction that wouldn't be a prohibited transaction (under Section 503(b)).
- (3) For purposes of paragraph (1) above, if a private foundation acquired stock under the terms of a trust that was irrevocable on May 26, 1969, or under the terms of a will executed by that date, which is in effect on that date and at all times thereafter, the foundation will be considered as owning the stock on that date.
- (4) A distribution which otherwise qualifies under Section 302 as a distribution in part or full payment in exchange for stock is not treated as essentially equivalent to a dividend because it does not meet the requirements above. See Treas. Reg. 53.4940-1(d)(3).

C.4. Deductions from Gross Investment Income

- (1) In determining net investment income, a private foundation may deduct from its gross investment income all the ordinary and necessary expenses paid or

incurred for the production or collection of gross investment income or for the management, conservation, or maintenance of property held for the production of such income. This includes the following:

- a. That portion of a private foundation's operating expenses which is paid or incurred for the production or collection of gross investment income.
- b. Taxes paid or incurred under Section 4940 aren't paid or incurred for the production of gross investment income. In *Lettie Pate Whitehead Foundation, Inc. v. U.S.*, 606 F.2d 534 (5th Cir. 1979), a foundation which was a charitable remainder beneficiary of a trust was denied a deduction for the trustee's termination fee because it was a liability of the trust, not the foundation.

(2) Operating expenses include:

- a. Compensation of officers,
- b. Other salaries and wages of employees, and
- c. Outside professional fees, interest, and rent and taxes upon property used in the operations of the foundation.

Note: "Deduction Modifications" are set forth under a separate heading below.

(3) Where a private foundation's officers or employees engage in activities on behalf of the foundation both for investment and exempt purposes, compensation and salaries paid to such officers and employees must be allocated between the investment and exempt activities.

- a. In *Julia R. & Estelle L. Foundation Inc. v. Commissioner*, 598 F.2d 755 (2d Cir. 1979), the Court of Appeals for the Second Circuit held that a foundation wasn't entitled to deduct its entire administrative expenses without allocating between its investment activities and its distribution activities.
- b. Expenses which are considered in computing the tax imposed under Section 511 aren't deductible for purposes of computing the tax imposed by Section 4940.

(4) Where only a portion of property is used to produce income subject to the excise tax imposed by Section 4940, and the remainder is used for exempt purposes, the deductions must be apportioned between the exempt and nonexempt purposes.

(5) Any amounts paid or incurred for purposes other than the production or collection of gross investment income or the management, conservation, or maintenance of property held to produce such income, aren't allowable as a deduction under Section 4940. Thus, the deductions under the following Code sections aren't allowable:

- a. The charitable deduction provided by Sections 170 and 642(c);
- b. The net operating loss deduction provided by Section 172; and

- c. The special deductions provided by Part VIII, subchapter B, Chapter 1 of the Code (special deductions for corporations). See Treas. Reg. 53.4940-1(e)(1)(iii).
- (6) A private foundation can't deduct or otherwise consider interest it paid on a loan in computing gross investment income where the loan was in turn loaned interest-free to another Section 501(c)(3) organization for the latter's exempt purposes. See Rev. Rul. 74-579, 1974-2 C.B. 383.

C.5. Deduction Modifications

- (1) The following are modifications of the deductions otherwise allowable with respect to gross investment income:
- a. The depreciation deduction is allowed, but only based on the straight-line method provided in Section 167(b)(1). Use of the accelerated cost recovery system of Section 168 isn't permitted.
 - b. The depletion deduction is allowed but is determined without regard to Section 613, relating to percentage depletion.
 - c. The basis for purposes of the deduction allowed for depreciation or depletion is the basis as determined under the normal basis rules of part II of subchapter O of Chapter 1, subject to the provisions of Section 4940(c)(3)(B) and without regard to Section 4940(c)(4)(B) or Section 362(c). Thus, a private foundation must reduce the cost or other substituted or transferred basis by an amount equal to the straight-line depreciation or cost depletion, without regard to whether the foundation deducted such depreciation or depletion during the period prior to its first taxable year beginning after December 31, 1969. However, where a private foundation has previously taken depreciation or depletion deductions in excess of the amount which would have been taken had the straight line or cost method been employed, such excess depreciation or depletion is also taken into account to reduce basis. The excess wasn't taken into consideration when a private foundation used the percentage depletion method to record depletion on its books and records but took no deduction for depletion because it paid no income tax. See Rev. Rul. 79-200, 1979-1 C.B.364. If the facts necessary to determine the basis of property in the hands of the donor or last preceding owner by whom it was acquired by gift are unknown to a donee private foundation, then the original basis to such foundation of such property is determined under the rules of Treas. Reg. 1.1015-1(a)(3).
 - d. 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. For example, in a taxable year where rental income is incidentally realized from historic buildings held open to the public, deductions paid or incurred in such year for the production of such income are limited to the amount of rental

income from such buildings includible as gross investment income for such year. See Treas. Reg. 53.4940-1(e)(2). However, rental income and potential admission fees must be distinguished because income from potential admission fees doesn't constitute rents received for the use of a portion of a building. See *Historic House Museum Corp. v. Commissioner*, 70 T.C. 12 (1978).

D. Capital Gains and Losses

- (1) For purposes of Section 4940, in determining capital gain net income:
 - a. Any gain or loss from the sale or other disposition of property isn't taken into account to the extent that gain or loss is taken into account for purposes of computing the tax imposed by Section 511.
 - b. The basis for determining gain in the case of property held by the private foundation on December 31, 1969, and continuously thereafter to the date of its disposition is deemed to be not less than the fair market value of such property on December 31, 1969.
 - c. Losses from sales or other dispositions of property are allowed only to the extent of gains from such sales or other dispositions, and there are no capital loss carryovers or carrybacks.
 - d. Except to the extent provided by regulation, under rules similar to the rules of Section 1031 (including the exception under subsection (a)(2) thereof), no gain or loss shall be taken into account with respect to any portion of property used for a period of not less than 1 year for a purpose or function constituting the basis of the private foundation's exemption if the entire property is exchanged immediately following such period solely for property of like kind which is to be used primarily for a purpose or function constituting the basis for such foundation's exemption. See Section 4940(c)(4).

Note: The Treas. Regs. under Section 4940 have not been revised to reflect the changes made by PPA 2006.

D.1. Gifts of Investment Property

- (1) For taxable years beginning after December 31, 1972, property is treated as held for investment purposes even though such property is disposed of by the foundation immediately upon its receipt, if it is property of a type which generally produces interest, dividends, rents, royalties, or capital gains through appreciation. See Treas. Reg. 53.4940-1(f)(1).

Examples: Rental real estate, stock, bonds, mineral interests, mortgages, and securities.

- (2) Treas. Reg. 53.4940-1(f)(1) was held to be a permissible interpretation of the statute by the Tax Court in *Ruth E. and Ralph Friedman Foundation, Inc. v. Commissioner*, 71 T.C. 40 (1978) and the Federal Circuit in *Greenacre Foundation v. U.S.*, 762 F.2d 965 (Fed. Cir. 1985). The Tax Court also held that

Treas. Reg. 53.4940-1(f)(2)(i)(B), which provides that the basis of donated stock is the basis in the hands of the donors, is valid.

D.2. Exceptions

- (1) A distribution of property for purposes described in Sections 170(c)(1) or 170(c)(2)(B) which is a qualifying distribution under Section 4942 shall not be treated as a sale or other disposition of property.

Note: Treas. Reg. 53.4940-1(f)(1) has not been updated to reflect PPA 2006 and the Tax Technical Corrections Act of 2007, Public Law 110-172, which broadened capital gain net income to include capital gains from appreciation, including capital gains or losses from the sale or other disposition of assets used to further an exempt purpose.

E. Basis Rules

- (1) The basis to be used in determining gain from the sale or other disposition of property is the greater of:
 - a. Fair market value on December 31, 1969, plus or minus all adjustments after December 31, 1969, and before the date of disposition under the rules of Part II of subchapter O of Chapter 1 of the IRC, provided that the property was held by the foundation on December 31, 1969, and continuously thereafter to the date of disposition, or
 - b. Basis as determined under the rules of Part II of subchapter O of Chapter 1 of the IRC; however, the special modification rules on deductions for depreciation and depletion apply (see Section 4940(c)(3)(B)) and the zero-basis rule of Section 362(c) doesn't apply.
- (2) For purposes of determining loss, the basis is determined under Part II of subchapter O of Chapter 1 of the IRC subject to the special modification rules on deductions for depreciation and depletion (see Section 4940(c)(3)(B)) and without regard to the zero-basis rule of Section 362(c). See Treas. Reg. 53.4940-1(f)(2).
- (3) There is no provision for a step-up in basis when a public charity converts to a private foundation and becomes subject to the net investment income tax.

F. Treatment of Capital Losses

- (1) For purposes of computing net investment income, capital losses from the sale or other disposition of property may be subtracted from capital gains during the same taxable year but only to the extent of such gains. See Section 4940(c)(4)(C). If capital losses exceed capital gains in a taxable year:
 - a. The excess may not be deducted from gross investment income under Section 4940(c)(3) in any taxable year;
 - b. Nor may such excess be used to reduce gains in either prior or future taxable years, regardless of whether the foundation is a corporation or a trust. See

Treas. Reg. 53.4940-1(f)(3) and the examples in Treas. Reg. 53.4940-1(f)(4), illustrating the rules on capital gains and losses in computing net investment income.

F.1. Special Rules

- (1) The net capital gain on the sale of a listed common stock purchased before December 31, 1969, is the difference between the selling price and the greater of either the foundation's basis in the stock, or the mean average of the highest and lowest quotations on December 31, 1969, plus or minus subsequent adjustment to the date of sale. See Rev. Rul. 74-403, 1974-2 C.B. 381.
- (2) Appreciated stock held continuously until it was distributed to a private foundation in 1971, in satisfaction of a specific bequest and a percentage of the residuary estate of an individual who died in 1967, will be considered held by the foundation on December 31, 1969, and the basis of the stock for purposes of computing capital gain includible in net investment income will be the fair market value of the stock as of December 31, 1969, even though, in the case of the residuary bequest, the property that ultimately passed to the foundation hadn't been identified on that date. See Rev. Rul. 76-424, 1976-2 C.B. 367.

F.2. Examples

- (1) The regulations sets forth three examples of the sale or other disposition of property referred to in Section 4940(c)(4)(A) which results in a capital loss as described in Treas. Reg. 53.4940-1(f)(3).

Example: A private foundation holds certain depreciable real property on December 31, 1969, having a basis of \$102,000. The fair market value of such property on that date was \$100,000. For its taxable year 1970 the foundation was allowed depreciation for such property of \$5,100 on the straight-line method, the allowable amount computed on the \$102,000 basis. The property was sold on January 1, 1971, for \$100,000. Because fair market value on December 31, 1969, less straight line depreciation of \$5,100 (\$94,900) is less than basis as determined by Part II of Subchapter O of Chapter 1, \$96,900 (\$102,000 less \$5,100), a gain of \$3,100 is recognized (sales price of \$100,000 less the greater of the two possible bases). Treas. Reg. 53.4940-1(f)(4) Example 1.

Example: Assume the same facts in the example above, except that the sale price was \$95,000. Because the sale price was \$1,900 less than the basis for loss (\$96,900 as determined by the application of subparagraph (2)(ii) of this paragraph), there is a capital loss of \$1,900 which may be deducted against capital gains for 1971 (if any) in determining capital gain net income (for taxable years beginning after December 31, 1976). Treas. Reg. 53.4940-1(f)(4) Example 2.

Example: A private foundation holds certain depreciable real property on December 31, 1969, having a basis of \$102,000. The fair market value of such

property on that date was \$110,000. For its taxable year 1970 the foundation was allowed depreciation for such property of \$5,100 on the straight line method, the allowable amount computed on the \$102,000 basis. The property was sold on January 1, 1971, for \$100,000. Fair market value on December 31, 1969, less straight line depreciation of \$5,100 (\$104,900) exceeds basis as determined by Part II of Subchapter O of Chapter 1, \$96,900 (\$102,000 less \$5,100), and will be used for purposes of determining gain. Because basis for purposes of determining gain exceeds sale price, there is no gain. There is no loss because basis for purposes of determining loss (\$96,900) is less than sale price. See Treas. Reg. 53.4940-1(f)(4) Example 3.

IV. Examination Techniques

- (1) This section focuses on how to calculate and assert the excise tax under Section 4940. It also contains information relevant to examinations of private foundations in general.

A. Introduction

- (1) For Section 4940, PPA 2006 makes clear that for taxable years beginning after enactment, gross investment income includes income (other than unrelated business taxable income (UBTI)) from sources like:
- Interest,
 - Dividends,
 - Rents,
 - Payments with respect to securities loans (Section 512(a)(5)), and
 - Royalties (including overriding royalties).
- (2) The law also changes how capital gains and losses are treated so that all capital gains and losses (other than UBTI, if applicable) are included in capital gain net income, with a specific exception for like-kind exchanges of related use property. The law also:
- Prohibits including carrybacks or carryovers of capital losses in computing capital gain net income.
 - Redefines capital gain net income to include property used to produce gross investment income. (The Tax Technical Corrections Act of 2007 clarifies that capital gain net income also includes capital gains from appreciation. In determining capital gain net income, capital gain or loss is taken into account except to the extent such gain or loss is taken into account for purposes of the tax imposed by Section 511. See Section 4940(c)(4)(A)).
- (3) Calculate net investment income using a series of simple calculations. See the tables below for the basic formulas to compute the tax.

Term	Equation
Net investment income =	Gross investment income Plus capital gain net income Minus allowable deductions
Capital gain net income* =	Capital gains Minus capital losses**
* Capital losses can't exceed capital gains (no net capital losses.) ** Capital losses can't be carried forward or back.	

- (4) Complete the Form 990-PF, Part I to ensure that you include all the appropriate income and deductions.
- (5) Effective for taxable periods beginning after December 20, 2019 the tax rate is 1.39%. However, prior to December 20, 2019 there are several possible tax rates applicable under Section 4940:
 - a. 0%,
 - b. 1%, and
 - c. 2%.

- (6) To use a 0% tax rate, a foundation must be a private operating foundation under Section 4942(j)(3) that meets the requirements, for the tax year in question, of an exempt operating foundation under Section 4940(d).

Note: A foundation must obtain an IRS determination letter recognizing its status as an exempt operating foundation to be exempt from the Section 4940 excise tax. See Rev. Proc. 2024-5, 2024-1 I.R.B. 262 (updated annually).

- (7) To use a 1% reduced tax rate, a foundation must meet the requirements of Section 4940(e) requirements. Complete the Form 990-PF, Parts X, XI, XII, and V to determine eligibility for the reduced rate. This typically requires redoing the Form 990-PF for the prior five years.
- (8) If the amount on Part V Line 8 is less than that of Part V Line 7, due to reclassifying expenses or disqualifying distributions, the foundation is subject to the 2% rate.
- (9) The tax is reported on Form 990-PF. Any adjustments to the tax are made to the Form 990-PF. Use Forms 4621 and 4883 to propose any changes in the Section 4940 tax. Use Form 870-E to secure agreement.

Note: Form 870-E is used with respect to 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.

B. Chapter 42 First Tier Excise Taxes Table

- (1) The table below identifies the parties subject to the Chapter 42 excise taxes, (initial/first tier taxes generally applicable to private foundations under subchapter A), 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. 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 Sections 4941, 4943, and 4944, the taxable period doesn't end until the earliest of:

- a. 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),
- b. Assessment, or
- c. Issuance of a notice of deficiency.

Note: The notice of deficiency should reflect taxes owed for all years and partial years up to the date of 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).

(4) For Sections 4942 and 4945, the taxable period ends on the earliest of:

- a. Issuance of a notice of deficiency, or
- b. Assessment.

Note: The notice of deficiency should reflect taxes owed for all years and partial years up to the date of 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 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. 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, and each taxpayer must file a separate Form 4720. Accordingly, for tax years after 2019, an agent preparing the Form 4720 under substitute for return (SFR) procedures to report an individual's 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. Please see the Form 4720 instructions for further information. Please see the instructions for Form 4720 and Notice 2021-01, 2021-2 IRB 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. 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. 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).
- (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 impacts 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 impose 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 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 won't 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%. This 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 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 Code 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.

D. 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) 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. See Treas. Reg. 53.4940-1(e).

E. 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 (507(a)(1)) or involuntarily (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 (resulting in Section 507(c) tax) when there have been multiple willful repeated acts committed under Chapter 42. Also consider Section 507(a)(2) if there has been one willful flagrant act committed triggering Chapter 42 treatment. If proposing involuntary termination, revocation may be proposed at the same time.

Note: If a private foundation’s Section 501(c)(3) status is revoked but its private foundation status is not terminated under Section 507, then the foundation becomes a taxable private foundation; it is 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.	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))
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).

F. 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 (Waiver of Restrictions on Assessment and Collection of Deficiency and Acceptance of Overassessment) is used to 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.

G. 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	If individual: Year of Form 1040, U.S. Individual Income Tax Return, in which transaction occurs. All others: Year of Form 1041 (trust), 1065 (partnership), or 1120 (corporation) in which transaction falls. *
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
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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: 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.

- (6) When preparing the extensions, reference the specific Code 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).

- (7) 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.
- (8) If there are multiple acts in a single tax year that trigger Chapter 42 taxes, you may list them on the modified Form 872.
- (9) 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.
- (10) 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.

H. 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(b)(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, estimated tax, 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. The penalty, which is an assessable penalty (assessed in the same manner as taxes) is not imposed with respect to Section 4940 and 4948(a) taxes. See IRM 20.1.8, Employee Plans and Exempt Organizations Miscellaneous Civil Penalties.

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 aren't subject to those penalties. Imposition of the penalties under Sections 6662 and 6663 requires that the taxpayer file a return. If the taxpayer did not file a return, those penalties do not 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.

I. 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).

J. 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.

Note: Regarding the filing requirements for private foundations, for tax years beginning on or after July 2, 2019, Section 3101 of P.L. 116-25 (Taxpayer First Act of 2019) requires that returns by exempt organizations be filed electronically. See Section 6033(n). 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. Electronic filing requirements have not changed for Form 990-PF filers with tax years beginning before July 1, 2019 (which includes calendar year 2019 Forms 990-PF). Required electronic filing for calendar year filers will apply for tax years beginning in 2020 or later. In addition, private foundations must file Form 4720 electronically for returns due on or after July 15, 2021. A limited exception applies for 2020 Form 4720 returns due on or after July 15, 2021, that are submitted on paper and bear a postmark date on or before June 16, 2021.

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 Accurant 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:

Review Form 990-PF:	
Verify the Statute of Limitations	
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).
Analyze the first page, Letters A through J (in the top third of the page)	
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.
Review Parts VII-A and VII-B, Statements Regarding Activities	
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.
Review Part VIII, Information About Officers, Directors, Trustees, Foundation Managers, Highly Paid Employees, and Contractors	
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.)
Review XVII, Information Regarding Transfers to and Transactions and Relationships With Noncharitable Exempt Organizations	
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.
Review Part XV, Supplementary Information	

1	Identify any large, unusual, or questionable items.
2	Compare any entries to information from the determination application.
Review Part IV, Capital Gains and Losses for Tax on Investment Income	
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.
Review Part I, Analysis of Revenue and Expenses	
1	Verify the math. Note any errors.
2	Identify any large, unusual, or questionable items.
Review Part XVI-A, Analysis of Income-Producing Activities and Part XVI-B, Relationship of Activities to the Accomplishment of Exempt Purposes	
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.
Review Part II, Balance Sheets **	
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.	
Review Part III, Analysis of Changes in Net Assets or Fund Balances	
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.
Review Part IX, Summary of Direct Charitable Activities, Summary of Program-Related Investments	
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.
Review Part X, Minimum Investment Return	
1	Verify the math. Note any errors.
2	Note the existence of any acquisition indebtedness for IRC Section 514 purposes.
Review Part XI, Distributable Amount	
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.
Review Part XII, Qualifying Distributions	
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.
Review Part XIII, Undistributed Income	
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."
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)	
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.
Review Part VI, Excise Tax Based on Investment Income	
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 is not 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.)
Review Part XIV, Private Operating Foundations	
1	Verify the math.
2	Note which operating foundation status was claimed. (IRC Section 4942(j)(3) vs. IRC Section 4942(j)(5)). If IRC Section 4942(j)(5), compare the charitable activities to the Code and regulation requirements. See the 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.

K. 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 IRC 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 DP's 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 aren't charitable expenditures, remove the amounts in your revised Form 990-PF. Self-dealing transactions and taxable expenditures generally should be removed 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:
 - a. Engaged in any self-dealing transactions.
 - b. 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 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. 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.
- (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.

L. 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 that 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 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 into 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 doesn't 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 tips when examining a private foundation, particularly with respect to investment income subject to tax under Section 4940.

A. Issue Indicators

- (1) Investment income reported on the filed Form 990-PF, and there are no Section 4940 excise taxes reported.
- (2) If the foundation allocated 100% of its expenses on Part I of the filed Form 990-PF against the investment income.
- (3) Look to see if the Form 990-PF indicates investment type income or “other income” just in column a, and not show it in column b of Part I. Also, on Part II, the foundation indicates significant investment type assets, such as savings, and no investment income reported on Part I.
- (4) Foundation status discrepancy based on internal records and filed Form 990-PF. An organization may incorrectly claim to be a private operating foundation to avoid paying the applicable excise tax.

B. Examination Tips

- (1) Request and review the foundation’s Determination File from the EO Records Unit. If available, the determination file could include the original application for exemption, any correspondence between the IRS and the foundation during the review, and the determination letter issued to the foundation. The determination letter will indicate the organization’s tax-exempt and foundation status.
- (2) Review IDRS prints INOLES and BMFOLO to verify the organization’s information. The prints include, among other things, the organization’s filing requirements, fiscal year end, exemption subsection, foundation status code, and determination ruling date. Review the information against the filed Form 990-PF for any discrepancies regarding foundation status—operating vs. non-operating foundation—to further investigate.
- (3) Review the Form 990-PF because an exempt operating foundation must attach a copy of its favorable determination letter to its initial return after securing the status. The organization should complete Part VI by checking the box and entering the date of the ruling or determination letter on line 1a and entering “N/A” on line 1. The rest of Part VI should be blank. If the organization retains this status, it’s not required to attach a copy of the letter to subsequent returns. See Form 990-PF Instructions for more details.
- (4) Review Statements Regarding Activities, and Private Operating Foundations, of Form 990-PF to confirm the applicant meets the requirements of private operating foundation status.

- (5) Tour the organization's facility. Perform an initial interview with someone that is knowledgeable of the organization's exempt (and non-exempt) activities.
- (6) As necessary, calculate public support under Section 170(b)(1)(A)(vi) and/or Section 509(a)(2).
- (7) Review the foundation's governing body and inquire about disqualified individuals and persons. Review Form 990-PF Instructions, Information About Officers, Directors, Trustees, Foundation managers, Highly Paid Employees and Contractors.
- (8) If a private foundation isn't an operating foundation, consider whether it has distributed sufficient amounts in qualifying distributions. If not, seek to impose the Section 4942 excise tax for failure to distribute income.

VI. Example Worksheets / Exhibits

- (1) This section provides worksheets as well as exhibits focusing on practical applications when asserting Section 4940 excise taxes.

A. Exhibit 1: Section 4940 Example (Using Prior Law 2% / 1% Rates)

- (1) During the examination of Private Foundation Alpha, Agent Williams review Part I of the Form 990-PF for the year under examination and the prior years. Agent Williams obtains the books and records for the five previous years.

Note: The amounts reported on Part V of the return under examination come from the prior years' Forms 990-PF. Because prior year amounts are reported on the return for the year under examination, agents may request books and records from those years to verify the reported amounts.

- (2) On Form 990-PF, the taxpayer paid a Section 4940 tax of \$13,192, claiming to be entitled to the Section 4940(e) 1% tax rate. The net investment income reported on Part I Line 27(b) was \$1,319,200. Private Foundation Alpha reported the following amounts for 2011-12 on Form 990-PF Part V.

Base Period Years	Adjusted Qualifying Distributions	Net Value of Noncharitable Use Assets	Distribution Ratio
2010	\$207,577	\$22,902,232	0.009063614
2009	\$1,708,660	\$30,524,083	0.055977439
2008	\$1,586,932	\$20,563,743	0.077171359
2007	\$1,854,083	\$20,386,458	0.090946794
2006	\$840,244	\$39,168,308	0.021452139
The sum of the distribution ratios			0.254611346
Average distribution ratio for the 5-year base period			0.050922269
The net value of non-charitable use assets for 2011			\$24,303,581
The average distribution ratio multiplied by the assets net value			\$1,237,593
1% of net investment income			\$13,192
The sum of the two above amounts			\$1,250,786
Qualifying distributions from Part XII			\$1,261,332

- (3) In reviewing the records, Agent Williams finds that in lieu of taking the average of 12 end-of-month balances for each year as required by Section 4940(e)(5), Section 4942(e)(2) and Treas. Reg. 53.4942(a)-2(c)(ii), the foundation used the January and December ending values divided by two to arrive at the net value of non-charitable use assets each year. Agent Williams compiles the following table of ending balances (cash and securities combined).

Month	2011	2010	2009	2008	2007	2006
Jan.	\$31,467,378	\$22,909,633	\$7,790,548	\$24,772,425	\$22,498,813	\$2,600,472
Feb.	\$36,106,867	\$38,109,497	\$7,812,389	\$28,594,378	\$21,152,025	\$20,145,814
Mar.	\$47,136,598	\$26,182,305	\$10,788,337	\$28,817,860	\$16,681,252	\$2,370,000
Apr.	\$32,926,971	\$29,863,039	\$19,031,437	\$21,156,140	\$20,279,695	\$25,270,619
May	\$31,875,373	\$27,058,917	\$33,118,231	\$39,092,678	\$39,887,291	\$26,965,403
Jun.	\$31,583,880	\$38,884,273	\$39,294,219	\$36,296,967	\$30,376,780	\$27,435,181
Jul.	\$30,528,076	\$36,832,683	\$53,680,220	\$10,716,462	\$29,931,354	\$29,136,744
Aug.	\$21,076,814	\$36,796,071	\$29,049,515	\$14,748,143	\$27,100,917	\$44,368,653
Sept.	\$19,892,556	\$42,501,813	\$57,976,763	\$15,576,231	\$19,211,371	\$50,075,854
Oct.	\$16,916,854	\$44,633,691	\$48,008,689	\$14,969,542	\$31,419,935	\$61,041,198
Nov.	\$16,298,983	\$19,057,261	\$33,245,104	\$14,814,622	\$23,810,364	\$74,151,584
Dec.	\$17,139,784	\$22,894,831	\$53,257,618	\$16,355,061	\$18,274,103	\$75,736,144
12 Month Avg.	\$27,745,845	\$32,143,668	\$32,754,423	\$22,159,209	\$25,051,992	\$36,608,139

(4) Using the 12-month averages, Agent Williams revises Part V. The schedule now reads:

Base Period Years	Adjusted Qualifying Distributions	Net Value of Noncharitable Use Assets	Distribution Ratio
2010	\$207,577	\$32,143,668	0.006457788
2009	\$1,708,660	\$32,754,423	0.052165779
2008	\$1,586,932	\$22,159,209	0.071615011
2007	\$1,854,083	\$25,051,992	0.074009405
2006	\$840,244	\$36,608,139	0.022952382
The sum of the distribution ratios			0.227200367
Average distribution ratio for the 5-year base period			0.045440073
The net value of non-charitable use assets for 2011			\$27,745,845
The average distribution ratio multiplied by the assets net value			\$1,260,773
1% of net investment income			\$13,192
The sum of the two above amounts			\$1,273,965
Qualifying distributions from Part XII			\$1,261,332

- (5) For PF Alpha to qualify for the 1% Section 4940 rate, the last line in the table (Qualifying distributions from Part XII) must be equal to or greater than the second to last line. As the foundation failed the computational test, Agent Williams prepares Forms 4883 and 4621 to assert the additional \$13,192 in tax.

Exempt Organizations Excise Tax Audit Changes

(Chapter 41, Chapter 42, and Section 170(f)(10)(F) Excise Taxes)

Name of Taxpayer Private Foundation Alpha	Employer ID No. [Insert EIN]	Schedule or Exhibit 1
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Name of Exempt Organization (*if different from Taxpayer*)

		Taxable Years Ended		
		12/31/2011		
Internal Revenue Code Section for Proposed Adjustment		4940(a)		
1. Adjustments	Tax rate change 1% to 2% - failed to qualify for reduced rate			
2.	Total Adjustments	0.00		
3.	Amount reported on return or as Previously adjusted	1,319,200.00		
4.	Total amount as corrected	1,319,200.00		
5.	Applicable tax rate %	2%		
6.	Initial tax liability as corrected (line 4 x Line 5)	26,384.00		
7.	Initial tax liability reported	13,192.00		
8.	Increase (or decrease) in tax	13,192.00		
9.	Additional tax (minimum)			
10.	Penalties (Code section)			

Explanation of Adjustments
See attached Explanation of Items

Exempt Organizations – Report of Examination

(Proposed Tax Changes)

1. Form No. 4720	2. Area Office [Insert name of your area]	3. Date of Report [Insert date]
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4. Name and Address of Taxpayer Private Foundation Alpha [Insert street address] [Insert city, state, and zip code]	5. Name and Address of Private Foundation or Other Exempt Organization (If different from Item 4)
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6. Social Security Number or Employer Identification Number [Insert EIN]	7. Tax Period(s) Ended		8. Private Foundation's or other Exempt Organization's Employer Identification Number (If different from Item 6)	9. Tax Period(s) Ended	
	12/31/2011				

10. Reporter Preparer's Name [Insert your name]	11. Agreement Secured (Check one.) Yes <input type="checkbox"/> No <input type="checkbox"/>
--	--

12. Findings Discussed with (Name and Title) [Insert name of a foundation manager or representative]	13. Agreement Date [Leave blank]
---	-------------------------------------

14a. Summary of Proposed Adjustments				14b. Penalty	
Internal Revenue Code Section (1)	Period Covered by Examination (2)	Amount of Tax (3)	Additional Tax (4)	Internal Revenue Code Section (1)	Amount (2)
4940(a)	12/31/2011	13,192.00			

15. Remarks See attached Explanation of Items
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16. Attachments

B. Exhibit 2: Section 4940 Example Using 1.39% Rate

- (1) During your examination of Private Foundation Alpha, Agent Williams reviews Part I of the Form 990-PF for the December 31, 2020 tax year under examination. The net investment income reported on Part I Line 27(b) was \$900,000, resulting in the taxpayer paying \$12,510 ($\$900,000 \times 1.39\%$) excise tax on the net investment income.
- (2) A review of the taxpayer's financial records yielded the disallowance of claimed investment expenses based on using an improper depreciation method—only the straight-line method of depreciation is allowed (Section 4940(c)(3)(b)(i)). Upon recalculating the depreciation using the straight-line method, a \$500,000 deduction was disallowed and resulted in the taxpayer's adjusted net investment income of \$1,400,000.
- (3) The taxpayer's adjusted net investment income excise tax on \$1,400,000 is \$19,460 ($\$1,400,000 \times 1.39\%$). Since the taxpayer had paid \$12,510, the amount outstanding based on the adjustment is \$6,950 ($\$19,460 - \$12,510$).
- (4) Based on the change in net investment income, Agent Williams prepares Forms 4883 and 4621 to assert the additional \$6,950 in tax.

Exempt Organizations Excise Tax Audit Changes

(Chapter 41, Chapter 42, and Section 170(f)(10)(F) Excise Taxes)

Name of Taxpayer Private Foundation Alpha	Employer ID No. [Insert EIN]	Schedule or Exhibit 1
--	---------------------------------	--------------------------

Name of Exempt Organization (if different from Taxpayer)

		Taxable Years Ended		
		12/31/2020		
Internal Revenue Code Section for Proposed Adjustment		4940(a)		
1. Adjustments	Disallowance of Depreciation Deduction	500,000.00		
2.	Total Adjustments	500,000.00		
3.	Amount reported on return or as Previously adjusted	900,000.00		
4.	Total amount as corrected	1,400,000.00		
5.	Applicable tax rate %	1.39%		
6.	Initial tax liability as corrected (line 4 x Line 5)*	19,460.00		
7.	Initial tax liability reported	(12,510.00)		
8.	Increase (or decrease) in tax	6,950.00		
9.	Additional tax (minimum)	0		
10.	Penalties (Code section)			

Explanation of Adjustments
See attached Explanation of Items

Form 4883 (Rev. 1-2004)

Catalog Number 42083F

Department of the Treasury
Internal Revenue Service
www.irs.gov

Exempt Organizations – Report of Examination

(Proposed Tax Changes)

1. Form No. 4720	2. Area Office [Insert name of your area]	3. Date of Report [Insert date]
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4. Name and Address of Taxpayer Private Foundation Alpha [Insert street address] [Insert city, state, and zip code]	5. Name and Address of Private Foundation or Other Exempt Organization (If different from Item 4)
--	---

6. Social Security Number or Employer Identification Number [Insert EIN]	7. Tax Period(s) Ended		8. Private Foundation's or other Exempt Organization's Employer Identification Number (If different from Item 6)	9. Tax Period(s) Ended	
	12/31/2020				

10. Reporter Preparer's Name [Insert your name]	11. Agreement Secured (Check one.) Yes <input type="checkbox"/> No <input type="checkbox"/>
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12. Findings Discussed with (Name and Title) [Insert name of a foundation manager or representative]	13. Agreement Date [Leave blank]
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14a. Summary of Proposed Adjustments				14b. Penalty	
Internal Revenue Code Section (1)	Period Covered by Examination (2)	Amount of Tax (3)	Additional Tax (4)	Internal Revenue Code Section (1)	Amount (2)
4940(a)	12/31/2020	6,950.00			

15. Remarks See attached Explanation of Items
--

16. Attachments

C. Statute Extension Example

- (1) This example can be used when extending the statute of limitations for assessing excise tax under Section 4940 and/or income tax against a private foundation.

[Insert Name of Taxpayer]

[Insert Continuation of Name, If Necessary]

(Name(s))

taxpayer(s) of [Insert Street Address, P.O. Box, or APO/FPO]

[Insert City, State, Zip Code, (and foreign country, if applicable)]

(Address)

and the Commissioner of Internal Revenue consent and agree to the following:

(1) The amount of any Federal _____ [Excise (Section 4940 and/or income)] _____

(Kind of tax)

tax due on any return(s) made by or for the above taxpayer(s) for the period(s) ended

[Insert Tax Year(s)]

may be assessed at any time on or before _____ [Insert Expiration Date] _____.

(Expiration date)

of the Internal Revenue Code suspends the running of the period of limitations to assess such tax, then, when, under the Internal Revenue Code, the running of the period resumes, the extended period to assess will include the number of days remaining in the extended period immediately before the suspension began.

(2) The taxpayer(s) may file a claim for credit or refund and the Service may credit or refund the tax within 6 months after this agreement ends, except with respect to the items in paragraph (4).

(3) Paragraph (4) applies only to any taxpayer who holds an interest, **either directly or indirectly**, in any partnership subject to subchapter C of chapter 63 of the Internal Revenue Code, as in effect for partnership taxable years beginning before January 1, 2018.

(4) Without otherwise limiting the applicability of this agreement, this agreement also extends the period of limitations for assessing any tax (including penalties, additions to tax and interest) attributable to any partnership items (see section 6231 (a)(3)), affected items (see section 6231(a)(5)), computational adjustments (see section 6231(a)(6)), and partnership items converted to nonpartnership items (see section 6231(b)). Additionally, this agreement extends the period of limitations for assessing any tax (including penalties, additions to tax, and interest) relating to any amounts carried over from the taxable year specified in paragraph (1) to any other taxable year(s). This agreement extends the period for filing a petition for adjustment under section 6228(b) but only if a timely request for administrative adjustment is filed under section 6227. For partnership items which have converted to nonpartnership items, this agreement extends the period for filing a suit for refund or credit under section 6532, but only if a timely claim for refund is filed for such items.

(5) This Form contains the entire terms of the Consent to Extend the Time to Assess Tax. There are no representations, promises, or agreements between the parties except those found or referenced on this Form.

Your Rights as a Taxpayer

You have the right to refuse to extend the period of limitations or limit this extension to a mutually agreed-upon issue(s) or mutually agreed-upon period of time. **Publication 1035, Extending the Tax Assessment Period**, provides a more detailed explanation of your rights and the consequences of the choices you may make. If you have not already received a Publication 1035, the publication can be obtained, free of charge, from the IRS official who requested that you sign this consent or from the IRS' web site at www.irs.gov or by calling toll free at 1-800-TAX-FORM (1-800-829-3676). Signing this consent will not deprive you of any appeal rights to which you would otherwise be entitled.

(Space for signature is on the back of this form and signature instructions are attached)

D. Section 4940 Excise Taxes on Net Investment Income Lead Sheet

Taxpayer Name:

Examiner:

TIN:

Date:

Tax Form:

Tax Year:

IRC 4940 Excise Tax on Net Investment Income Lead Sheet				
Tax Period	Per Return	Per Exam	Adjustment	Reference
Conclusion: (Reflects the final determination on the issue.)				
<i>The following techniques are not intended to be all-inclusive nor are they mandatory steps to be followed. Judgment should be used in selecting the techniques that apply to each taxpayer.</i>				
Audit Steps: (Document audit steps taken or to be taken.)				Workpaper Reference
1. Determine if the organization is a domestic taxable, exempt, or exempt operating private foundation. Section 4940 does not apply to an exempt operating foundation defined in IRC 4940(d). See IRC 4948(a) regarding foreign foundations				
2. Identify income producing investments (non-charitable use) assets.				
3. Calculate the net value of these assets.				
4. Calculate the gross investment income.				
5. Calculate net capital gains and losses on investment property.				
6. Identify qualifying distributions; IRC 4940(e) and 4942(c).				
7. Calculate net investment income.				
8. Calculate the investment excise tax on exempt foundations, IRC 4940(a), or calculate the investment excise tax taxable foundations, IRC 4940(b).				
9. For taxable years before December 20, 2019, determine if the IRC 4940(e) reduced rate (1%) requirements are met.				
10. Determine if IRC 4942, <i>Taxes on Failure to Distribute Income</i> , are applicable if an excise tax is assessed.				
11. Determine if a six-year statute applies; IRC 6501(e)(3)				
Facts: (Document the relevant facts.)				
Law: (Tax Law, Regulations, court cases, and other authorities.)				
IRC Section: 509, 4940, 4942, 4948, 6501(e)(3), 53.4940-1				

Taxpayer Name:

Examiner:

TIN:

Date:

Tax Form:

Tax Year:

Specific citations:

Taxpayer Position: (If applicable)